TAX FORUM
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STATEMENT OF REFORM PRIORITIES

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The two most significant issues that I believe deserve a place at the forefront of any discussion concerning the reform of Australia's tax system are:

1. the reform of personal income tax - specifically the simplification and flattening of marginal rates and brackets; and

2. tax system governance.

The reason why I believe that reform in these two areas should be a priority is because both of these areas are particularly visible to Australian taxpayers and each has an important and immediate impact upon the average Australian's view of the fairness of the Australian tax system.

The OECD has recognised that the concept of fairness is a key factor in encouraging a high level of compliance with the various tax laws and regulations in place within any jurisdiction[1]:

> Research suggests that fairness, as exhibited by the revenue body or government, can play a role in taxpayer behaviour. Three types of fairness are discussed in the note. *Distributive fairness* is the perception that the government acts as a good custodian and wise spender of tax revenues. *Procedural fairness* is the perception that the revenue body adheres to procedures that are fair in dealing with taxpayers. *Retributive fairness* is the perception that the revenue body is fair in the application of punishment when the rules are broken. Studies show that a lack of fairness is linked to a taxpayer's inclination (or justification) to not comply.

These concepts of fairness, as outlined by the OECD, underpin both of the areas of reform which I believe should be a priority for any Australian government. The ongoing simplification and flattening of the personal tax rates and brackets is a key element underpinning distributive fairness. Likewise, tax system governance is an important factor in how Australian taxpayers perceive both the procedural and the retributive fairness of Australia's tax system.

Together, any improvement in both of these reform areas will serve only to increase Australian taxpayers' confidence in the Australian tax system, which will in turn lead to higher levels of voluntary compliance.

I have explored each of these priorities in more detail below.

1. Personal income tax - flattening and reform of personal tax rates and brackets

The importance of personal tax reforms was highlighted in Recommendation 2 of the Henry Report[2]:

> Progressivity in the tax and transfer systems should be delivered through the personal income tax rates scale and transfer payments. A high tax-free threshold with a constant marginal rate for most people should be introduced to provide greater transparency and simplicity.

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[1] OECD Information Note, Forum on Tax Administration, "*Understanding and Influencing Taxpayers' Compliance Behaviour*", November 2010.
[2] K Henry, J Harmer J Piggott, H Ridout and G Smith, "*Australia's future tax system: report to the Treasurer*", December 2009, page 22.

A simplification and flattening of the personal tax rates and brackets must be an absolute priority for any government. It is important in any discussion to recognise that flatter tax schedules do not necessarily mean less progressivity since this also depends upon how the tax base is defined and on the effectiveness of other compliance measures.

The complexity of the present system, combined with the frequent manipulation of tax rates, thresholds and offsets by the Government is not conducive to good tax policy or to taxpayers' perceptions of distributive fairness.

At the same time there should also be vigorous discussion about the influence on taxpayers' behaviour arising as a result of the large difference between the highest personal income tax rate and the company tax rate. Much has already been said by the Government about the need to reduce Australia's company tax rate to below 30% in order to maintain Australia's competitiveness in the Asia-Pacific region. Little or no discussion has been held on the need to reduce personal income tax rates or to more closely align those rates with the Australian company tax rate. The increased mobility of labour, together with the current focus on the potential skills shortage and productivity in Australia, provide the government with an ideal opportunity to address the obvious steps that can be taken to attract, and retain, the brightest and most productive human capital assets. Offering attractive and competitive personal income tax rates is one of the most visible and effective ways in which Australia can achieve these aims.

A reduction in the top personal income tax rate is also necessary to address the fundamental inequity that exists between individuals who are able to structure their business affairs using a corporate vehicle, and ordinary salary and wage earners who have no such flexibility. In many circumstances individuals may be performing similar roles and yet there is a pronounced difference in the rates at which those individuals are taxed and therefore how they are rewarded for their labour. This distortion needs to be addressed in order to foster the belief in all taxpayers that they are bearing an appropriate share of the overall tax burden

In Australia the top marginal rate (including the medicare levy and flood levy) is currently 47.5%. If the company rate is reduced to 29% (as proposed[3]), then the effective margin becomes 18.5%. Such a difference is, in my experience, one of the most significant factors driving aggressive tax planning behaviour by taxpayers.

By way of comparison, New Zealand now has a company tax rate of 28%. The top marginal personal income tax rate is 33%, leaving a margin of only 5%. In Singapore the respective rates are 17% and 20% with a margin of 3%. In Hong Kong the standard personal income tax rates are less than the company rate of 16.5%[4], and in the United States the top personal rate is 35% with an average blended company tax rate of between 34 and 35%[5].

Reducing the margin between personal and company tax rates would be instrumental in eliminating tax loopholes and addressing the potential arbitrage opportunities that exist under Australia's current tax system. In turn, this will reduce the need for special provisions and targeted reliefs and will assist in other aspects of the reform agenda such as simplification and efficiency.

Whatever arguments may support Australia retaining a high marginal tax rate on individuals, those arguments do not provide an adequate explanation as to why the current government policy bias is towards widening the gap between company and personal tax rates rather than reducing it.

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[3] Joint media release No 028 issued on 02 July 2010 by the Prime Minister, the Treasurer and the Minister for Resources and Energy.
[4] Individuals are taxed at a standard rate of 15% on net income (i.e. income after deductions) or progressive rates on their net chargeable income (i.e. assessable income after deductions and allowances) starting at 2% and ending at 17%; whichever is lower.
[5] The United States imposes tax on a graduated basis on corporations.

