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*Personal income tax reform:  
consensus, outliers, specifics and the  
longer-term socio-economic context*

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**PERSONAL INCOME TAX REFORM: CONSENSUS, OUTLIERS, SPECIFICS AND THE  
LONGER-TERM SOCIO-ECONOMIC CONTEXT**

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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 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 offsets, the introduction of withholding taxes and much greater use of technological solutions. The final part of the paper considers the main longer-term socio-economic factors that need to be considered before undertaking significant PIT reform, including the effects of globalisation, the ageing population, inter-generational distribution, industry composition and workplace reform. The author concludes by emphasising the key issues and challenges facing this complex Australian PIT reform debate.*

NOTE

*This paper cites relevant published data in specific year dollars; data is not expressed on a common year price basis. Also, this paper generally minimises the use of previously published material by other researchers at this Symposium in order to avoid possible repetition, unless critical to a particular argument.*

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## I INTRODUCTION

Australia last undertook major tax reform in 2000 that included the introduction of its Goods and Services Tax (GST)<sup>1</sup>, although some may consider changes to the taxation of superannuation since then as significant reform<sup>2</sup>. 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% of voters considered tax policy as very important<sup>3</sup>. The millions of unorganised PIT payers may be contrasted with the powerful lobby groups of business eg Business Council of Australia, Australia Chamber of Commerce and Industry, the professions eg Australian Medical Association, agriculture eg National Farmers' Federation, and social and welfare eg 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. This author takes the view that, without the support of the powerful business lobby groups, PIT reform has little chance of success. Even with the strongest business support, it remains a difficult challenge because of the nature of the Australian democratic process.

This author has strongly argued earlier that the Australian PIT system is an outdated relic of the post-war period up until the 1980s<sup>4</sup>. 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'<sup>5</sup>. 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<sup>6</sup>. Most OECD countries have higher income thresholds than Australia and lower rates for many taxpayers<sup>7</sup>, although international comparisons are always 'fraught with difficulty' and need to be treated cautiously. There is undoubtedly a strong consensus recognising and favouring PIT reform, as the Symposium in Sydney in April 2007 demonstrates. The key question is 'how?'

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<sup>1</sup> ANTS (1998): *Tax Reform: Not A New Tax, A New Tax System*, White Paper (Canberra: Commonwealth of Australia); Pope, J. and Fernandez, P. (2001), 'Current Tax Reform in Australia: An Ambitious Programme', *British Tax Review*, 2, 135-151.

<sup>2</sup> 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. (2003), *The Hidden Costs of the Superannuation Surcharge Tax*, Australian Tax Research Foundation, Sydney, 1-97, at 89.

<sup>3</sup> Davidson, S. (2004) 'Who Pays the Lion's Share of Personal Income Tax?', CIS Policy Monograph 63 (St Leonards: The Centre for Independent Studies and at [www.cis.org.au](http://www.cis.org.au)), at 3.

<sup>4</sup> Pope, J. (2005), 'Reform of the Personal Income Tax System in Australia', *Economic Papers* 24 (4), 316-331; Pope, J. (2006), 'The Political Economy of Personal Income Tax Reform in Australia', Paper presented at The Economic Society of Australia 35<sup>th</sup> 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](http://www.cbs.curtin.edu.au/cbs/ace2006)).

<sup>5</sup> Business Coalition for Tax Reform (BCTR) (2006), *Personal Income Tax Reform: Public Discussion Paper*, BCTR, Melbourne, at 1.

<sup>6</sup> Sandford, C. (2000) *Why Tax Systems Differ* (Bath: Fiscal Publications) at 51-52 and 158-160.

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

The main purpose of this paper is thus to identify and succinctly evaluate the key proposals and arguments put forward to date. To begin with, a criteria in terms of PIT revenue (expressed in dollars and as a percentage) to establish the magnitude and importance of PIT reform is proposed, building upon earlier work by Pope<sup>8</sup>. Whilst others may disagree with the specific definitions, this should be an important starting-point of any PIT reform discussion, without which terms such as 'major', 'significant' remain subjective and the realm of the politicians and so-called 'spin doctors'. 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. Strictly speaking, economists would wish to see all year on year comparisons expressed in real terms.

Further, this paper places an emphasis on identifying and citing the costs of proposals, without which they merely become 'wish lists'. Indeed, the absence of adequate costing - of critical importance to Treasury and decision-makers - is a weakness of some PIT reform proposals, particularly the earlier ones. Proposals are broadly categorised into those on which there is some consensus or reasonably common agreement, and those that, whilst strongly advocated by one author or a small group of authors, are in a minority (outliers). The section on 'specifics' then discusses the detail of some of the main proposals, focusing in particular on tax rates and simplification of the current PIT system.

Many of the arguments in favour of PIT reform are already based, or likely to be based, upon Australia's longer-term economic aspirations, future demographics and socio-economic characteristics, as well as the effects of globalisation. The main issues are succinctly reviewed as an important part of this paper's analysis. The paper concludes by emphasising the major challenges facing the Australian PIT reform debate from this author's perspective.

For the record this paper recognises the important distributional issues involved in PIT reform but leaves that debate aside for further work. Arguably, the Australian democratic process and the critical role of the media in any tax reform debate overly-dominate the economic efficiency and longer-term arguments favouring PIT reform<sup>9</sup>, a point not discussed further.

## II DEFINING TAX REFORM AND THE MAGNITUDE OF PIT 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'<sup>10</sup>, or 'improve'. The other is to 'form again'<sup>11</sup>, or to 'restructure', to 'change'. 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

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<sup>8</sup> Pope (2005 and 2006), supra note 4.

<sup>9</sup> The media debate prior to the introduction of the GST provides a good example.

<sup>10</sup> The Concise Oxford Dictionary (1990), Clarendon Press, Oxford.

<sup>11</sup> Ibid..

work of the eminent late Professor Cedric Sandford<sup>12</sup>. 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<sup>13</sup>, although this view 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.'

In the specific context of Australian PIT reform and current discussion, what is meant by the term 'reform'? Further, when various authors and commentators use words such as 'major', 'significant' and possibly 'fundamental', what exactly is meant and how does one usage relate to another? Pope<sup>14</sup> has proposed definitions that are now modified somewhat mainly because of the passage of time and ensuing PIT revenue increases. What is important here is not that these definitions are accepted, but that the principle of needing robust definitions, in terms of PIT revenue and as a percentage of PIT revenue<sup>15</sup>, is an essential pre-requisite and part of any reform debate.

Slightly amending the earlier definitions<sup>16</sup> in terms of percentage of net tax revenue<sup>17</sup>, rounding to a convenient number and citing the latest published ATO statistics for the year 2003-04<sup>18</sup>, gives three definitions as follows:

- 1 minor, or 'tinkering and tokenism': costing less than five per cent of net (annual) tax revenue (less than \$5 billion in 2003-04)<sup>19</sup>
- 2 moderate: costing between five and up to 20 per cent (\$5 billion and \$19 billion in 2003-04)
- 3 significant: costing 20 per cent or more (more than \$19 billion in 2003-04)

Thus by having clear definitions any PIT reform proposal may be viewed against a common yardstick.

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<sup>12</sup> Sandford (2000), *supra* note 6, at 157. Discussion here of the term 'tax reform' is based on Sandford's commentary, and acknowledged with thanks.

<sup>13</sup> The introduction of the GST in Singapore in the 1990s followed this principle; refer Pope, J. and E. H. Poh (2001) 'Compensating for the Goods and Services Tax: The Contrasting Policy Approaches of Singapore and Australia', *Economic Papers*, 18 (2) at 1-9; and Poh, E. H., Pope, J. and Hasseldine, J. (2003), 'The Political Economy of Compensating for the Distributional Effects of Value-Added Taxes: The Recent Cases of Singapore and Australia', *New Zealand Journal of Taxation Law and Policy*, 9 (3) at 267-286.

