

The Senate

Economics References Committee

The structure and distributive effects
of the Australian taxation system

June 2004

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CHAPTER ONE

THE INQUIRY

Referral and terms of reference

1.1 On 12 December 2002, on the motion of Senator Jacinta Collins, the Senate referred the following terms of reference to the Economics References Committee, for inquiry and report by June 2004:

The structure and distributive effects of the Australian taxation system with reference to:

- a) the level, extent and distribution of the current tax burden on individuals and businesses;
- b) the impact of (a) on taxpayers' families;
- c) the use and efficacy of various tax and expenditure incentives to influence social and economic conduct, for instance participation in the workforce;
- d) the long term social and economic impact of the current distribution of taxation, government spending and employment including the intergenerational consequences of the tax structure;
- e) the respective roles of the Commonwealth and the States in relation to the collection and distribution of taxation revenue; and
- f) any other relevant issues which may arise in the course of the inquiry.

1.2 On receiving this reference, the Committee noted that the terms of reference are exceptionally wide, and amount to an invitation to the Committee to conduct a wide-ranging assessment of the Australian taxation system.

Conduct of the inquiry

1.3 The Committee placed a call for submissions in *The Australian* newspaper and on the Senate's website. Closing date for submissions was 28 July 2003, and 111 submissions were received. A list of the parties who provided submissions is at **Appendix 1**.

1.4 The Committee held a total of four hearings during 2003. The first two hearings, on 28 and 29 July 2003, focussed on issues of distributional justice with particular reference to the combined effect of the welfare and taxation systems on households in different circumstances. The third hearing, on 12 September 2003, focussed on compliance and the impact of tax reform on the cash economy. The final hearing, on 2 December 2003, was a round table of experts convened to consider further directions of inquiry for the Committee. It is discussed further below. A list of the witnesses who appeared at these hearings is at **Appendix 2**.

Round Table of Experts

1.5 As noted above, the terms of reference for this inquiry are unusually broad. While the Committee received a substantial number of submissions, it became clear to the Committee that insufficient evidence had been received to support a thorough and wide-ranging reassessment of the entire taxation system. However the submissions and evidence did point to specific areas of concern within the taxation system.

1.6 In October 2003, the Committee met with officers from the Department of the Parliamentary Library¹ to discuss possible options for dealing with the breadth of the current reference. Following that meeting, the Committee determined that it would report the evidence obtained in this inquiry process, and would endeavour to establish the basis for a subsequent series of more focussed references on particular taxation issues. To that end, the Committee convened a round table of experts on 2 December 2003, to discuss the areas of policy within its current terms of reference that might usefully form the basis for future, more focused references from the Senate to the committee, and to give the Committee some guidance about the priority which might be given to these references.

1.7 The outcome of this round table, together with the Committee's subsequent deliberations, form the basis of Chapter 6 of this report.

Objectives of this report

1.8 As noted above, the Committee has not responded to the current terms of reference by undertaking a sweeping review of all aspects of the current taxation system. This report will not, as a result, recommend substantial changes to the tax system. Instead, this report has the following objectives:

- to present the evidence received by the Committee in the form of submissions and oral evidence, as a contribution to ongoing public discussion of taxation issues;
- to present the views expressed during the round table of experts, which were explicitly presented as guidance for future references; and
- to set out a proposed series of references which the Committee might usefully consider during the remainder of the 40th Parliament and during the term of office of the 41st Parliament.

Structure of this report

1.9 The first chapters of this report will set out the evidence received by the Committee in submissions and oral evidence. This evidence has been arranged by

1 Now part of the Department of Parliamentary Services.

issue, and these issues formed the basis of the discussions with the round table of experts.

1.10 Chapter 2 of the report focuses on the taxation of families. It discusses whether the taxation system supports or penalises couples wishing to establish families, and whether the interaction between the taxation system and the welfare system (through both direct payments and tax benefits) provides sufficient support to families.

1.11 Chapter 3 of the report discusses the tax system and low income earners. Consequently, this chapter discusses the impact of 'bracket creep' on low income earners, and the impact of high effective marginal tax rates on low income earners attempting to move from welfare into paid work.

1.12 Chapter 4 of the report discusses issues of taxation compliance and, as a related issue, the impact of the cash economy on the taxation system. This chapter examines the use of trusts as a vehicle for tax avoidance, and the taxation treatment of Pay as You Go (PAYG) taxpayers in comparison with the tax treatment of self-employed taxpayers.

1.13 Chapter 5 of the report discusses other issues raised in evidence, including the issue of vertical fiscal imbalance, the use of taxation to promote social objectives (such as a reduction in gambling and alcohol consumption), and the support in some submissions for a flat tax or a debit tax.

1.14 The final chapter, Chapter 6, sets out the results of the round table, and points to a number of areas where the Economics References Committee might usefully undertake future inquiries. These issues are set out in three general categories:

- tax avoidance and erosion of the tax base;
- the relationship between the tax system and the social security system; and
- equity in the tax system.

CHAPTER TWO

THE TAXATION OF FAMILIES

2.1 Term of reference (b) for the current inquiry asks the Committee to consider the impact of the current tax burden on taxpayers' families. A substantial number of the submissions to the current inquiry dealt with this issue, as did a number of witnesses. Further, the impact of the taxation system, and the effectiveness of family tax benefits as a means of supporting families, have continued as a source of wider political debate.

2.2 This chapter will present evidence obtained on issues relating to the impact of the taxation system on families. Those issues are:

- whether the current tax system provides a disincentive to couples considering establishing a family;
- whether income splitting, or some other variation of family unit taxation, should be introduced;
- whether tax concessions, such as the Family Tax Benefits, are a suitable model for family support, and whether they are currently applied in an equitable way;
- the availability and cost of childcare, and whether the tax system takes sufficient account of this cost;
- whether the HECS scheme has an impact on when, and whether, couples establish families;
- whether the impact of tax on families in rural and regional Australia has special characteristics which should be considered; and
- whether the current tax system is equitable on a 'lifetime' basis.

