Australian Government

A tax plan for our future
Stronger • Fairer • Simpler

# TAX FORUM 4-5 October 2011

## STATEMENT OF REFORM PRIORITIES

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### STATEMENT OF PRIORITIES

**Priority reform directions for the tax and transfer system**

The final Report produced by Australia's Future Tax System Review (AFTS, or the Henry Review) is – in many ways – an inspiring vision of how we might wish the Australian tax and transfer system to develop in the next 40 years. Its recommendations should stand the test of time, and we should see many of its reform options implemented by governments in coming years. It is particularly pleasing to note its commitment to an "equitable, transparent and simplified personal tax system", its suggestion of "integrating consumption tax compliance with business systems" and its desire for a "more open, understandable and responsive tax system". Each of these broad themes goes to the heart of what I consider to be one of Australia's priority reform directions for its tax and transfer system – the capacity of the system to manage tax system complexity, to provide certainty for taxpayers and to operate in a manner which imposes the least possible level of compliance burden on its participants, business or personal.

A substantial amount of evidence – anecdotal and empirical – suggests that the Australian tax system is highly complex both in absolute terms and relative to most other tax systems. One look at the sheer size and density of Tax-Pack is enough to scare off most otherwise would-be compliant personal taxpayers. Businesses fare little better with myriad forms, returns and obligations related to tax. Australia has more than 100 separate taxes, some of the lengthiest and most illegible tax legislation known to man, high compliance costs that are regressive and not decreasing over time, and arguably the highest rate of tax agent-dependency in the world.

It is therefore not surprising that issues relating to tax simplification – or how to manage tax system complexity – featured prominently in the Henry Report made public by the Government in early May 2010 together with the Government's initial and subsequent responses. But while the Henry Report contains a lot about the importance of simplifying the tax system and encouraging a more citizen-centric design to the way that the tax system mediates the interaction between taxpayers and the agencies of the Government, close scrutiny reveals that much of this may be little more than rhetoric. The underlying substance to show how the various recommendations can lead the way to a more simplified interaction between the key participants is missing at times and the Report relies too heavily on one or two obvious "solutions" without exploring a number of other possibilities.

Moreover the Government's initial response to the Report, headlined "Stronger, Fairer, **Simpler**" (emphasis added), does virtually nothing to build on the more positive features relating to simplification that do exist in the Report.

This is not to suggest that what the Henry Report recommends is not without merit – merely that often it does not go far enough. But it does nonetheless contain a number of recommendations that can help to simplify the Australian tax system for personal and business taxpayers. These – and their shortcomings – can be considered under the three broad areas where it is possible to conceive of tax simplification potentially happening –in the areas of tax **policy**, tax **legislation** and tax **administration**.

In the first place there is the possibility of simplification taking place in the area of tax **policy**. Opportunities for simplifying tax policy are often limited and not entirely promising, and this is borne out by the Henry Report recommendations. Despite the widely-quoted comment about there being more taxes in Australia than species of hairy-nosed wombats, the immediate outcome was that one more tax was proposed to be added to the Australian list of taxes (initially the Resources Super Profits Tax, now to be replaced by the Mineral Rent Resources Tax) and none were actually removed – though there is a lot of background discussion in the Report about the need to rationalise inefficient State taxes and replace them with fewer and "better" taxes after appropriate consultation and agreement between the Commonwealth and the States. The need to move swiftly to eradicate inefficient and inappropriate taxes is therefore a key reform priority.

One obvious example is the Fringe Benefits Tax (FBT). The Report recommends that "easily valued" benefits should be taxed on the employee and collected through the Pay As You Go (PAYG) mechanism. This is eminently sensible and a long overdue reform. But the recommendation does not then advance to its logical conclusion – that the FBT could be abolished by passing liability for all (not just those easily valued) employee benefits to the employee, albeit collected through the employer (as is the case in most OECD countries). Instead we are left with a proposed "betwixt and between" regime. Some benefits will be assessed on the employee. Others will stay within the FBT regime. This is not simplification. Parallel universes of legislation will co-exist where one set of rules more sensibly appended to the income tax provisions could have done the entire job. Even the opportunity to align the FBT and income tax years seems to have been overlooked. That would have been a compromise, but still better than the proposed confusion of two sets of rules and two tax periods, for taxing the benefits of employees.

The Henry Report recommendation to allow a standard deduction for work related expenses (a recommendation accepted by the Government in its Budget of 11 May 2010 and due to come into operation in July 2012) is another example of reform at the policy level that is positive but which does not go far enough. If the Review Panel was truly committed to simplification it would have proposed removing deductions for work related expenses entirely – perhaps to be accompanied by a compensatory reduction in headline tax rates for personal taxpayers. Potentially this could have helped lead the way to reduced annual filing, a topic dealt with further below. More importantly it would yield immediate simplicity dividends for most personal taxpayers. But the legislated outcome as it stands will lead to a "worst of both worlds" outcome. Personal taxpayers will have the choice of either taking a standard deduction for work related expenses or opting to itemise and claim actual expenses. Choice is a key determinant of compliance costs, and also a key determinant of tax agent dependency. Faced with the choice of two methods, many taxpayers will seek to calculate the outcomes under both before choosing which to use. It is perhaps better not to offer a choice in such circumstances.

Yet another area where proposals for policy simplification have arguably fallen short of expectations is in the Review Panel's support for a policy which taxes most labour income (wages, salaries, most employee benefits) and business income at full progressive tax rates, while most income from capital (capital gains, rental income, bank interest) was proposed to be taxed after a 40% discount had been given. One other item of capital income – dividends received from companies – would be taxed at yet another rate of taxes. The Government announced in its initial response that the 50% CGT discount would not be reduced to 40%. Subsequently in its May 2010 Budget the Government announced that the first $1,000 of savings income would attract a 50% discount. This means even more complexity with differential tax rates for virtually all forms of income. A simple income tax system would either treat all income, no matter from where it was derived, in the same manner using the same schedule of tax rates; or – if it felt obliged to tax capital income more lightly than labour income – it would move to a sensibly structured dual income tax modelled on the successful Scandinavian experiences. It would not create the potential "mishmash" of rates and treatments that currently appears to be developing.