<sup>14</sup> *Supra* note 4.

<sup>15</sup> The criterion or measure 'as a percentage of GDP' should also be used. This is considered of relatively minor importance in the overall context of this paper.

<sup>16</sup> The initial classifications and definitions were proposed in Pope (2005, at 322-3), *supra* note 4, based on 2001-02 ATO data.

<sup>17</sup> To allow for bracket creep and roughly the same real effect of reform irrespective of tax year data.

<sup>18</sup> Data for 2003-04 (Taxation Statistics, 2003-04, Australian Taxation Office (ATO), Canberra, 2006, at 10) shows that \$96 billion was paid in net tax.

<sup>19</sup> In terms of the original analysis the figure would be 6 per cent (\$6 billion in 2003-04 figures).

### III THE RECENT CONSENSUS FOR PIT REFORM

The consensus for meaningful PIT reform 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 and detail. 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'<sup>20</sup>. 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<sup>21</sup>.

*Table 1*

*The Consensus for PIT Reform, 2004 to date*

<i>Author/Year</i>	<i>30% Top Rate</i>	<i>Approximate Gross Cost of Package \$ billion</i>	<i>Comments</i>
Walker (2004) <sup>22</sup>	Yes	Not stated. Emphasises Laffer effect**	IMF supports 30% top rate
Saunders and Maley (2004) <sup>23</sup>	Flat-rate (unspecified; 40% top rate initially)	PIT 16.3 (plus 12 other)	Phased. Overall funding shortfall of \$15 billion
Warren (2004b) <sup>24*</sup>	40% 'most realistic'	Na	Justification for PIT reform in media
CPA Australia (2004) <sup>25</sup>	Yes	Option costs outlined	Phased. 18 scales modelled: rates of 16/29/42 preferred in short-term

<sup>20</sup> Walker, G. (2004), 'The Tax Wilderness: How to Restore the Rule of Law', CIS Policy Monograph 60 (St Leonards: The Centre for Independent Studies, at [www.cis.org.au](http://www.cis.org.au)), at 10, and International Monetary Fund (IMF) (2002) Staff Report for the 2002 Article IV Consultation (Washington D.C.: IMF), at 15, respectively.

<sup>21</sup> The West Australian, 14 February 2007, 'Tax cuts key to growth in jobs, says OECD' at 4, citing the latest OECD report at [www.oecd.org](http://www.oecd.org) (available on a fee basis).

<sup>22</sup> Walker (2004), *supra* note 20.

<sup>23</sup> Saunders, P. and Maley, B. (2004), 'Tax Reform to Make Work Pay', CIS Policy Monograph 62 (St Leonards: The Centre for Independent Studies, [www.cis.org.au](http://www.cis.org.au)).

<sup>24</sup> Warren, N. (2004b), 'Slash taxes from the top', The Australian, 21 October.

<sup>25</sup> CPA Australia (2004) Reforming Australia's Personal Tax System – A Model for the Future, Discussion Paper, March (Melbourne: CPA Australia).

ACCI (2004) <sup>26</sup>	Yes	PIT 10 (plus 4 other)	Phased. 6 PIT options considered
Deutsch (2004) <sup>27*</sup>	Yes	Not costed	'Real, robust and fundamental simplification' needed
Business Council of Australia (2005) <sup>28</sup>	Yes; 40% top rate by 2007-08; 30% 'eventually'	5.1 in 2007-08 (40% rate)	'Crucial to economic and business success ...'
Pope (2005; updated 2006) <sup>29</sup>	Yes	22 (approx.)	Revenue neutral; funding by PIT simplification and GST rate increase (to 15%), with compensation package <sup>a</sup>
Humphries (2005) <sup>30</sup>	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) <sup>31</sup>	Yes; eventually, but initially around 40%	10	Increase CGT to 30%; emphasises efficiency and simplicity
BCTR (2006) <sup>32</sup>	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 <sup>b</sup>

<sup>26</sup> Australian Chamber of Commerce and Industry (ACCI) (2004) Taxation Reform Blueprint: A Strategy for the Australian Tax System 2004-2014, [www.acci.asn.au](http://www.acci.asn.au) (18.11.04).

<sup>27</sup> Deutsch, B. (2004) 'Focus on Tax Simplification', *Tax Matters*, 3, 6 (Sydney: ATAX).

<sup>28</sup> Business Council of Australia (2005), 'Taxation Action Plan for Future Prosperity', April, Melbourne, [www.bci.com.au](http://www.bci.com.au).

<sup>29</sup> *Supra* note 4.

<sup>30</sup> Humphries, J. (2005), 'Reform 30/30: Rebuilding Australia's Tax and Welfare Systems', CIS Policy Monograph 70 (St Leonards: The Centre for Independent Studies, [www.cis.org.au](http://www.cis.org.au)).

<sup>31</sup> Freebairn, J. (2005) 'Income Tax Reform: Base Broadening to Fund Lower Tax Rates', mimeo, 1-14, and in Dawkins, P. and Stuthbury (Ed.) (2005), *Sustaining Prosperity*, Melbourne University Press.

<sup>32</sup> Business Coalition for Tax Reform (BCTR) (2006), *Personal Income Tax Reform: Public Discussion Paper*, Melbourne.

Ernst and Young (2006) <sup>33</sup>	2007-08: One top rate of 40% <sup>c</sup>	Not costed	Focus on taxation of investment reform including PIT
Australian Industry Group (2005; updated 2006* and 2007*) <sup>34</sup>	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.

a For welfare recipients, the elderly and retired, and other low-income persons (cost excluded from \$22 billion gross estimate).

b A phase-in of rate equalisation from 22% to 20% 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.

c For 2006-07 the two top rates should be 45% and 40% (reduced from 47% and 42% respectively), a proposal that the Government has since adopted.

Qualifying Table Notes:

1 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.

2 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<sup>35</sup>, the balance is evenly divided in the initial or short-term, with six supporters apiece for a top rate of 30 per cent or less. It may well be that the former are more radical or idealistic, whilst the latter are more pragmatic and realistic in terms of the political and democratic 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

<sup>33</sup> Ernst and Young (2006), *Taxation of Investment in Australia: The need for ongoing reform*.

<sup>34</sup> Australian Industry Group (AIG) (2005), *Building Incentive: An Ai Group proposal to reduce the tax burden* (December); AIG (2006), cited in the *Australian Financial Review* (2006), "Rates too high, say business", 27 February, at 4; AIG (2007), 'Pre-Budget Submission: Ambitions for Australia', Press Release, 1-3, all at [www.aigroup.asn.au](http://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.

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

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 2003-04 personal taxpayers claimed \$22.9 billion in total deductions, including \$11.1 billion in work-related expenses (WREs), and tax offsets and credits worth \$11.6 billion were paid to 7.5 million (or 68 per cent) of the 11 million personal taxpayers lodging returns<sup>36</sup>. However, when it comes to specific details it remains difficult to identify any particular consensus. These issues are considered later in the section on Specifics.

#### 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'<sup>37</sup>. 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<sup>38</sup>. The extent to which any particular proposal differs *greatly* from the mainstream remains, as always, a matter of personal judgment. Others are welcome to agree or disagree, and to add or subtract from the list. 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 PAYG (Pay-As-You-Go) and non-PAYG income, especially regarding the use of trusts
- Negative gearing on housing should be abolished

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<sup>36</sup> Taxation Statistics, 2003-04, *supra* note 18, at 10.

<sup>37</sup> The Concise Oxford Dictionary (1990), Clarendon Press, Oxford.

<sup>38</sup> 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.