2.3 Very late in the Committee's deliberations, the Government introduced the 2004/2005 Federal Budget, which proposed changes to a number of family tax programs. Those making submissions to this inquiry, and those who appeared at hearings in the course of 2003, were of course referring to the system as it was at that time. As a result, this chapter will present evidence reflecting the tax system prior to the 2004/05 budget, and will point out areas where the budget has proposed changes.

Is the tax system a disincentive to establishing a family?

2.4 A number of submissions suggested that current tax arrangements either reward people for remaining single and childless, or penalise them for marrying or having children. It was suggested that, while children are regarded as socially desirable in the context of an ageing population likely to reach a population peak

during this century, the taxation system gives contrary behavioural cues, making the options of partnering and having children less attractive.

2.5 The Shop Distributive and Allied Employees Association (SDA), for instance, stated in evidence:

The presence of children does place great burdens on families, it does lead to disparities of wealth and it does lead to reduced disposable income. Families should not be penalised for having children. It is no wonder Australia has a declining fertility rate when we effectively penalise families for having children. That needs to be taken account of properly in the taxation and social security system.¹

2.6 Support for this view came from a disparate range of sources and perspectives. The Festival of Light, for instance, stated in its submission:

Children represent another long-term cost to the family budget. If one were to perform a cost/benefit analysis for having children, the costs, particularly the economic costs, would generally outweigh the benefits. As the economic commitment to the rearing of children increases, there is more and more pressure on the family either to delay the bearing of children, or to avoid it altogether. Clearly, financial considerations play a large part in a couple's decision to have or not to have children.

Financial pressures force many women to choose employment rather than motherhood. Social pressures also cause many women to seek a career rather than merely a temporary source of income. Both of these forces militate against the bearing of children or cause women to wait until much later in life to have their children.²

2.7 The Women's Action Alliance set the importance of taxation within the wider context of the economic circumstances facing young couples who may be contemplating starting a family:

It is very difficult at the moment. I come from Sydney and, particularly in Sydney but increasingly in other parts of Australia too where housing costs are increasing, it is very difficult to start a family while you are trying to buy a house and perhaps pay off one or two HECS debts. It means that if you want to try and establish yourself in the housing market and do this at the same time you are almost inevitably going to look to postpone having children, because it is very difficult. Increasingly, women particularly are recognising that it is very difficult to combine the two. It is certainly difficult to combine two full-time incomes and have a family. I do think that there are problems there and that it is increasingly being postponed.³

1 *Transcript of Evidence*, Blandthorn, 28 July 2003, pp. 4-5

2 Submission 59, Festival of Light, p.2.

3 *Transcript of Evidence*, Beard, 28 July 2003, p. 54.

2.8 The Committee noted that the submissions which drew attention to this point did not propose solutions directly designed to increase the attractiveness of partnering and having children. Rather, they pointed to this issue as an underlying problem, which can be addressed by reform of the taxation system in specific areas such as by allowing income splitting for wage and salary earners, by reforming the family tax benefit system, and reforming arrangements for subsidising child care.

Income splitting and family unit taxation

2.9 Income splitting was one of the most widely supported proposals put before the Committee. The concept itself is quite simple: that couples ought to be allowed to share their income for tax purposes, enabling them to increase the amount of their total wages in the lower tax brackets. In his submission, for instance, Mr. Nick Renton stated:

Married and de facto couples should be given the option to have each member taxed on half of their combined taxable incomes. The concept of treating couples as one unit is already enshrined in the social security legislation. At present investment income can often be split 50/50 whereas personal exertion income cannot.⁴

2.10 A number of submissions noted that income splitting is already possible for many types of incomes, such as investment income, and suggested that it is unfair that PAYG taxpayers cannot take advantage of income splitting, where other taxpayers can do so:

We further recommend that income splitting between spouses be an option. The argument that this will benefit higher-income groups is a red herring as such couples either already split their income through business partnerships and trusts, or both spouses are already paying at the top level of tax and income-splitting is of no benefit to them.⁵

2.11 One taxpayer exhibited a sense of outrage at the perceived unfairness of this situation:

Why does a couple with two incomes and no kids pay relatively less tax than a single income family? They get the benefit of two tax free thresholds and live comfortably, while we get just one free threshold. We are helping the future of this country by struggling to bring up three kids properly, they are not. The tax free threshold should be available for my wife who is my dependent. All the money I earn is in reality split in half between us – it should be halved for tax reasons as well as in reality.⁶

2.12 A number of submissions favoured another model, currently operating in France, which might be referred to as 'family unit taxation':

4 Submission 48, Renton, p.1.

5 Submission 86, Endeavour Forum, p.1

6 Submission 32, Brad Finegan, p.1

As I understand it, the system that operates in France is somewhat different from what we in Australia would call income splitting. If we are talking about income splitting as it is normally discussed in Australia, no, I am not advocating income splitting. I believe it gives disproportionate advantage to high-income earners who have the capacity to split their income. On the other hand, if you are looking at a system like that which exists in France that takes into account the number of dependants in a family then I think that is worth looking at very seriously.⁷

2.13 The Womens Action Alliance provided more detail on how the French scheme operates, and how it might operate in Australia:

It is an extension of income splitting; it is not pure income splitting between husband and wife. It allows you to total the income in your family and divide it by the number of dependants that you have. In France they allow a quantity for each dependant, so each adult in a family unit is one unit and every child in a family unit is half a unit. With a couple of exceptions, with a single income family they allow the eldest child to be a whole unit, which provides for equity for sole parent families. Handicapped children get a whole unit, in some sort of acknowledgment of the extra costs that are involved. You have a system whereby you total up all the income in a family so you say, for example, that there are a husband and wife and two children, that that totals three units and so the total family income is divided up among three units and is taxed based on three individual units. So if the family earned \$30,000 they will be taxed individually as \$10,000, \$10,000 and \$10,000. It provides benefits to all families, both to two income families, because they have the benefit of splitting up among children, and to single income families on an income and a half. It ensures that the tax system itself takes into account the total family income and the number of dependants, which it currently does not. [...]