The second area for potential simplification lies in the approaches that can be taken to the drafting of tax **legislation**. But here again the likely simplification benefits from the Henry Report are marginal at best. To be fair, the Review Panel's terms of reference did not encompass consideration of issues relating to legislative drafting. This did not stop the Review Panel from making the suggestion that the Capital Gains Tax (CGT) legislation should be re-drafted using a principles-based approach. It is somewhat surprising that this particular statutory extension should be singled out for special treatment. From experience it is by no means the worst drafted part of the Income Tax Assessment Acts – in fact the CGT regime is an exemplar of clarity compared to some of its legislative counterparts. Little is likely to be achieved – in the struggle for simplicity – by redrafting the CGT provisions if the rest of the Acts is not tackled.

But it is the Henry Report's proposals (and Government response) in relation to the third and most promising area where simplicity can be achieved – the area of tax **administration** – that is the most disappointing.

There are a number of obvious shortcomings in this area. Perhaps the most striking is the underlying assumption that all taxpayers will need to continue to lodge a tax return, albeit that the return for many will be pre-populated and taxpayers will be required only to check and confirm. This "flick and tick" or pre-filling approach is in contrast to the system in use in more than half of OECD countries where large numbers of taxpayers with relatively simple tax affairs are "washed out" of the tax system and are not required to lodge a tax return at all. The careful use of various *de minimus* limits (such as an annual exemption for CGT), combined with no or limited deductions for workplace expenses and a more sophisticated PAYG system, can enable a large number of taxpayers simply not to have to bother with engaging with the tax system at all at the end of the tax year by lodging a return – they neither owe any tax nor are owed any refund of tax. The correct amount of tax has been taken at the correct time during the year and they can simply exit the tax system at the end of the year with no need for stressful or costly interactions with the revenue authority.

The Henry Report has gone for a less radical but also less rewarding solution than this reduced filing approach by opting for the pre-filled approach. And the Government has apparently endorsed this less than optimal outcome, having given its support to the "flick and tick" in the Budget of 11 May 2010. It is a minimalist policy that will achieve minimalist outcomes in terms of simplifying the tax system for most taxpayers. It does very little for personal taxpayers and nothing for taxpayers who are in business.

There are other areas where the opportunity for simplification has been missed. The Report does not always identify the different contexts applying to different forms of taxpayers – for example personal and business taxpayers have different issues. A "one size fits all" approach is often adopted in the Report. It also says relatively little about the role that intermediaries – tax agents and tax advisers – play in smoothing the interaction between taxpayers and revenue authorities, especially business taxpayers.

There is much to be commended in the Henry Report. But in the area of tax simplification there is, unfortunately, a lot that is missing. Giving taxpayers more choices to make and asking them to continue to lodge returns will not reduce the costs of complying for most taxpayers.

In summary, therefore, my priorities for tax reform lie in seeking to better manage the complexity in the tax system and reduce the compliance burden on personal and business taxpayers. This can be achieved through a mixture of policy simplification initiatives (for example, abolition of the FBT); and administrative simplification initiatives (for example the adoption of reduced filing obligations for many personal taxpayers and the increased use of existing processes for compliance reporting for business taxpayers).

**Financing over the short and longer term**

Simplification initiatives do not necessarily (or even usually) carry any cost to revenue. Indeed, the simplicity and efficiency dividends derived from reduced taxpayer compliance costs and greater taxpayer compliance can far outweigh any additional administrative costs that may arise for the revenue authority and other agencies charged with the implementation and monitoring of such initiatives.

## LIST OF ATTACHMENTS

The following publications sum up my views on the imperative of tax system simplification and the manner in which such simplification might begin to be achieved:

"Reflections on the Mirrlees Review: An Australasian perspective", *Fiscal Studies*, Vol 32 No 3, pp 375-393, 2011.

"Prefilled Personal Income Tax Returns: Australia", (with B Tran-Nam), in *Prefilled Personal Tax*

*Returns: A Comparative Analysis of Australia, Belgium, California, Quebec and Spain* (edited Vaillancourt F), Fraser Institute, Vancouver, pp 9-30, 2011.

"Controlling Tax Complexity: Rhetoric or Reality", (with B Tran-Nam) in *Australia's Future Tax System: The Prospects After Henry* (edited Evans C, Krever R and Mellor P) Thomson Reuters, Sydney, pp 439-463, 2010.

"Towards systemic reform of the Australian personal income tax: developing a sustainable model for the future", Evans C, Tran-Nam B and Andrew B, *Australian Tax Forum*, Vol 22 No 2, pp 15-47, 2007.

*An Analysis of the Impact of Record Keeping Systems and Practices on the Problems of Tax Compliance for the Small Business Sector*, Evans C, Carlon S and Massey D, CPA Australia, Melbourne, 2005.

"Taxing personal capital gains in Australia: causes of complexity and proposals for reform", *Australian Tax Forum*, Vol 19 No 3, pp 371-432, 2004.

"Diminishing returns: the case for reduced annual filing for personal income taxpayers in Australia", *Australian Tax Review*, Vol 33 No 3, pp 168-181, 2004.

In addition, the following publication is in final draft stage and will be available for circulation at or near the time of the Tax Forum.

"Tax policy simplification: An evaluation of the proposal for a standard deduction for work related expenses", *Australian Tax Forum*, forthcoming, 2011.