- 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 Centrelink<sup>39</sup>
- 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*<sup>40</sup>

### 1 *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<sup>41</sup>. If the 1978-79 tax-free threshold had been raised in line with inflation ie in real terms, it would have been \$13,549 in July 2003 and not \$6,000 ie 126 per cent higher<sup>42</sup>. In 2007-08 it is likely to be well over \$15,000.

Three academic reports<sup>43</sup> and only part of one business report (the major option of the BCTR) support such a proposal. The main arguments<sup>44</sup>, summarised here, include: lower compliance costs of PIT; lower ATO administrative costs; (at least) restoration of the real tax-free threshold rate to its 1978-79 level; greater incentive to work for some casual or part-time workers, including students, house-persons and welfare recipients. Another and more recent argument in support of a significantly higher tax-free threshold are lower real wages for some low-income workers in certain occupations eg in retail, hospitality and child care, arising from Government industrial relations reform in 2005 and 2006. 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<sup>45</sup>. 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'. Disentangling welfare payments from PIT is a very complex yet potentially economically fruitful area in terms of productivity and

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<sup>39</sup> They would have to be re-named, presumably!

<sup>40</sup> Covick, O. (2004), 'Put Not Your Trust(s) in Tax Reform: Rather Do the Opposite', *Economic Papers*, 23, 3, 257-270, especially at 268-9. Whether this was 'tongue-in-cheek' is for the reader to decide! This interesting proposal is not considered further.

<sup>41</sup> Pope (2005), *supra* note 4, at 316-331.

<sup>42</sup> In the UK for 2003-04 the tax-free threshold was 4,615 pounds ([www.inlandrevenue.gov.uk/rates](http://www.inlandrevenue.gov.uk/rates)), or A\$11,538 at a typical exchange rate of one pound = 2.5 Australian dollars. Note that the UK figure for 30 June 2001 given by Warren (2004a, *supra* note 7, at 121) has omitted the tax-free threshold or zero rate. For further comparison, in countries where tax-free thresholds exist, the rates converted to A\$ as at 30 June 2001 were: France A\$6,759; Canada (Federal) A\$9,647; Singapore A\$8,117 (selected examples only; Warren, 2004a, 121-122).

<sup>43</sup> Walker (2004); Saunders and Maley (2004); and Pope (2005), *supra* notes 20, 23 and 4 respectively.

<sup>44</sup> Pope (2005) *supra* note 4.

<sup>45</sup> Walker (2004, at 13) and Saunders and Maley (2004, at 6-12), *supra* notes 20 and 23 respectively.

efficiency, yet there seems to be a strong political preference for intertwining rather than separating them.

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. This author considers that appropriate anti-avoidance legislation can overcome such concerns or difficulties, but recognises that 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.'<sup>46</sup> This point is often ignored by researchers and particularly by politicians and in the media.

## 2 *An Increased Low Income Tax Offset*

In 2005 the AIG proposed an increase in the Low Income Tax Offset (LITO) from the (then) \$235 to \$435, representing an increase in the effective tax free threshold for a single person from \$7,567 to \$8,900<sup>47</sup>. The BCTR has also proposed increasing this to \$375 but only in its modest option; in the moderate and major options it is abolished<sup>48</sup>. Increasing the LITO seems in line with current Government policy.

## 3 *The Elimination of the Current \$6,000 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)<sup>49</sup>.

## 4 *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. Trusts<sup>50</sup> and partnerships pay no tax, but are entities that distribute income to other entities ie individuals and companies, to which

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<sup>46</sup> Sandford (2000), *supra* note 6, at 52. See the worked example at 52-53.

<sup>47</sup> AIG (2005), *supra* note 34, at 2.

<sup>48</sup> BCTR (2006), *supra* note 32, at 39, 42 and 49 respectively.

<sup>49</sup> *Ibid.*.

<sup>50</sup> 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), *supra* note 40, at 259-263.

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<sup>51</sup>.

Pope has argued very strongly on this point, particularly citing the work of Covick<sup>52</sup> in support, yet this aspect of the PIT reform debate has largely been ignored by others. Although Pope's earlier work did not emphasise previous Government policy regarding trusts, Pope implied that rate alignment (or equalisation) at 30 per cent would alleviate this inequity to a large extent rather 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 ago<sup>53</sup> and is currently most unlikely to garner any new support. In short, the economic incentive to avoid a PIT rate of 30 per cent would be considerably less than that of 45 per cent.

The key arguments and data regarding the role of trusts include:

- Use of trusts for business and investment income and ensuing tax avoidance is inequitable (both vertically and particularly horizontally)
- Average business income of trusts is relatively very low, at \$401,206<sup>54</sup>
- 58 per cent of trusts have a loss or nil business income, compared with 13 per cent for companies<sup>55</sup>
- A further 39 per cent ('micro trusts') have business income of up to \$2 million<sup>56</sup>
- Only 3 per cent have business income of \$2 million pa or greater
- Net tax compliance costs of small trusts (ie after tax deductions) were roughly double that of other business entities in 1994-95<sup>57</sup> (\$55.34 per \$1,000 of turnover compared with an average of \$26.96<sup>58</sup>)
- Taxpayers that are part of the PAYG system (or 'nation'<sup>59</sup>) have lower tax compliance costs on average than taxpayers using trusts (the 'other nation')

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<sup>51</sup> 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), supra note 40; Sandford (2000), supra note 6, at 54-61; Head, J. G and R. Krever (1996) (Ed) *Tax Units and The Tax Rate Scale* (Sydney: Australian Tax Research Foundation); Dwyer, T. (2004) 'The Taxation of Shared Family Incomes', CIS Policy Monograph 61 (St Leonards: The Centre for Independent Studies, www.cis.org.au).

<sup>52</sup> 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. This analysis clearly shows why PIT reform is long overdue. See also Pope (2005 and 2006), supra note 4.

<sup>53</sup> The Government's proposed entity tax reform, first mooted in 1998 (under ANTS, 1998, supra note 1, and at the time of the major 'push' for the GST) and developed under Ralph (Ralph Report, 1999, *Review of Business Taxation: A Tax System Re-Designed*, Final Report, Canberra: Commonwealth of Australia), 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, supra note 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.

<sup>54</sup> 2003-04 figures, derived from Taxation Statistics, 2003-04, supra note 18, at 88.

<sup>55</sup> *Ibid.*, at 88 and 55 respectively.

<sup>56</sup> *Ibid.*, at 88.

<sup>57</sup> Australian Taxation Office (ATO) (1997), *Taxpayer Costs of Compliance* (Canberra: Commonwealth of Australia), at 80.

<sup>58</sup> Sole traders were lowest at \$21.10, followed by partnerships (\$24.81), superannuation funds (\$27.51) and companies (\$28.56). The report explains these relatively high compliance costs in terms of: the nature of the personnel (internal and external, and 'primarily more expensive lawyers') and trusts relatively low turnover (that increases the ratio of compliance costs to turnover). Both of these reasons support the proposition of trusts being a vehicle for tax avoidance, particularly by relatively small business entities.

<sup>59</sup> As far as this author is aware, the term 'two nations' was first referred to in Covick (2004), supra note 40, explained at 257-259. This provides an apt description of the situation.

The composition of the 12.9 million entities submitting returns (in rounded figures) in 2003-04<sup>60</sup> was:

- 11 million personal taxpayers (85.4%, from 85.3% in 2001-02)
- 684,000 companies (5.3%, unchanged)
- 502,000 trusts (3.9%, 3.8%, an increase of 10% in two years)
- 447,000 partnerships (3.5%, 3.8%)
- 248,000 superannuation and life insurance funds (1.9%, 1.7%)

The role and economic importance of around half a million trusts in the PIT system, including their higher compliance costs, has thus been shown by this 'snapshot'. 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.