The system is flexible enough to provide for different family types equitably. For example, in France, while the first and second child have a half unit value, a third or subsequent child is worth a whole unit.⁸

Family Tax Benefits

2.14 A number of payments and tax concessions are available to provide assistance to families. These include the Family Tax Benefits (type A and B), the Child Care Benefit, and the Maternity Allowance (all administered by the Families Assistance Office) and the Parenting Payment (administered by Centrelink). The 2004/05 budget proposed abolishing the Maternity Allowance and another program, the 'Baby Bonus', and using those resources to fund a new 'Maternity Payment'. While some of these payments (such as the Maternity Allowance, the proposed Maternity Allowance, and the Parenting Payment) are provided as direct payments rather than as tax concessions, and may therefore be outside the terms of reference of this inquiry,

7 *Transcript of Evidence*, Blandthorn, 28 July 2003, pp.8-9

8 Submission 53, Women's Action Alliance, p. 8

submitters and witnesses made the point that in the area of family support, the welfare system and tax system have become so entwined that any attempt to separate them may in fact distort rather than illuminate.

2.15 Evidence before the Committee related primarily to Family Tax Benefit A, Family Tax Benefit B, the Parenting Payment, and the Child Care Benefit (which is dealt with in the next section).

Program descriptions

2.16 Before discussing evidence received in relation to these benefits, this section will outline the benefits themselves. These benefits are, by their nature, quite complex and this report can only give a very broad overview. Further information is available on the Family Assistance Office website at www.familyassist.gov.au and the Centrelink website at www.centrelink.gov.au.

Family Tax Benefit A

2.17 Family Tax Benefit A was established by the *Family Assistance Act 1999*, and came into operation on 1 July 2000. Its purpose is "to assist families with the cost of raising children."⁹ The benefit is means tested and varies according to the number and age of the children in the family. As the scheme stood in 2003, families earning \$31,755 per year or less were entitled to the full amount, while for a family with one child under 18 years of age, the benefit cut out completely once the family income reached \$85,702 per year. The maximum benefit for a family with one child under 13 years of age was \$3,401.80 per year.

2.18 Under the 2004/05 budget, Family Tax Benefit A will change in two key ways. There will be an annual increase to all recipients, regardless of income, of \$600. This will be paid as a lump sum when the recipient's end of year benefit reconciliation takes place. Second, the 'taper rate' for Family Tax Benefit A, that is, the rate at which the benefit reduces once the recipient earns too much to receive the full benefit, will decrease from 30 cents in the dollar to 20 cents in the dollar.¹⁰ This will mean that families earning more than the minimum threshold income will receive a higher benefit than they previously did.

2.19 Family Tax Benefit A (and Family Tax Benefit B) are payable in four ways:

- as regular payments into a bank account;
- as a lump sum payment into a bank account at the end of the year;
- by reductions in tax withheld by the parent's employer; and

9 Family Assistance Office, *Family Assistance Guide*, <http://www.facs.gov.au/faguide>

10 2004 Budget Paper No. 2, Part 1.

- as a lump sum rebate on the parent's tax return.

2.20 Family Tax Benefit A and B are therefore either part of the welfare system, or the tax system, or potentially both, depending on the payment choices made by the recipients.

Family Tax Benefit B

2.21 Family Tax Benefit B was also established by the *Family Assistance Act 1999*, and came into operation on 1 July 2000. Its purpose is 'to provide additional assistance to families with one main earner.' Sole parents automatically receive the maximum amount of Family Tax Benefit B, while partnered parents who are not their family's primary income earner can still receive some amount of Family Tax Benefit B provided their annual income is less than \$11,559. The maximum benefit for a child under 5 years of age is \$2,920 and for a child older than 5 years, \$2,036.70.

2.22 The payment options for Family Tax Benefit B are the same as those for Family Tax Benefit A. However, it should be noted that a recipient of both types of Family Tax Benefit can, if they wish, select a different payment option for each form of benefit.

2.23 Family Tax Benefit B was also amended during the 2004/05 budget. It was amended in three ways. First, the income limit for recipients receiving the full amount of Family Tax Benefit B has been raised to \$4000. Second, the taper rate has been reduced from 30 cents in the dollar to 20 cents in the dollar. Finally, where mothers who have been outside the paid workforce and in receipt of Family Tax Benefit B return to the paid workforce, their work income will not be counted against Family Tax Benefits already received.¹¹

Parenting Payment

2.24 The Parenting Payment is an income support payment under the *Social Security Act 1991* (Part 2.10). Its purpose is to provide primary carers of children with recognition of their parenting responsibilities, adequate income and opportunities for greater financial independence. It is payable to both sole and partnered parents who meet the relevant income, asset and participation tests.

2.25 The maximum Parenting Payment for singles is currently \$464.20 per fortnight. This payment begins to reduce once the parent earns \$144.60 per fortnight (for a sole parent with one child) and cuts out altogether when the parent earns \$1319.60 per fortnight.

2.26 The maximum Parenting Payment for a partnered parent is \$351.10 per fortnight. This begins to reduce if the recipient's income is greater than \$62 per fortnight or their partner's income is greater than \$587 per fortnight.

11 2004 Budget Paper No. 2, Part 1.

2.27 Since September 2003, Parenting Payment recipients whose youngest child is older than six years of age have had to attend an annual participation interview, and recipients whose youngest child is older than thirteen years of age have had to satisfy a part time participation requirement. [more]

Issues raised

2.28 Issues raised in relation to Family Tax Benefits and the Parenting Payment related primarily to:

- the application of means testing for Family Tax benefits;
- end of year reconciliations;
- the role of the parenting payment; and
- the complexity of the family tax/welfare system.

Means testing

2.29 A number of submissions argued that the application of a means test to Family Tax Benefit A is fundamentally inequitable and runs counter to the rationale for the payment. The Womens Action Alliance, for instance, stated:

The basic rate of family tax benefit part A really should apply to all families regardless of income, if it is going to be a true measure of horizontal equity. We recognise that that is unlikely to happen in the current environment but, as a matter of principle, I think it should be acknowledged that all families with children are deserving of support and that, at whatever level of income, you have a lesser capacity to pay tax if you are supporting children than if you are not. I think that is a basic principle that should underlie our system.¹²

2.30 The SDA argues that the means test is too harsh, resulting in families, who are in need, being unable to claim the full benefit:

Income limits applying to family payments are too low and need to be adjusted. Given the current level of withdrawal that applies to family tax benefit A, under the current situation you could have two shop assistants each earning \$507 a week. Because of the way the means test would apply to them, they would only receive the base and part of the additional payment of family tax benefit A. I do not think anyone in this room would regard a family earning two lots of \$507 a week as being high or even middle income earners, yet these people are not entitled to receive the full benefit of family tax benefit A.¹³

12 *Transcript of Evidence*, Beard, 28 July 2003, p. 47.

