Australian Government

A tax plan for our future
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STATEMENT OF REFORM PRIORITIES

PARTICIPANT NAME AND POSITION

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STATEMENT OF PRIORITIES

1. What are your priority reform directions for the tax and transfer system?

Priority 1: Simplification of the personal income tax

As noted at page 6 (Chapter A1) of the Australia's Future Tax System (AFTS) report, the personal income tax (PIT) system is too complex and the compliance burden too high. Factors contributing to this for many taxpayers are the large set of complex deduction rules, numerous tax offsets and different forms of exempt income. Through a combination of these factors, and their interaction with the PAYE withholding and PAYG instalment arrangements and system of dividend imputation, the PIT system is also characterised by a high incidence of "refund churn" (that is, a significant volume and amount of tax refunds (i.e. almost 20% of gross collections)). In addition to denying taxpayers use of their monies for a fair period of time—another form of compliance burden—this situation adds to the ATO's workload and complicates the detection of tax refund frauds.

A major area of complication and compliance burden, as well as tax non-compliance, concerns deductions for work related expenses (WRE) which continue to grow faster than employment income, in part due to excessively liberal interpretations of the relevant tax law by taxpayers and their agents and deliberate and careless over-claims. As described in the AFTS, Australia's PIT system is relatively generous to work expense claims and one gets a sense of the degree of this generosity by comparing the incidence of WREs/ employment income in Australia (3.6%) with other countries—Canada, where deductions are specifically legislated (around 1.2%) and New Zealand, where deductions are generally denied (effectively 0%).

While no attempt is made in Australia to measure the overall incidence of over-claimed WRE deductions, there are indications that it could be of the order of 15-20% of total WRE deductions, resulting in revenue leakage of around $600 million (and growing) per annum. In my view, the scale of this problem is now well beyond an administrative response and can only be effectively dealt with by legislative action. While the Government has already announced a proposal for a standard deduction to address part of the problem, its proposal is not as robust as the AFTS report's recommendations and it has a number of other downsides—it is not well targeted and it will be excessively costly when fully implemented (i.e. over $700 million per annum). Furthermore, the AFTS recommended that there should be a tighter nexus between the deductibility of the expense and its role in producing income (for example, as seen in Canada). This particular issue has not, as yet, been addressed.

For all of the reasons stated in the AFTS report, its recommendations as reflected below (and subject to some further suggestions as indicated) should be given priority attention as part of an comprehensive program of actions for PIT system simplification:

- **Recommendation 5:** The Medicare levy and structural offsets should be removed as separate components of the system and factored into the personal rate scales.

- **Recommendation 6:** To remove complexity and ensure that Government assistance is properly targeted, concessional offsets should be removed, rationalised, or replaced by outlays.

- **Recommendation 11:** A standard deduction should be introduced to cover work related expenses and the cost of managing tax affairs to simplify personal tax for most taxpayers. Taxpayers should be able to choose either to take a standard deduction or to claim actual expenses where they are above the claims threshold, with full substantiation.

  Additional comment: Unlike the Government's current proposal for a flat amount standard deduction, the AFTS proposed a standard deduction ***consisting of a nominal base amount and an additional amount calculated as a proportion of labour income up to a capped amount.*** In other words, the value of the standard deduction would rise in line with employment income, as is the case in practice with average WRE claims and employment income. The AFTS's proposed approach makes it much more robust and in line with capturing the bulk of WRE claimants.

- **Recommendation 12:** There should be a tighter nexus between the deductibility of the (work-related) expense and its role in producing income.

  Additional comment: Ideally, this recommendation would be implemented in advance of, or in conjunction with, the AFTS's form of standard deduction.

- **Recommendation 13:** Gift deductibility should be retained, with the deductibility threshold raised to $25.

  Additional comment: The costs of gifts made to an approved body should be brought within the scope of the proposed standard deduction to reduce the need for millions of taxpayers to itemise relatively small gift claims, while much larger amounts of WRE are covered by the standard deduction.

Addressing all of the abovementioned recommendations would bring enormous simplification to the PIT system, enabling an additional enhancement to be made that would significantly reduce the compliance burden of most taxpayers—the capability to generate fully completed prefilled tax returns for the majority of taxpayers. Such arrangements are already well entrenched in a number of Scandinavian countries, most notably in Denmark where in excess of 80% of personal income taxpayers receive the equivalent of a fully completed tax return and related assessment calculations.

- **Recommendation 123:** Prefilled personal income tax returns should be provided to most personal income taxpayers as a default method of settling their tax affairs each year.