##### 5 *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 under longer-term socio-economic factors.

##### 6 *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<sup>61</sup>. Freebairn has estimated savings of around \$2.5 billion pa<sup>62</sup>. Several other papers have recognised the issue. Essentially the arguments for its abolition are two-fold: it is an unnecessary complication on the PIT return whose compliance costs can be avoided; more importantly, economic distortions to aggregate savings and investment occur<sup>63</sup>. 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.

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<sup>60</sup> Taxation Statistics, 2003-04 and 2001-02, both at 7, respectively.

<sup>61</sup> Supra notes 4 and 31 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.

<sup>62</sup> Freebairn (2005), supra note 31, at 4.

<sup>63</sup> Ibid., at 6.

## 7 *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<sup>64</sup>. 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 theory<sup>65</sup> largely for reasons of efficiency, goes against current thinking by many politicians and governments, an aspect not considered further here.

## 8 *Fringe Benefits Tax Simplification or Abolition*

The BCTR<sup>66</sup> in its major reform scenario essentially proposed the abolition Fringe Benefits Tax (FBT), with provisions to ensure no misuse of company deductions (with a new test of 'personal benefit'). Other researchers generally have tended not to be drawn into the ramifications of PIT reform on other taxes such as FBT and Capital Gains Tax (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<sup>67</sup>.

## 9 *Increase the Rate of the Goods and Services Tax as an Offset to Loss of PIT Revenue from Significant Reform*

Pope<sup>68</sup> considered that, *realistically*, the most that could be saved by the removal of PIT concessions and deductions, including work-related expenses (WREs), was around \$5 billion, based on 2004-05 PIT figures. Pope therefore advocated a GST rate increase from 10 per cent to 15 per cent, with the proviso of a compensation package to transfer payment recipients<sup>69</sup>, would generate at least \$17 billion in extra revenue in 2004-05 figures. These two sources thus effectively funded Pope's PIT reform proposal of rate alignment at 30% 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, a 'growth dividend' in tax revenues (effectively the Laffer effect in economic terms) and diaspora effect (return of ex-pats) 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.

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<sup>64</sup> BCTR (2006), *supra* note 5, at 47-59.

<sup>65</sup> 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.

<sup>66</sup> BCTR (2006), *supra* note 5, at 47-59.

<sup>67</sup> Australian Financial Review, 'Push for higher GST to share the load', 4 April 2006 at 6.

<sup>68</sup> Pope (2005), *supra* note 4, at 328.

<sup>69</sup> *Ibid.*, at 329, and also the elderly, similar to that in July 2000 when the GST was first introduced.

For the record, Pope noted that currently all net GST revenue flows through to the States and Territories. There would be undoubted but not insurmountable difficulties in increasing the GST rate<sup>70</sup> 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<sup>71</sup>. This issue is recognised but not pursued further here.

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<sup>72</sup>, to date Pope has been the only main researcher to link PIT reform with a 'tax mix' change<sup>73</sup>. 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 ie 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, based on this author's analysis<sup>74</sup>, is simply insufficient for significant PIT reform, as defined by Pope.

#### *10 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 not pursued here as they 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 generally would like to see it abolished! Wealth and inheritance taxes, used in some European countries, can also be noted.

#### *11 Abolition or Reform of Trusts*

Briefly, ACOSS has proposed the 'cutting of trusts'<sup>75</sup>. Covick and Pope have emphasised their role and benefits in the tax system, but neither called for their abolition, preferring indirect measures.

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<sup>70</sup> This proposition was contested by one prominent economist during discussion of Pope's paper at a 2006 economics conference, supra note 4.

<sup>71</sup> Supra note 40, at 269.

<sup>72</sup> 2001 figure; Pope (2005) at 320.

<sup>73</sup> Australian Financial Review (2006), supra note 67, 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.

<sup>74</sup> See Pope (2005), supra note 4, at 327-329.

<sup>75</sup> Australian Financial Review (2006), supra note 67.

## 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. In this author's view the main objectives should be:

- A clear distinction and different definitions in ATO statistics between a person who pays tax and a person who must submit a tax return<sup>76</sup>
- Eliminate or reduce to an absolute minimum the number of persons who must submit a tax return who do not eventually pay any tax ie effectively take persons out of the tax system
- Automate submission of as many annual tax returns as possible, particularly those whose tax affairs are straightforward
- Reduce tax administration and compliance costs
- Reduce the percentage of Australians using tax agents
- Improve compliance and hence revenue
- Improve economic incentives covering a wide range of work, family, welfare, investment, inter-generational, ageing population and migration issues<sup>77</sup>

In support of these objectives the following PIT data is pertinent<sup>78</sup>.

1. Data for 2003-04 showed that: 11.0 million personal taxpayers lodged returns; personal taxpayers had total income of \$414 billion, taxable income of \$395 billion and paid \$96 billion in net tax<sup>79</sup>.
2. In 2003-04 personal taxpayers claimed \$22.9 billion in total deductions, including \$11.1 billion in work-related expenses (WREs), and tax offsets and credits worth \$11.6 billion were paid to 7.5 million (or 68 per cent) of the 11 million personal taxpayers lodging returns<sup>80</sup>.
3. Overall, the average PIT rate is 23 per cent<sup>81</sup>, a surprisingly relatively low figure given the highest marginal rate of 47% at the time.
4. Around 75 per cent of Australian taxpayers use a tax agent, one of the highest figures in the world<sup>82</sup>, and such fees are tax-deductible, costing \$1.1 billion in 2003-04<sup>83</sup>.
5. The better-off contribute a relatively high, and arguably an unduly high, proportion of PIT. The bottom 37 per cent of taxpayers<sup>84</sup> account for only 3 per cent of tax revenue;

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<sup>76</sup> It is worth emphasising that the ATO publication Taxation Statistics uses the term 'taxpayer' to mean different things in different tables, and care should be exercised when using this data source.

<sup>77</sup> The major issues are discussed in the next section.

<sup>78</sup> Where possible, amended and updated from Pope (2005), *supra* note 4, at 319-320.

<sup>79</sup> Taxation Statistics, 2003-04, *supra* note 18, at 10.

<sup>80</sup> *Ibid.*

<sup>81</sup> Pope (2005), *supra* note 4, at 319. It would be interesting to investigate how many PIT taxpayers would accept a simple, no deduction and no offset flat rate of 23 per cent!

<sup>82</sup> Highfield, R. (2006), 'Pre-populated Income Tax Returns: The Next "Big Thing" in Reform of the Administration of Australia's Personal Income Tax System?', Paper presented at the 7<sup>th</sup> International Tax Administration Conference, Sydney, April 2006, Paper 24, 1-30, at 12.

<sup>83</sup> Taxation Statistics, 2003-04, *supra* note 18, at 14.

<sup>84</sup> A taxpayer is defined as someone who submits a PIT return, thus including 1.9 million taxpayers (18 per cent) who paid zero PIT out of a total of 10.3 million PIT payers in 2001-02.

the middle 45 per cent of taxpayers account for 38 per cent of tax revenue; the top 18 per cent of taxpayers account for 59 per cent of tax revenue<sup>85</sup>. In 2003-04 around 2.2 million personal taxpayers who lodged returns did not pay any tax<sup>86</sup>!

6. As discussed 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<sup>87</sup>.
7. 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<sup>88</sup>. That 55 per cent of 'top rate' tax-payers use tax avoidance is one of the most compelling reasons in favour of PIT reform.
8. The (net) tax compliance costs of PIT are relatively high - around two-thirds higher than those of the UK<sup>89</sup> - 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<sup>90</sup>. Low income earners account for 31 per cent of these costs, a surprisingly high figure.
9. ATO administrative costs of the PIT system are estimated at around \$1.2 billion in 2005-06<sup>91</sup>.
10. Operating costs of the PIT system are estimated at around \$5-5.5 billion, or 4.1 per cent of PIT revenue in 2005-06<sup>92</sup>.