13 *Transcript of Evidence*, Blandthorn, 28 July 2003, p. 5.

2.31 The SDA made a similar point in relation to the Parenting Payment:

Parenting payment was introduced to help low-income families and also to recognise the caring role played by the person at home looking after dependants. The reality is that, because of the means test that applies, virtually nobody in the paid work force today is receiving the parenting payment. Parenting payment recipients are almost totally social security recipients.¹⁴

End of year reconciliations

2.32 A number of submissions raised concerns regarding the end of year reconciliation process for a person receiving family tax benefits on a more frequent basis. A recipient who has been unable to correctly estimate their income (and therefore their entitlement to receive the benefit) may find themselves indebted to the Commonwealth or, alternatively, may not claim the full benefit they are entitled to during the year. This issue will be discussed in more detail in relation to the Child Care benefit, where it has an especially significant impact.

2.33 In evidence, ACOSS outlined the nature of the problem:

One of those taxation principles which have caused a great deal of trouble is end-of-year reconciliation. Traditionally, social security payments do not have that end-of-year reconciliation, partly because information on incomes is collected more frequently than once annually. We actually advised the government through the bureaucracy at the time that it would be better to collect the income information more frequently and to avoid this end-of-year reconciliation process. We still think that that is the case, for exactly the reasons you raise. It particularly affects sole-parent families and 1½ earner families where the primary earner is on a low wage and where the family income hovers around \$30,000 to \$40,000 a year in that income test range. There are a lot of families in that range.¹⁵

2.34 Catholic Welfare Australia noted:

the current situation is that approximately 500,000 families are significantly indebted to the Commonwealth due to difficulties associated with forecasting their family income. This outcome is *prima [facie]* evidence of system failure in the administration of family taxation. Notwithstanding recent measures to give families more choices under the family tax model, the problems are endemic. The resulting indebtedness to the Government adversely affects families' wellbeing.¹⁶

2.35 In February 2003, the Commonwealth Ombudsman released a report on this issue, entitled *Own Motion Investigation into Family assistance administration and*

14 *Transcript of Evidence*, Blandthorn, 28 July 2003, p. 5.

15 *Transcript of Evidence*, Davidson, 29 July 2003, p. 32.

16 Submission 83, Catholic Welfare Australia, p. 11

impacts on Family Assistance Office Customers. The investigation was a result of some 1,855 complaints received regarding the Family Tax Benefits and the Child Care Benefit during the period 1 July 2000 to 3 September 2002.¹⁷ The report noted:

Many complaints related to family assistance debts that had arisen from income estimates. These generally arose because a parent's employment or income had unexpectedly changed during the course of the year. Even in cases where Centrelink was notified immediately and payments were adjusted for the rest of the financial year, there was still a debt at reconciliation.¹⁸

2.36 The Ombudsman outlined the problems associated with the current end of year reconciliation process:

Many families experience periods of low (or reduced income) within a year. During those times, they may have a significant need for the assistance available through family payments. Because family assistance entitlement is based on actual total taxable income over the year, those periods of lower income during the year are effectively averaged out. (Previous or later higher income periods can mean that any assistance provided in these low income periods becomes a debt.)

The new income assessment arrangements can also be difficult for families to understand, particularly because they are different to the income testing approach that applies to other Centrelink payments. Income testing for pensions and benefits use a person's rate of income at a particular point in time as the basis for calculating the payment rate for that fortnightly period. If the rate of income being received changes, the rate of payment changes and, providing Centrelink have been notified promptly, no overpayment will occur. However, under an income assessment based on actual, taxable income for the year in progress, the rate of payment can only be calculated on a forecast or estimate, and some overpayments are inevitable.

There has been a relatively high incidence of debts arising from the end-of-year income reconciliation process where fortnightly payments have been claimed (with the level of debt being relatively high in many cases). Some level of end-of-year adjustment is unavoidable under the family tax benefit system, given that payments during the year are based on a forecast of income. Our complaints also suggest that deficiencies in the clarity and availability of information and the approach taken to income changes notified during the year have increased the incidence and level of debts.¹⁹

17 Commonwealth Ombudsman, *Own Motion Investigation into Family assistance administration and impacts on Family Assistance Office Customers*, p.6.

18 Commonwealth Ombudsman, *Own Motion Investigation into Family assistance administration and impacts on Family Assistance Office Customers*, p.6.

19 Commonwealth Ombudsman, *Own Motion Investigation into Family assistance administration and impacts on Family Assistance Office Customers*, pp. 11-12.

2.37 In response to widespread public concern regarding debts arising from the end of year reconciliation process, the Government released a package entitled *More Choice For Families*.²⁰ This package did not contain measures to waive or relieve the debts of families whose income changes had resulted in unavoidable debts; rather, the system allowed them to elect to reduce their payments below their current entitlements, effectively 'paying off' the future debt before it became payable at the end of the year. The Committee notes that, even with the *More Choice For Families* measures in place, families who promptly inform Centrelink or the FAO of income changes end up with a debt to the government. The only change is that the debt can now be paid off incrementally – in advance.

2.38 The Ombudsman made a similar observation:

the analysis suggests that, even if my recommendations are adopted in full, the scheme is likely to continue to result in significant numbers of unavoidable debts for families.²¹

2.39 The 2004/05 budget contains two measures (both noted above) which may go some way to reducing the scale of this problem. The \$600 annual payment to Family Tax Benefit A recipients will be paid at the end of the year, upon completion of the end-of-year reconciliation. As a result, families who have unsuccessfully forecast their income, and who incur a debt, will have \$600 available to assist the repayment of that debt.

2.40 Second, the budget proposal to amend Family Tax Benefit B so that the income earned by a mother returning to work does not count against the Family Tax benefit B already received, reduces the likelihood of an end of year debt arising from Family Tax benefit B.