Priority area 2: GST reform as a prerequisite for state tax reform

While the Government has indicated that it is not prepared to consider GST reform, the practical reality is that it is essential to much of the broader reform directions envisaged in the AFTS report.

Today's GST exists, effectively, as an under-utilised and seemingly "unloved" appendage to Australia's tax system, because of the perceived political downsides associated with its reform. As a result, Australia is "stuck with" an over-reliance on direct taxes (and high marginal rates of tax that encourage avoidance and evasion), the anomalous tax treatment of some goods and services, inefficient state taxes, and a GST that is relatively expensive to administer, given its relatively low rate and narrow base that limit its revenue raising potential. (It costs around 40% more to collect $100 of GST than the cost of collecting $100 of all other taxes collected by the ATO.)

The AFTS examined the regime of state taxes and made many recommendations concerning their rationalisation. Most notably, these included elimination of payroll tax and stamp duties, major sources of state Government revenue.

GST revenue (net of administrative costs) is already fully distributed to the states and there would seem to be a fairly compelling logic to GST base broadening and a slightly higher rate (e.g. 12.5%) as a means of rationalising the major state taxes and compensating low income citizens that would otherwise be unfairly impacted by GST expansion.

GST reform might also be linked to a longer term strategic direction for tax reform that envisaged:

- Abolishing state mining royalties (in conjunction with an enhanced mining resource rent tax), removing the current situation where states' decisions re rates of royalties will impact the proposed MRT revenue base;

- Sharing GST receipts with states on the basis of their share of personal consumption expenditure, thereby removing grounds for claims of unfair distributions (as regularly occurs under current arrangements).

Priority 3: Personal income tax-Expanded information reporting obligations

Australia's tax system relies significantly on the personal income tax (PIT) which contributes around 37% of all Government tax revenue (P3, chapter A1 of the AFTS report). It follows that achieving a high degree of compliance with its obligations is critical to efficient fiscal management.

Compliance with the PIT is facilitated greatly by the use of tax withholding and information reporting obligations. Operating together and administered effectively very high rates of compliance can be demonstrated for the categories of income subject to these requirements. However, the same cannot be said for categories of income which are not subject to withholding and/or information reporting obligations. Although not measured scientifically by the ATO the differential in rates of compliance between incomes subject to these requirements and those that are not is likely to be quite significant, drawing on the results of ATO compliance programs and observations from compliance-related research of other revenue bodies (e.g. in Denmark, Sweden, UK and USA).

The table below sets out information on the use of withholding and information reporting obligations for Australia's PIT and the gaps in coverage are obvious.

Table 1. PIT—Use of withholding and information reporting obligations

Income category	Withholding requirement	Reporting requirement
Employment	Yes	Yes
Government benefits	Yes	Yes
Pensions	Yes	Yes
Interest	Generally not; only for TFN non-quotation	Yes
Dividends	Generally not; only for TFN non-quotation	Yes
Capital gains	No	No
Rental properties	No	No
Self-employed/ business	Generally not; only for ABN non-quotation which is rare	Generally not; only for ABN non-quotation which is rare

As a result of these gaps in the legislative framework, around 40% of assessable personal income is not subject systematic reporting to the ATO, seriously impacting the level of compliance achieved in practice.

In its 2012 Budget, the Government announced new information reporting proposals for contractors in the building and construction industry, payments by Government (all levels) for services provided, and assessable grants and payments made by Government to small businesses/ self-employed taxpayers. While this is a positive development, considerable scope remains to do much more and in the process generate significant additional revenue from improved compliance and enhanced ATO verification programs.

Finally, the availability of new income information sources would significantly increase opportunities for enhanced use of prefilled tax returns, as already described earlier in this note.

2. How are your proposals financed over the short and longer term?

Priority 1: Simplification of the personal income tax

There are no funding implications, and potential savings to Government and enormous reductions in taxpayers compliance costs:

- Attention to offsets, all other thing being equal, would facilitate a lowering of rate scales.
- Savings from tightening WRE deductibility could, in part, be directed to funding the more comprehensive form of standard deduction envisaged by the AFTS and this writer.
- The administrative costs of a comprehensive system of prefilled returns in all likelihood could be covered by existing ATO budgets.

Priority area 2: GST reform as a prerequisite for state tax reform

Proposal envisages expanding GST revenue base to replace inefficient state taxes and provide relief for lower income citizens otherwise unfairly impacted by GST expansion.

Priority 3: Personal income tax-Expanded information reporting obligations

This is a revenue-generating proposal and in the longer term one that could assist reduce the compliance burden of affected taxpayers

Feel free to attach supporting papers if you wish. Please list them here.