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, legal and political. From this author's perspective and analysis to date, 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 2003-04 nearly 7 million taxpayers claimed \$11.1 billion in WREs, representing 48 per cent of total personal taxpayer deductions of \$22.9 billion<sup>93</sup>. 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 5.2 million taxpayers, then clothing (uniform) with 4.7 million taxpayers (presumably mainly lower income taxpayers), motor vehicle with 2.2 million (presumably

<sup>85</sup> Estimated from Taxation Statistics, 2001-02, Table 3.1, at 16 and Table 3.10, at 24.

<sup>86</sup> Taxation Statistics, 2003-04, at 10 and 22 (Table 3.9).

<sup>87</sup> Warren (2004a), supra note 7, at 106.

<sup>88</sup> CPA Australia (2004), supra note 25, 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.

<sup>89</sup> 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) (ATO, 1997, supra note 57, 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.

<sup>90</sup> ATO (1997), supra note 57, at 26-28. This major study has yet to be updated, largely, one suspects, because of political reasons.

<sup>91</sup> Highfield (2006), supra note 82, at 15.

<sup>92</sup> Ibid., at 16.

<sup>93</sup> Taxation Statistics, 2003-04, supra note 18, at 14 (Table 3.2).

mainly middle and higher income taxpayers), with 'other travel' (0.6 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<sup>94</sup>.

Overall, higher income taxpayers are likely to claim more in WREs, although recent ATO data on this aspect is limited. However, top rate taxpayers (with \$60,001 or more taxable income pa in 2001-02) accounted for 24 per cent of *all deductions* (totalling \$19.7 billion) claimed<sup>95</sup>. 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 4.7 million taxpayers claim an average of \$227 for uniforms. 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 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<sup>96</sup> estimated savings of \$4.7 billion pa from abolishing WREs alone. 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<sup>97</sup>.

### C *Abolition of the Cost of Managing Tax Affairs*

In 2003-04 around 5 million personal taxpayers claimed around \$1.1 billion in deductions. 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 (value of time not tax deductible) as against equity between personal income taxpayers who use an agent and those who have a

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<sup>94</sup> The total number of taxpayers making a claim in each category, namely 13.2 million taxpayers, divided by the overall number of taxpayers making a WRE claim of 7 million, gives a figure of 1.9. The overall average WRE claim per taxpayer is \$1,609.

<sup>95</sup> Taxation Statistics, 2001-02 at 15.

<sup>96</sup> CPA Australia (2004), *supra* note 25, at 56.

<sup>97</sup> Baldry, J. (1998), 'Income Tax Deductions for Work-related Expenses: The Rationale Examined', Australian Economic Papers 37 (1), 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.

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. 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 2003-04 7.5 million taxpayers claimed \$11.6 billion in total. The most important in monetary terms were total franking credits (53 per cent), termination payments (14 per cent) and Senior Australians tax offset (9 per cent). In numerical terms the low income offset applied to 3.5 million PIT payers, followed by total franking credits claimed by 3.4 million.

Line-by-line analysis of other deductions and offsets is complex and beyond the scope of this paper. However, a few pertinent comments should be made. This author generally supports the proposal by the BCTR<sup>98</sup> to abolish the major PIT expenditures/deductions including WREs, passive income losses eg negative gearing of housing rentals<sup>99</sup>, medical expenses, geographical zone, income averaging for authors etc, entrepreneurs offset, non-superannuation termination benefits, private health insurance rebate. 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 return.

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<sup>100</sup>. Ideally, there should be a standard high tax-free threshold for all taxpayers irrespective of age, work or family circumstances.

As noted earlier, 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. As a 'second-best' position, and given possible

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<sup>98</sup> BCTR (2006), supra note 32.

<sup>99</sup> Pope does not support the abolition of negative gearing at the present time, an issue discussed further in the next section.

<sup>100</sup> In 2003-04 senior Australians had a tax-free threshold of \$20,500 for singles and \$16,806 for couples.

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.

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

The annual refund system for many PIT payers accounts 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 6.8 million PIT payers earning more than \$21,600 who actually paid tax in 2003-04<sup>101</sup>, 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 3.5 million, or roughly a third of the current level of 11 million. This view is supported by the BCTR who, under their major option, advocate a maximum number of 3.3 million PIT returns<sup>102</sup>.

F *Automated Returns and Tax Management Software*

There are two main possibilities in this area, closely related to the point above.

First, the method of pre-populated returns has been identified<sup>103</sup>, 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<sup>104</sup>. 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

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<sup>101</sup> Such taxpayers account for 97 per cent of all tax paid. Taxation Statistics, 2003-04, supra note 18, at 22 (Table 3.9).

<sup>102</sup> BCTR (2006), supra note 32, at 51.

<sup>103</sup> Highfield (2006), supra note 82. It is a tax office administrative arrangement originating in the Nordic countries, with claimed 'substantial benefits' overall. This issue is not discussed further here.

<sup>104</sup> 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. (2004), 'The Turbo Tax Revolution: Can Technology Solve Tax Complexity', in Aaron, H. and Slemrod, J. (Ed.) (2004), *The Crisis in Tax Administration*, Brookings Institution Press, Washington DC, 124-147, at 125.

technological solution to tax complexity rather than the latter<sup>105</sup>. 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'<sup>106</sup>. These approaches and issues are worthy of further consideration in an Australian context.

## VI The Longer-Term Socio-Economic Context<sup>107</sup>

Personal income tax reform needs to be seen in an overall socio-economic context, from both an Australian and international perspective. Simply put, the world in which we live has changed rapidly over the last twenty or so years yet the Australian PIT system did not: it is a 1980s relic totally ill-suited to the economic realities of the 21<sup>st</sup> Century.

Socio-economic factors relevant to PIT reform discussion may be considered under two main heads: external and internal. The main external factors are:

- Tax competition<sup>108</sup>
- Globalisation
- International movement of professional/skilled workers and Australian diaspora

The main internal factors are:

- Demographics, ageing population and household composition
- Inter-generational distribution
- Superannuation
- Work incentives and labour productivity
- Workplace agreements and real wages
- Composition of the economy
- Rental housing market and negative gearing
- Effects upon the tax and financial planning industry

### A *Globalisation*

The measurement of globalisation is complex, but most empirical studies focus on international trade and financial flows. One balanced perspective is that '...the global political economy of the early twenty-first century is best understood as a partially, but highly unevenly globalised world in which the political role of the state continues to be

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<sup>105</sup> *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.

<sup>106</sup> *Ibid.*, at 138.

<sup>107</sup> This section is an overview of major factors and issues. The relationship of each issue to PIT reform requires in-depth research; each topic could warrant a paper in its own right.

<sup>108</sup> The critical issue in the context of this paper is the increasing international mobility of labour and the effect of taxation. This is discussed briefly in the sub-section on Australian diaspora.

important.<sup>109</sup> Foreign Direct Investment (FDI) is another measure of globalisation. Over the period 1982 to 2000 FDI increased by 22 times in real terms, from US\$57 billion to US\$1,271 billion. By 2000 the USA, European Union and Japan accounted for 71 per cent of FDI inflows and 92 per cent of FDI outflows. The main driving force is cross border mergers and acquisitions, accounting for around 90 per cent of FDI<sup>110</sup>.