Participation requirements and the Parenting Payment

2.41 Submissions for this inquiry closed before the participation requirements for the Parenting Payment were introduced (in the *Family and Community Services Legislation Amendment (Australians Working Together and Other 2001 Budget Measures) Act 2003*). However, evidence before the Committee did argue against what were then proposals to introduce an activity requirement. The SDA, for instance, argued that a participation requirement for parents with a youngest child under 16 years of age devalued the work of a full time parent:

If a family decides to have a parent at home on a full-time basis they should be supported by government, not penalized. Forcing parents to justify to

20 The scheme was announced by Minister Vanstone on 19 September 2002, in a press release entitled *FTB Fine Tuning – More Choice and Flexibility for Families*. A fact sheet on the package is available in a range of languages at the following internet address: <http://www.familyassist.gov.au/Internet/FAO/FAO1.nsf/Publications/mhf.html>.

21 Commonwealth Ombudsman, *Own Motion Investigation into Family assistance administration and impacts on Family Assistance Office Customers*, p.10.

third parties why they choose to stay at home with their children, would be to put such families under enormous pressure.

The idea of requiring parents caring for children (those under 16 years) to attend regular interviews to discuss return to paid work is an unacceptable attack upon families.

Proposals to effectively discontinue parenting payments when a child reaches thirteen, currently the age barrier is sixteen, are of considerable concern. Is a child of thirteen old enough to come home alone to an empty house while their parent is at work? Such an initiative clearly implies that a caring parent of a thirteen year old is superfluous to requirements. Sixteen years should continue to be the minimum for withdrawal of support.²²

Complexity of the Family Tax/Welfare system

2.42 A number of submissions and witnesses noted that the current family assistance system, operating as a mix of direct payments and tax expenditures, has become extremely complex and consequently difficult for families to comply with. Catholic Welfare Australia described the situation in the following terms:

The ultimate cause of these problems is that the income transfer system in Australia seems to be like a house under constant renovation. Every few years Government will knock down a wall here, add a level there, excavate in this area, seal off that section. The result is a rather large and precarious structure in which many get lost and no one is very certain that everything really functions. The problems are so significant that the Australian system has become an example of a model to be avoided.²³

2.43 The Womans Action Alliance made a similar point:

I do not think you will find anybody who has anything to do with the current family payment system who will not acknowledge that it really is a mish-mash. It is extremely complicated; it is very confusing for users—even for those of us who deal with it from day to day and have some sort of knowledge of it. It has been built up over a number of years and payments have been put on payments and, while the government has made an effort to simplify it by combining what were previously 12 payments into three, what we really have now is a whole heap of different parts of three payments so, in effect, it really has not simplified things that much.²⁴

22 Submission 44, Shop Distributive and Allied Employees Association, p. 38.

23 Submission 83, Catholic Welfare Australia, p. 11

24 *Transcript of Evidence*, Beard, 28 July 2003, p. 47.

Support for the current system

2.44 While almost all of the evidence presented to the Committee in relation to the family assistance system was critical, the Committee did hear some statements of support. ACOSS, for instance, stated:

... in international terms our family tax benefit system is probably one of the best designed and targeted anywhere in the OECD from the standpoint of alleviating child poverty. And that is not just a feature of the present family tax benefit; that was a feature of previous reforms such as the family allowance supplement on which it built. It is actually much simpler than many overseas systems that have separate payments for working parents and jobless parents. With the FTB, those are rolled into the one payment, based on need and the costs of the children.²⁵

Child Care and the Tax System

2.45 Whilst the Child Care Benefit is delivered as a subsidy (in the form of reduced child care fees) rather than through the taxation system, a number of submissions and witnesses provided the Committee with views regarding it. There are a number of good reasons for the Committee to consider the Child Care Benefit in this report. First, it is clear that the Child Care Benefit is an integral part of the overall family assistance system. It would be remiss of the Committee to consider benefits such as Family Tax Benefits (A and B) and the Parenting Payment without also considering the impact of the Child Care Benefit. Second, the processes for assessing eligibility for the Child Care Benefit, reporting incomes, and reconciling the benefit at the end of the year, are all shared with the Family Tax Benefits. The Ombudsman, for instance, in the *Own Motion Investigation into Family assistance administration and impacts on Family Assistance Office Customers*, appeared essentially to treat the schemes as targeted variants of the same model.

2.46 Finally, a more direct reason for the Committee to consider this issue emerged from the evidence. It is clear that the rate and nature of workforce participation among parents (and particularly among sole parents and secondary income earners within couples) depends very much upon the availability and affordability of child care. Mr John Wicks, Vice President of the St Vincent de Paul Society's National Social Justice Committee, stated:

What we say is that financial stress will make sure you are poor; deprivation of opportunity will make sure you stay there. The important thing really is deprivation of opportunity, because if you have a temporary financial stress it may go on for a few years, but if you have equal opportunity to get out of it then you have solved the problem. Really what is more important than a short term family benefit here or there—and I am not saying you should not have that—is equality of opportunity in

25 *Transcript of Evidence*, Davidson, 29 July 2003, p. 32.

education, in training, in employment opportunities, in housing, in child care. Once you get that, the other side of poverty starts to decrease.²⁶

2.47 Dr Steve Hatfield Dodds from UnitingCare gave similar evidence:

Many people who we are working with are living in areas that are far away from the areas they need to work in. I have heard several stories from Sydney about people who are travelling an hour and a half each way every day to access work. That is not impossible, but it makes it very difficult if you are a single mum with two or three small children. Where do you leave them and how do you do that?²⁷

2.48 The SDA noted the relationship between formal child care and paid employment:

Overwhelmingly child care of a formal nature is used by parents in the paid workforce for work related purposes. In excess of 90% of long day care, family day care, outside school hours care and vacation care places are utilised for work purposes.²⁸

Program Description

2.49 The Child Care Benefit is a benefit paid in accordance with Section 42 of the *Family Assistance Act 1999*. According to the *Family Assistance Guide*, its aims are to:

- assist families with the cost of child care,
- provide incentives for low and middle income families with dependent children to participate in the:
 - (a) workforce, and
 - (b) community, and
- support parents in balancing work and family commitments.