Any reduction in the margin between the company tax rate and the top personal tax rate will most likely be a gradual reduction rather than something that is achieved instantly. However, that does not mean that it should not be a policy objective of any Australian government and remain at the forefront of any discussion concerning the reform of the Australian tax system.

2. Tax Governance

The Tax Forum Discussion Paper recognises that the Australian tax and transfer system needs to be robust, accessible and enable people to make informed choices[6]. Tax system governance, and perceptions of procedural fairness, are key elements in building trust between the Australian tax system and taxpayers. In this manner, a taxpayer may perceive the tax system as just and fair where the system provides procedures and outcomes that are consistent, accurate, and neutral. In my experience, these factors are often just as important, if not more so, than whether the actual outcome for the taxpayer is positive or negative.

The most obvious impediments to building taxpayer's trust in the Australian tax system are complexity, uncertainty and a lack of transparency. Any discussion on the reform of Australia's tax system therefore needs to address these issues.

Two of the key recommendations in the area of tax governance made in the Henry Report included:

- information or advice provided by Treasury to assist the ATO in determining the purpose or object of the law, or materials used by the ATO to determine policy intent should be made public (Recommendation 114); and

- the clarification of the role of the Inspector-General of Taxation in examining systemic tax administration issues and the monitoring of the ATO's implementation of any recommendations made by the Inspector-General (Recommendations 116 and 118).

The first of these recommendations addresses issues of uncertainty and transparency. The second addresses issues of neutrality and consistency arising from the administration of the tax and transfer system by the ATO. Both recommendations are focused on improving the procedural fairness of the Australian tax system.

Given the ATO's crucial role in influencing perceptions of procedural and retributive fairness, I think it is increasingly important to ensure that the ATO engages with taxpayers in a consistent and transparent manner, and that systems are in place that encourage the ATO to treat taxpayers with empathy and respect. The tax laws impose harsh penalties on taxpayers who make false and misleading statements to the Commissioner, however taxpayers are acutely aware that no penalties can be imposed on the Commissioner for making any similar statements of a false or misleading nature. Similarly, the Commissioner can never be penalised for taking a position that is not reasonably arguable. These imbalances exemplify the difficulties faced when discussing the reform of tax system governance.

Unfortunately, the approach of the ATO in many instances is to view the affairs of a taxpayer with outright suspicion and the resulting approach is often an unduly aggressive one. Reviews such as the Inspector-General of Taxation's recent review into the ATO's small and medium enterprise audit and risk review policies, procedures and practices are therefore critically important. Any tax system governance policies should ensure that any recommendations arising from such independent reviews are implemented in a timely and effective manner. It is also important that the ATO is held accountable for any failure to adhere to the recommendations.

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[6] Australian Government, *"Tax Forum Discussion Paper - Tax Reform - Next steps for Australia"*, page 33.

It is my view that the role of the Inspector-General of Taxation forms an important part of maintaining the fairness of the Australian tax system. Indeed, the reviews conducted by the Inspector General have brought about significant positive improvements in the functioning and administration of the Australian Taxation Office. I fully support the role of the Inspector-General in the ongoing review of systemic tax administration issues and agree with the recommendations in the Henry Report concerning the need to direct the focus of the Inspector-General to issues affecting businesses rather than individual taxpayer concerns (which are dealt with by the Ombudsman).

As identified in the Henry Report[7], it is imperative that the Inspector-General of Taxation is sufficiently resourced. I believe that the current level of resources made available to the Inspector-General to perform the required role are inadequate. To enable the Inspector-General to carry out his role in the most effective manner, and to undertake further reviews in areas that may be identified in the future, more funding should be allocated by the government.

A focus on the reform of tax governance along the above lines will promote feelings of procedural fairness, and in doing so will further bolster trust and levels of voluntary compliance by taxpayers.

3. Financing of the above proposals

The Statement of Reform Priorities sent to participants requests submissions regarding how the reform proposals identified by the participant might be financed over the short and longer term.

The reform proposals identified above in relation to tax governance should have little or no impact on revenue over both the short and the long term. Accordingly, there is no reason for the Government not to immediately address some of the governance issues and reforms that will be raised as part the tax forum.

Estimating the impact on revenue of any changes directed towards flattening the personal tax rates and brackets, and addressing the unacceptably wide margin between personal and company tax rates, is more difficult. The potential savings from implementing these reforms are difficult to measure. The increase in voluntary compliance, the decline in aggressive tax planning, the savings in compliance costs and the resulting reduction in the resources required by the ATO all need to be considered before being balanced against any short term loss in tax revenue that may occur. It is by no means certain that a gradual reduction in the top personal tax rate would lead to a material reduction in tax revenues[8].

As noted above, the definition of the tax base and other compliance measures will all impact upon the cost of implementing any reforms. Accordingly, a robust debate concerning personal tax reforms can never be held in isolation from considering the impact of other key areas of tax reform such as the carbon tax, the minerals resources rent tax and the GST rate.

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[7] K Henry, J Harmer J Piggott, H Ridout and G Smith, "*Australia's future tax system: report to the Treasurer*", December 2009, page 667.

[8] For example, the Laffer curve in economic theory is often used to illustrate the concept of taxable income elasticity. The curve provides support for the argument that increasing tax rates beyond a certain optimal point will be counterproductive to raising further revenue.