Another approach to globalisation is the country ranking of the most globalised countries based on economic, personal (contact), technological and political criteria. This approach emphasises a wider understanding of globalisation and the different ways it is occurring, with some countries performing better on economic factors and others on political factors<sup>111</sup>. Based on 2004 data, Singapore is assessed as the most globalised economy. Australia moved up four places to eighth place, mainly due to high commodity prices, strong services and greater foreign investment<sup>112</sup>.

The key effect in terms of PIT reform is that the economic 'factors of production' of capital and labour are increasingly internationally mobile. Net financial returns are emphasised, and much less consideration given to such traditional concepts as the 'public good', the value of social capital, the 'social wage' and so on. Greater factor mobility, personal and business travel, together with the international media, mean that individual concepts of 'equity', where they exist, may be seen now more in international terms (cross-sectionally, across countries) than merely vertically, within one country.

The PIT system in many OECD countries has done nothing to prevent the increasing growth of income and wealth in the hands of the richest 1 per cent over the last 20 years<sup>113</sup>. Research shows that the richest 1 per cent of Australians increased their share of all personal income from 5 per cent in 1980 to 9 per cent in 2000, and roughly back to its 1921 level of 10 per cent. Similar patterns exist in other Anglo-Saxon countries<sup>114</sup>. Other percentile groups in the remaining 99 per cent of income earners had much more moderate, if any, increases in their share of personal income.

The reasons for such a dramatic change in the top 1 per cent of personal income require much further research, especially regarding the effect of reductions in taxation over the period. For example, the top rate of Australian PIT fell from 69 per cent in 1970, to 60 per cent in 1980 and 47 per cent since 1990 (up until 2006, when it became 45 per cent). Whilst

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<sup>109</sup> Hout, W. (2004), 'A global economy, polycentric world or system of nation-states?' in O'Hara, P. (Ed.) (2004), *Global Political Economy and the Wealth of Nations*, Routledge, London, 19-38 at 36. Changes to globalisation are gradual rather than sudden. On average world trade grew at 0.44 per cent pa between 1960 and 1999, based on World Bank data (at 22-23). The trade in derivatives eg futures, foreign exchange, equity and commodities options, grew from around 4 per cent of world GDP in 1986 to 47 per cent (\$14,000 billion) in 1998 – 'probably the clearest sign of financial globalisation in the current era' (Ibid. at 24-25). However, financial globalisation, like trade globalisation, is very uneven, being focused on North America (over 50 per cent), Europe (nearly one-third) and Asia-Pacific countries (over 15 per cent).

<sup>110</sup> Burton, M. and Nesiba, R. (2004), 'Transnational financial institutions, global financial flows and the International Monetary Fund', in O'Hara, P. (2004), *ibid.*, 147-169, at 157-8. Figures in constant 2000 prices, based on UNCTAD data.

<sup>111</sup> France is a good example of this, with high involvement in treaties and international organisations, but poor on the economic side because of its high tariffs and agricultural subsidies.

<sup>112</sup> A. T. Kearney/Foreign Policy Globalization Index, at [www.atkearney.com](http://www.atkearney.com). Interestingly, Japan is ranked 28<sup>th</sup>. Switzerland, USA and Ireland are ranked 2<sup>nd</sup> to 4<sup>th</sup> respectively.

<sup>113</sup> In 14 out of 18 OECD the very rich had pulled ahead. See 'Inequality rampant as winners take all', *Sydney Morning Herald*, 15 February, 2007 at [www.smh.com.au](http://www.smh.com.au), citing recent research by Sir Anthony Atkinson, Nuffield College, Oxford.

<sup>114</sup> Canada, New Zealand, UK and USA. See Atkinson, A. and Leigh, A. (2007), 'The changing fortunes of top income earners over the 20<sup>th</sup> Century', Australian National University, 1-4, at 3, at <http://info.anu.edu.au>.

Atkinson and Leigh consider changes to marginal tax rates to be 'particularly important' because of the incentive effective, others, particularly in the USA, speculate that globalisation factors, including the internationalisation of the market for chief/senior executives and performance-related share option schemes, are primarily responsible<sup>115</sup>.

Growing overall inequality in various countries throughout the world between the 1970s and 1990s is shown by other authoritative economic data. Over this period Australian inequality increased by around 9 per cent, New Zealand's by 29 per cent, the UK's by 23 per cent and the USA's by 18 per cent<sup>116</sup>.

Such data should therefore lead the Australian PIT reform debate into fundamentals, such as whether growing income inequality is a 'good or bad thing', and a range of issues such as the extent that performance, incentive-driven top personal income is a driver of economic growth and the extent that the richest 1 per cent may avoid any (perceived) 'penal' rate<sup>117</sup>. More specifically, it focuses on the top PIT rate and its threshold level, and the extent to which consideration of the top 1 per cent should affect the PIT system affecting the remaining 99 per cent. This author remains dubious that any realistic top PIT rate would have any significant effect vis-a-vis the strength of the major economic drivers of growing income inequality in the years ahead; other types of taxes are likely to afford relatively better options.

#### B *International Movement of Professional/Skilled Workers and Australian Diaspora*

Currently 0.9 million Australians are working overseas<sup>118</sup>. Of these a high percentage, typically around 75-80 per cent<sup>119</sup>, are professional and skilled workers, many of who would be motivated to move from Australia by higher net incomes, of which taxation is a part and PIT often a significant part. Data is hard to obtain. Around one-third of diaspora survey respondents considered the attraction of higher incomes and lower taxation as important factors in their decision to leave Australia<sup>120</sup>. The major destination countries in 2004-05 were Hong Kong, Singapore, UK, USA and New Zealand, accounting for around two-thirds of Australian-born emigrants<sup>121</sup>. Overall, these countries have lower PIT rates for the vast

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<sup>115</sup> *Ibid.*, at 3-4. For a US perspective see the interesting conjecture 'Why is the top one per cent earning more?' at [www.marginalrevolution.com](http://www.marginalrevolution.com).

<sup>116</sup> O'Hara, P. (2004), 'Wealth and welfare of nations, continents and corporations', in O'Hara, P. (Ed.) (2004), *Global Political Economy and the Wealth of Nations*, Routledge, London, 39-62, at 56. Percentage change estimates by Pope based on Gini coefficients (Table 2.10) adapted from OECD, United Nations and other sources. O'Hara states that these countries have enhanced their degree of globalisation over the period, accompanied by privatisation, financial deregulation, reduced capital controls and labour market liberalisation.

<sup>117</sup> This is subjective and relative, with varying historical rates.

<sup>118</sup> In 2001 the Department of Foreign Affairs and Trade estimated there were 860,000 Australian citizens living overseas on a long-term basis, plus 265,000 on a shorter term basis, as cited by Hugo, G. Rudd, D. and Harris, K. (2003), 'Australia's Diaspora: Its Size, Nature and Policy Implications', Committee for Economic Development of Australia (CEDA) Information Paper No. 80, Melbourne, 1-88, at 10. The overall figure represents around 5 per cent of Australia's population.

<sup>119</sup> Department of Immigration and Multicultural Affairs (DIMA), 'Population Flows: Immigration Aspects', 2004-05 edition, Canberra, cited in Business Council of Australia (BCA) (2006), 'Keeping a Permanent Watch on Australia's Tax System', BCA, Melbourne, at 16 (Table 1).

<sup>120</sup> Hugo, G. Rudd, D. and Harris, K. (2003), *supra* note 118, at 44. In the United Arab Emirates (UAE), a tax free country, taxation, salary and career reasons were found to be of equal importance (and very highly statistically significant) in explaining Australian diaspora reasons for living and working there. See Simpson, J. (2003), 'Socio-Economic Factors in Australian Diaspora: The Case of the United Arab Emirates', mimeo, 1-12, at 3 and 12.