2.50 The Child Care Benefit is means tested. Families earning less than \$31,755 per year receive the full benefit, which amounts to \$2.74 per hour, or up to \$137 per week if the maximum 50 hours of subsidised care are used. Over the \$31,755 threshold, the amount of the benefit begins to reduce. For single-child families with incomes in excess of \$91,035, the minimum amount (46 cents per hour, or a maximum of \$23 per week) is payable. There is no income limit at which support cuts out altogether.

2.51 Payments are available for children in *approved care* (essentially child care centres and some home based child care centres) and in *registered care* (care provided

26 *Transcript of Evidence*, Wicks, 28 July 2003, p. 38.

27 *Transcript of Evidence*, Hatfield Dodds, S, 28 July 2003, p. 29.

28 Submission 44, Shop Distributive and Allied Employees Association, p. 51.

by friends, grandparents, nannies or other carers registered with the Family Assistance Office).

Issues Raised

Availability of places

2.52 The availability of child care places clearly provide one potential barrier to workforce participation. A lack of available places has two effects: parents who cannot get their children into care cannot move back into the workforce; and market economics associated with an undersupply tend to lead to price increases for those parents whose children *are* in care.

2.53 Evidence before the Committee suggested that the overall number of child care places is sufficient, but that the distribution of places did not evenly match the distribution of need, resulting in localised undersupply of places. The SDA stated:

In total Australia has about 443,400 child care places available in 9,700 funded services.

At June 2000 estimated demand met for below school age children was 121.7%.

This suggests that overall Australia has sufficient child care places.

However, there are still areas of high local need, especially in rural and remote communities, because of the uneven distribution of places.²⁹

Adequacy of the payment

2.54 The maximum Child Care Benefit of \$2.74 per hour will be inadequate in most cases to pay the full costs of childcare. Evidence before the Committee suggested that \$4.30 per hour is a reasonable estimate of the cost of long day child care, though in some areas the cost will be significantly higher.³⁰ This clearly leaves a 'gap' which must be paid for by the parents. For a child using the full 50 hours of care per week, the gap on these figures would amount to \$78 per week, or \$4056 per year (from a total family income not exceeding \$31,755). This significant gap is effectively a cost of working, and may therefore restrict workforce participation.

2.55 The SDA stated:

We find that many low-income families cannot access child care because they cannot afford, effectively, to pay the gap between the level of assistance they receive and what else they need to pay. Meanwhile, families who look after their own children or do not utilise formal child care

29 Submission 44, Shop Distributive and Allied Employees Association, p. 51, citing the Department of Family and Community Affairs *Annual Report 1999-2000*.

30 *Transcript of Evidence*, Toohey, 28 July 2003, p. 66.

effectively get no support at all out of the system. The whole structure of child-care support, for example, is quite frankly a mess.³¹

Support for other forms of care

2.56 The Committee received some evidence that the child care benefit, or some equivalent benefit, should not be restricted to children in approved or registered care, but instead should be paid to all parents. The payments could therefore provide subsidised childcare for parents who wish to place their children in child care, and income support for parents who choose to forego working in order to stay at home with their children. The Women's Action Alliance stated:

We would prefer to see the same amount of money go to families with children at all of those ages—that is what a neutral system is supposed to do—and give families the option as to how they choose to spend that money, whether that be on child care, preschool or keeping their children at home with them, if that is what they choose.³²

End of year reconciliations

2.57 The Committee noted that the issue of families unavoidably becoming indebted to Centrelink as a result of changing incomes applies also to the Child Care benefit. This was the source of a substantial number of complaints to the Ombudsman prior to the *Own Motion Investigation into Family assistance administration and impacts on Family Assistance Office Customers*. The Committee has dealt with this issue above.

Families, Tax and HECS

2.58 Like the Child Care Benefit, the Higher Education Contribution Scheme (HECS) initially appears to be somewhat beyond the Committee's terms of reference. However, HECS is collected along with income tax, and may be viewed by many HECS payers as essentially a component of their income tax bill – analogous to the Medicare contribution, which is also collected alongside income tax.

2.59 The SDA argued that HECS had now become a significant impost on young graduates, many of whom are required to repay their HECS well before they achieve any elevated level of income:

The current impact of the Higher Education Contribution Scheme puts many low income students and families under pressure and operates as a disincentive for low income students to go to tertiary education.

When HECS was first introduced in 1989 debts were repayable at the rate of 1% on incomes greater than \$22,000. In today's terms that would equate to approximately \$32,000, given that in 1989 average weekly earnings were

31 *Transcript of Evidence*, Blandthorn, 28 July 2003, p. 10.

32 *Transcript of Evidence*, Beard, 28 July 2003, p. 49.

\$524.50 and in 2000 were \$761.50. Below that level, repayments were not required.

The Howard government cut the repayment threshold to \$20,701 in 1997-98, thereafter adjusted for movements in the average wage. Moreover the rate of repayment is now higher and generally varies between 3% and 4.5%. This is simply a tax impost by another name.

The HECS scheme should be remodelled to establish equity and fairness for young people. Adding to the current impost on young people and their families by increasing the burden upon those in tertiary education is unfair.³³

2.60 The Womens Action Alliance argued that the current HECS arrangements provide a significant disincentive to graduates, and especially female graduates, starting a family:

I think the HECS debt works in two ways. Firstly, when you are looking to start a family, having a HECS debt there is off-putting. The notion that you have an accumulating HECS debt can be a disincentive to taking time off from paid work to raise a family or care for a child. I think the reverse is also true: if you do take time out to care for a child and if you have a HECS debt sitting there accumulating while you are out of paid work, that is quite a disincentive to returning to paid work. It may well look to you as though it is not worth going back to paid work and having to repay a HECS debt that has been accumulating. We have made a recommendation that, while a spouse is out of paid employment caring for a family, their HECS debt should not accumulate during that time. There should not be any CPI interest on their HECS debt; it should remain as it was when they left the work force. They can return to it when they go back to work. Otherwise, it is just too difficult for families to face.³⁴

2.61 The WAA also argued that the threshold for HECS repayment should recognise the number of dependents the graduate supports:

we think it is appalling that the income threshold for HECS does not take into account the number of dependants that you have on an income. We have a member in South Australia who is at home. They have three small children. Her husband is a nurse; he is on an income of \$35,000 a year and he is repaying a HECS debt at the rate of \$100 a fortnight. That family is in such dire straits that they are receiving something like—I think I worked it out—\$8,500 dollars in family payments in recognition of the fact that this family are doing it tough, but the government is still requiring them to repay \$100 a fortnight in HECS repayments, despite the fact that this man is supporting five people on his \$35,000 a year. We think that is absolutely outrageous, and we think that HECS repayments need to be tailored according to the number of dependants upon that income. It is fine to start repaying your debt at \$24,000 or whatever if you are a single earner and are

33 Submission 44, Shop Distributive and Allied Employees Association, p.71

34 *Transcript of Evidence*, Beard, 28 July 2003, p. 52.

only supporting yourself, but if you are supporting dependants there should be some allowance within that to increase the amount of income that you are allowed to receive before you start repaying your HECS, dependent upon the number of dependants upon that income.³⁵

Lifetime Assessment

2.62 As a result of the breadth of the terms of reference for this inquiry, the Committee received a number of submissions advocating fundamental or innovative forms of tax reform. One of those was contained in the submission from Mr Gavin Moodie from the Office of the Vice Chancellor at Griffith University. His submission proposes assessment of the tax liability of adults over their entire lifetime, to be achieved by a final reconciliation upon their death. Mr Moodie's proposal can be summarised from his submission as follows:

Currently tax collections and benefit payments are assessed provisionally periodically throughout the year, fortnightly to quarterly depending on the circumstances. So any over- or under-payment of tax or benefits during the year are recovered at the end of the year when a final assessment is made. This has unfair results for people with income that varies significantly from year to year. Thus a person who earns \$30,000 in one year and \$0 in another year pays more tax than a person who earns \$15,000 in both years. The fairest tax collection system would average income over a whole lifetime.

The transfer system is means tested on current income and assets, but no attempt is made to recover benefits from recipients who subsequently acquire assets and/or income above, say, the Australian average. Furthermore, we have seen that very considerable benefits are transferred to people with superannuation funds, and these benefits are regressive, being of most value to high income earners. Again, no attempt is made to recover these benefits after they have served their purpose of encouraging saving/providing for retirement.

These inequities would be redressed by making each annual tax assessment and (re)payment provisional until a final reckoning upon death. Upon death the deceased's adult income would be summed. Included in income would be not only taxable income as presently defined, but also transfer payments received by the deceased person during their adult life. This would include benefits, but also major tax expenditures such as concessional treatment of superannuation income and major subsidies such as for the cost of specialised aged accommodation, personal care and health care in the last decades of life.

Set against the adult life income would be the income tax paid by the deceased while an adult. There would be a final tax assessment at an adult lifetime rate. Where the final assessment found that the deceased had paid more than the adult lifetime rate there would be an appropriate repayment to the deceased's estate. Where the final assessment found that the

deceased had paid less tax than the adult lifetime rate the additional payment would be levied against the deceased's estate. There would be a threshold value of an estate below which all additional assessed tax would be forgiven, say \$1 million. Above the threshold tax would be forgiven/collected at a tapering rate.³⁶

2.63 The Committee does not endorse the lifetime tax assessment model. Most of the evidence before the Committee, discussed earlier in this chapter, suggested that even an annual reconciliation may result in unfair and onerous debts incurred by taxpayers (in particular, recipients of Family Tax Benefit A and B, or the Child Care Benefit) notwithstanding that they had done everything they could to acquit their responsibilities. Evidence before the Committee suggests that the answer may lie in shorter, not longer, periods of acquittal.

Families in Rural and Regional Australia

2.64 The Committee is concerned that families in rural and regional Australia face a different set of challenges to those faced by families in major centres. The tax/welfare system designed to support families must ensure that it reflects these different challenges. Representatives of UnitingCare told the Committee about the particular challenges they face in supporting rural and regional families:

we provide services right across the country and right into remote areas, particularly through Frontier Services but also through our range of agencies. This is a really big issue. The Uniting Church subsidises most of our rural services and all of our remote rural services, particularly anything involving residential care. Any of you who know the situation in remote and rural Australia will know that it is often just impossible to get staff to come and work in agencies, so we pay for agency staff to come out. There are real issues of equity and justice there. As providers of community services we struggle with those issues every day.³⁷

2.65 The Country Women's Association of NSW suggested that the tax imposed on working families, who face the costs of living and working in regional Australia, may in fact be an incentive to move from paid work onto welfare:

A respondent from the Mid North Coast area writes that she and her husband earn \$43,000 a year, struggling to pay for a car and fuel to get to work. Her children have to work part-time to assist with the budget. Her children's peers - with parents on benefits - are funded under Youth Allowance - and have a comparative advantage with more available study time than those part-time working children of working families.³⁸

36 Submission 39, Griffith University, p. 13.

37 *Transcript of Evidence*, Hatfield Dodds, L, 28 July 2003, p. 20.

38 Submission 62, Country Women's Association of NSW, p. 5.

2.66 Some of the most compelling evidence on this issue came from the submission of Tony and Veronica Addicoat, residents of rural South Australia with two university-aged children. Excerpts from their submission indicate the particular challenges posed for rural and regional families by the current taxation system:

As the income into the household is \$70,000/year we do not receive many government benefits but our children must leave home to further their education. For the past three years we have supported our eldest child while she attended university in Adelaide, she will be continuing in 2003 doing an honours in chemistry. This year we will also have our youngest leave home to attend university to study law. [...]

City dwellers on our income receive the same family tax benefits as us and their children are able to live at home. This is discrimination against rural people as the cost of living in the country is higher. If the new tax system was fair then all Australians should pay the same tax. [...]

Living in the rural area also has the problem with health services. In order to access some services we have to travel to the city. The GST on petrol, motel accommodation and food when you are in this situation is immoral. If you have ever had to do an emergency trip to the city for health reasons then you will know that all else leaves your mind and you find the closest food, accommodation and transport. [...]