<sup>121</sup> DIMA (2004-05), *supra* note 119.

majority of such migrating workers<sup>122</sup>. The loss of PIT revenue from the 'net exit' of skilled professionals in 2003-04 has been estimated at over \$1 billion pa<sup>123</sup>. The overall economic cost would be much higher if other taxation and particularly multiplier effects were taken into account.

Looking to the future, as a global employment characteristic, the international movement of workers, particularly professional and skilled, is likely to increase<sup>124</sup>. Policy recommendations arising from research into Australian diaspora include '...an examination of the taxation regime...' to ensure that there are not elements inhibiting expatriates from returning, and that 'Australia should develop a national diaspora/expatriate policy ...'<sup>125</sup>.

### C *Demographics, Ageing Population and Household Composition*

The Government is becomingly increasingly concerned with an ageing population and its impact upon a wide range of policy areas. Although it is 'not expected to have a major impact on the Commonwealth's budget for at least another 15 years, forward planning for these developments is important ...'<sup>126</sup>. Whilst the Government is concerned with achieving budget balance, one of its longer-term aims may be to encourage mature age participation in the labour force.

The Government notes that in monetary terms an ageing population would reduce PIT revenue, *ceteris paribus*, citing data that basically shows that average annual PIT reaches its highest at between 40 and 54 years of age, at around \$7,000 in 1998-99, falling to around \$1,000 at 70 years of age and older<sup>127</sup>. However, as a percentage of GDP tax revenue is relatively unchanged<sup>128</sup>.

The combined aged and child to working-age ratio, a critical component in population projections, is expected to be 'slightly higher' in 2042 than in 1972. However, historically the cost of caring for the aged is much more expensive for the Government than the cost of children, so it is the gradually rising aged to working-age ratio that is of much greater concern for the Government from a revenue-expenditure perspective<sup>129</sup>. Migration of course also affects population projections<sup>130</sup>.

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<sup>122</sup> For comparative international tax data see Warren (2004a, especially at 119-127) and Treasury (2006) International Comparison of Australian Taxes, *supra* note 7.

<sup>123</sup> BCTR (2006), *supra* note 5, at 26.

<sup>124</sup> Hugo, G. Rudd, D. and Harris, K. (2003), *supra* note 118, at 11. Most emigrants leave Australia for 'better employment opportunities'.

<sup>125</sup> *Ibid.*, at 15 and 14 respectively.

<sup>126</sup> Budget Paper No. 5 (2002-03), Intergenerational Report 2002-03, Treasury, Canberra (May 2002), at 1. An update (second report) is expected soon (Australian Financial Review, 'Howard and Rudd talk tough on economy', 28 February 2007 at 3).

<sup>127</sup> *Ibid.*, at 54 (Chart 28).

<sup>128</sup> '... because labour force and wages growth trends affect income tax and GDP growth more or less equally', *ibid.* at 55.

<sup>129</sup> *Ibid.* at 23-24 (Charts 13 and 14).

<sup>130</sup> The Government currently expects (longer-term) future net migration to be around 90,000 people pa, with the same age-gender profiles as at present, and favouring skilled migrants, *ibid.* at 21. The ability of immigration to alleviate the difficulties associated with an ageing population is economically complex and not considered further here.

The changing nature of household composition, with an increasingly higher percentage of one-person households and single-parent families, also needs to be taken into account in any PIT reform.

In a telling last sentence of its report, the Government concluded that 'Tax reform is also important in terms of providing a robust tax base that will grow in line with the economy'<sup>131</sup>.

#### D *Inter-Generational Distribution*

This factor is obviously related to the demographic issues discussed above. However, it is much more than those. It has a sharper economic focus in terms of two major aged-related factors 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, 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 marginal tax rates for many of those affected. In 2003-04 some 344,257 taxpayers had HECS assessment debt of \$655 million, an average of \$1,903 per taxpayer<sup>132</sup>. With recent fee increases this sum is likely to grow. The debt is repaid at rates of between 3.0 per cent and 6.0 per cent on a sliding scale above certain threshold income levels<sup>133</sup>, on top of the usual PIT rates. Thus, for 2006-07, the highest earning graduates with HECS debt would typically face a marginal PIT rate of 47.5 per cent<sup>134</sup>.

The affordability of property for the younger generation is also increasingly being recognised and becoming a political issue<sup>135</sup>.

#### E *Superannuation*<sup>136</sup>

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

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<sup>131</sup> Ibid., at 68. Previously it noted that it had already adopted relevant policies to ensure long-term economic growth, for example in the areas of the labour market, welfare and macroeconomic policy.

<sup>132</sup> Taxation Statistics, 2003-04, *supra* note 18, at 23 (Table 3.10). Student Financial Supplement Scheme debt of \$53 million in 2003-04 should also be noted.

<sup>133</sup> \$25,348 and \$45,629 respectively in income year 2003-04, Box 3.8, *ibid*.

<sup>134</sup> PIT rate of 40 per cent for taxable incomes between \$75,001 and \$150,000 pa plus the HECS repayment rate of 6 per cent. The Medicare levy of 1.5 per cent increases the effective marginal tax rate to 47.5 per cent. *Ibid.* at 23 (Box 3.8). 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.

<sup>135</sup> Not considered further here.

<sup>136</sup> See the in-depth analysis by Bateman, H. and Kingston, G. (2007), 'Superannuation and the personal income tax reform after the 2006 Budget', Personal Income Tax Reform Symposium, University of New South Wales, Sydney, 2-3 April.

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<sup>137</sup>. 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-generational issues identified above. The longer-term effects of this change are likely to be profound.

#### F *Work Incentives and Labour Productivity*

Whilst a rather basic view is that lower PIT rates would improve the incentive for paid work generally, including overtime work, economic research overall emphasises that '... labour supply and incomes rise mostly because of increased participation, not because those already in work decide to work more'<sup>138</sup>. Moreover, the supply of female labour is more responsive to lower PIT rates than males, essentially because many women are 'at the extensive margin' and deciding whether to participate in work or not.

In the 21<sup>st</sup> Century such sensitivities may apply equally to the elderly and retired irrespective of gender, depending upon government welfare, pension, superannuation and other policies. The effect of participation rates, particularly males over 55 years, has been recognised by the Australian Government. Participation rates in 2000-01 were 72 per cent for males and 55 per cent for females (83 per cent and 36 per cent respectively in 1960-61)<sup>139</sup>.

Productivity growth, and labour productivity in particular, is 'extremely difficult' to forecast into the future, but is expected to grow at its longer-term (30 year average rate) of 1.75 per cent pa<sup>140</sup>. Whilst significant PIT reform may have some medium- and longer-term impact on productivity, it is only one of many important factors<sup>141</sup>.

#### G *Workplace Agreements and Real Wages*

Australian (Commonwealth) Government workplace reform in recent years, particularly the use of Australian Workplace Agreements (AWAs) and the overall move towards individual bargaining rather than collective bargaining, is beginning to have an impact in the labour market, particularly downward movement in the real wages of some groups of workers. Australian Bureau of Statistics (ABS) data shows that real hourly earnings between 2002 and

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<sup>137</sup> Treasurer Press Release No. 131, 'Simplified Superannuation legislation introduced into Parliament', 7 December 2006, at 2.

<sup>138</sup> Committee for Economic Development of Australia (CEDA) (2006), 'Tax Cuts for Growth: The impact of marginal tax rates on Australia's labour supply', CEDA Information Paper No. 84, Melbourne, at 8. Note that this comment is based on largely US research in the 1970s and 1980s reviewed by Heckman, J. (1993), 'What has been learned about labour supply in the past twenty years?', *American Economic Review*, Papers and Proceedings, 83 (2) at 116-121.

<sup>139</sup> Budget Paper No. 5 (2002-03), Intergenerational Report 2002-03, Treasury, Canberra (May 2002), at 26-28.

<sup>140</sup> *Ibid.*, at 25-26.

<sup>141</sup> Discussion and citation of complex economic research on this topic is beyond the scope and length of this paper.

2004 fell by around 20 per cent for female non-managerial workers on AWAs overall<sup>142</sup>. The comparative figure for males was a negligible increase. Female workers in the clerical, retail and services industries suffered the largest fall at 22 per cent. The only male employment category to show a real fall was trades, down around 2 per cent. Thus 'women [in lower paid, non-managerial positions] are likely to be significantly disadvantaged in a system where primacy is given to individual bargaining.'<sup>143</sup> The so-called gender gap is therefore likely to widen in the years ahead, *ceteris paribus*.

The major implication of these labour market research findings for PIT reform is that attention must be paid to lower paid workers, particularly the elimination of PIT or its significant reduction, in order to mitigate any effects of falling real wages in the current environment. Household composition and overall household income also needs to be considered. Such arguments are additional to, but supportive of, the PIT-welfare nexus recognised earlier.

Although much of this paper has focussed on upper income earners and top marginal tax rates, this author considers PIT reform to benefit lower income taxpayers of equal importance.

## H *Composition of the Economy*

The composition of the economy in terms of industry<sup>144</sup> groups and changes over time needs to be understood and taken account of in any PIT reform. In short, for a number of decades, both in Australia and richer countries overseas, there is a relative decline in the economic importance of firstly agriculture and then manufacturing within the economy and a relative increase in that of service industries. The latter includes retail, leisure, tourism, travel, hospitality and the legal and financial service industries, and increasingly 'personal service' industries.

In 2000-01 services accounted for nearly half (48.4 per cent) of Australia's GDP, having increased its share from 31 per cent in 1900-01. By contrast, manufacturing contributed 11.9 per cent, roughly comparable to its share in 1900-01, but half its contribution of 22.4 per cent in 1950-51. The mining and construction industries (historically rather variable) contributed 5.6 per cent in 2000-01, and agriculture (the largest individual industry in 1900-01 and 1950-51) only 3.7 per cent<sup>145</sup>.

Such economic trends in Australia reflect overall international experience in the richer countries of the world, and are likely to continue for the foreseeable future. The increasing importance of services within an economy partially explain and justify the role and importance of the Value-Added Tax (VAT)/Goods and Services Tax (GST) in many

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<sup>142</sup> Estimated from Table 5A in Preston, A., Jefferson, T. and Guthrie, R. (2007), 'Australian Workplace Agreements and Gender Equity', Women in Social and Economic Research (WISER), Curtin University of Technology, mimeo, at 9.

<sup>143</sup> *Ibid.*, at 11. The authors note that, whilst earnings may have been traded off for other benefits eg annual leave, other research suggests that individual agreements are inferior to awards (at 11-12). They are also critical of research findings from the Office of the Employment Advocate (OEA) (at 4-6), particularly its use of definitions and data in reports that support the benefits of AWAs.

<sup>144</sup> A possible misnomer but traditionally used term.

<sup>145</sup> Australian Bureau of Statistics (ABS) (2005), '100 years of change in Australian industry', No. 1301.0, Year Book Australia 2005, 1-10, at 1-3, at [www.abs.gov.au](http://www.abs.gov.au).

economies, particularly in terms of revenue-raising in OECD countries, at an average rate of 18.5 per cent. As is often recognised in various tax reports, Australia's GST rate of 10 per cent clearly is well below the OECD average, and GST remains a potentially much greater tax revenue source than hitherto.

### I *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<sup>146</sup>.

The Productivity Commission<sup>147</sup> 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.'<sup>148</sup>

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 sector<sup>149</sup> with its high ensuing costs. Private rental housing investors, now numbering around 1.5 million<sup>150</sup>, generally achieve a reduction in their PIT (because allowable housing deductions exceed rents), as well as the opportunity for capital growth. 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<sup>151</sup>.

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

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<sup>146</sup> A point recognised by Warren (2004a), *supra* note 7, at 154-5.

<sup>147</sup> Inquiry on First Home Ownership (2004) at [www.pc.gov.au](http://www.pc.gov.au).

<sup>148</sup> Treasurer, Press Release No. 051, 23 June 2004.

<sup>149</sup> Druitt, R. (2007) *The West Australian*, 'Five ways to make housing affordable', 23 February, at 16.

<sup>150</sup> *The West Australian* (2006), 'Taxman to check for negative gearing scams', 21 October, at 4.

<sup>151</sup> *The West Australian*, 'Rents to leap 35pc as market catches up, say expert', 19 February 2007, at 7.

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.

This author takes the view that 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<sup>152</sup>, up from around \$1.2 billion in 2000-01<sup>153</sup>. The so-called negative gearing gap has increased dramatically in the past four years, from \$670 million to \$4.1 billion, or around five-fold. Such growth is obviously far stronger than prevailing economic growth<sup>154</sup>. However, improved ATO checking and auditing of claims<sup>155</sup> 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 unrealistic and probably near impossible. This author considers that it can be rightly disregarded at the present time.

#### J *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<sup>156</sup>. 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<sup>157</sup>. 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. From an overall longer-term economic efficiency viewpoint, such effects would be beneficial, although may not be well received in the short-term by those affected.

To sum up this section on socio-economic factors, significant PIT reform needs to consider a wide range of longer-term issues, both within Australia and overseas. It is possible that a cost-benefit analysis framework could be used in this task<sup>158</sup>.

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<sup>152</sup> Supra note 150. 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.

<sup>153</sup> Estimated by Warren (2004a), Table 9.8, supra note 7, at 150 (based on original data from ATO Taxation Statistics 2000-01), with further discussion at 149-158.

<sup>154</sup> 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.

<sup>155</sup> Supra note 150. 150,000 letters and 11,000 audits respectively in 2005-06. The latter represents around a 1 in a 136 chance of an audit.

<sup>156</sup> This is an area for further economic research.

<sup>157</sup> The loss of over 7 million tax returns pa could be worth around \$1.4 billion pa, and currently 7 per cent of tax agents annually are leaving the profession. See Evans, C. and Drum, P. (2006), 'Ten Million Reasons for Personal Tax Reform in Australia', Paper presented at the 7<sup>th</sup> International Tax Administration Conference, Sydney, April 2006, Paper 3, 1-21, at 19-20.

<sup>158</sup> This suggestion could be pursued in future work, depending on developments in the PIT reform debate.

## VII CONCLUDING COMMENTS

The case favouring reform of the present PIT is over-whelming, with a clear business, professional and academic consensus in favour. It is a matter of 'when' rather than 'if'. This paper has stressed the importance of defining terms, at least by academic researchers. This author suggests that significant PIT reform should mean a reduction in PIT revenue of at least 20 per cent of the current level, or around \$20 billion in monetary terms. It would include, of course, major simplification measures too.

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<sup>159</sup>. The political difficulties of this proposal, in the context of Commonwealth-State governance, are recognised but not considered further at this time. As well as helping to fund the author's significant PIT proposal, 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 \$20,000<sup>160</sup>. 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 as WREs, is the crux of the PIT reform debate rather than specific rates and thresholds. The knowledge, technological 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

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<sup>159</sup> The emphasis should be on the longer-term benefits for the whole country.

<sup>160</sup> It is possible that enhanced anti-avoidance measures for unearned income may be needed.

of the system altogether. This author ambitiously proposes a cull of around 7.5 million, thereby reducing the number of PIT payers who complete a PIT return annually to around 3.5 million, or roughly a third of the current level of 11 million.

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'<sup>161</sup>.

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<sup>161</sup> A term first used by Sandford in his excellent analysis of tax reform in six major countries. *Supra* note 6, at 184-186.