In all of this the rural area is suffering in many areas. Most of our money finds its way to the city to support our children. This means that we cannot afford to support our local businesses as we are doing without, even to the point of not being able to afford a raffle ticket for the local footy club, Lions, Rotary and all the other charities. This means that businesses close down and more services go and then it is even harder to get doctors, nurses, and teachers to come to the rural areas.

Maybe there should be a locality tax rebate of worthwhile proportions to rural wage earners on postcode or employment locality. It would have to be in the order of \$5000/year. It would not cover all the extra expenses of living in a rural community, but it would help.³⁹

2.67 The WA Farmers Federation supported the Addicoat's call for a rebate for rural and regional areas:

Zonal tax rebates are an effective means of compensating for loss/lack of government services (education, health, water, electricity, law & enforcement, transport access, access to labour) and directing people into regional and rural areas.⁴⁰

39 Submission 87, Tony and Veronica Addicoat, pp. 1-2.

40 Submission 60, WA Farmers Federation, p. 4.

Conclusions

2.68 The Committee received substantial evidence in relation to the impact of the current tax system on Australian families. While the Committee does not intend to make substantive recommendations in this report, a number of the ideas put to the Committee bear further consideration.

2.69 It is clear that any efforts to increase Australia's birth rate (by encouraging people to have more children, and to have them earlier) must be underpinned by changes to the tax system to encourage and reward the decision to have children. One way to do this may be to allow for income splitting or assessment of tax on the basis of a family income. It may also be appropriate to assess the threshold for HECS repayment on the basis of family income, or at least on a basis which recognises the number of dependents supported by the HECS debtor.

2.70 Substantial evidence in relation to the Family Tax Benefit, the Parenting Payment and the Child Care Benefit pointed to difficulties in the administration of these benefits which may result in families facing significant debts, and which may result in the assistance being poorly targeted, so that those in greatest need receive insufficient help.

2.71 Finally, the Committee recognises that any tax/welfare based family assistance system which seeks to achieve distributive justice must take into account the particular challenges faced by families in rural and regional areas.

CHAPTER THREE

THE TAX SYSTEM AND LOW INCOME EARNERS

3.1 The terms of reference for this inquiry do not explicitly mention the impact of the tax system on low income earners. However, one focus of the inquiry is on the *distributive effects* of the taxation system, which inherently suggests attention to those with lower wealth and incomes. In effect, all of the Committee's terms of reference invite the Committee to consider the effect of the tax system on low income earners, and a substantial amount of the evidence received from witnesses and submissions related to this issue.

3.2 That evidence highlighted a number of specific issues, which will be considered in this chapter. Those are:

- the link between this inquiry and the Senate Community Affairs Committee's Inquiry into Poverty and Financial Hardship;
- the level of the tax free threshold for income tax;
- income tax and 'bracket creep';
- the impact of high effective marginal tax rates;
- proposals for the use of income tax credits;
- the impact of the GST and regressive taxes on low income earners;
- the tax system and workforce participation;
- income tax as a disincentive to delayed retirement; and
- proposals for wealth taxes.

3.3 Like Chapter 2, a number of issues discussed in this chapter were affected by the 2004/05 budget. These changes will be noted as appropriate during the chapter.

The Senate Community Affairs Committee's Inquiry into Poverty and Financial Hardship

3.4 On 24 March 2004, the Senate Community Affairs References Committee tabled the report of its Inquiry into Poverty and Financial Hardship ('the Poverty Inquiry'), entitled *A hand up not a hand out: Renewing the fight against poverty*. As a result, for much of 2003, the Economics Committee and the Community Affairs Committee were both taking and considering evidence in relation to the impact of taxation on low income earners. A number of organisations made submissions or gave evidence to both inquiries.

3.5 Some stakeholders have asked the Committee to indicate the relationship between this report and *A hand up not a hand out*. The terms of reference for the Community Affairs committee and for this report were quite different, leading to some inevitable differences of focus between the two reports. In the case of this report, the broader ambit of the report is taxation, and the impact of taxation on low income earners is one component. For the Community Affairs Committee, the task was to consider the plight of those in poverty, and as a result tax was one component of their considerations. As a result, while the Committee will draw on *A hand up not a hand out* as appropriate during this chapter, the two reports should be seen as separate exercises.

3.6 Sections of *A hand up not a hand out* which are relevant to the current inquiry include:

- the latter part of Chapter Three, which deals with the impacts of taxes (including the GST), transfers and other benefits on poverty, and examines the distribution of wealth in Australia;
- Chapter Four, which examines unemployment and the labour market (and in particular the section on 'The working poor', from page 73 to page 84); and
- Chapter Five, which examines the social security system (and in particular the section entitled 'poverty traps', from page 117 to page 120, which examines the interaction between the tax and transfer systems in Australia, with a particular focus on effective marginal tax rates).

Level of the Tax Free Threshold

3.7 The tax free threshold for Pay As You Go (PAYG) taxpayers is set at \$6000 per annum. That is, no income tax is payable on the first \$6000 earned. The tax free threshold itself should not be confused with notions of an 'effective tax free threshold' which are sometimes discussed in public debate on taxation. 'Effective tax free thresholds' are essentially the value of the tax free threshold, plus the value of any taxation benefits (such as, for instance, the family tax benefit) to which the taxpayer may be entitled. The tax free threshold is universal, while 'effective tax free thresholds' depend on personal circumstances.

3.8 Two common concerns expressed about the current operation of the tax free threshold are that it is not necessary to offer the tax free threshold to all earners, and that the threshold itself is set at too low a level.

3.9 On the first of these issues, the concern is that all PAYG taxpayers earn the tax free threshold. A taxpayer earning \$10,000 per annum does not pay tax on the first \$6000 earned, but neither does a taxpayer on substantially more money. If the tax free threshold was withdrawn for higher income earners, the additional tax received could fund further tax relief for low and middle income earners. ACOSS observed this issue, but considered that it is relatively unimportant:

...the tax free threshold ... is the single most important element of progressivity in our income tax system. It offers the same flat exemption from tax for low-income earners as it does for high-income earners. Of course, it is proportionally of much more benefit to those at the bottom end. While some people would ask why that \$6000 exemption is offered to millionaires, my answer would be that it is not worth that much to them but it is worth a hell of a lot to someone on \$10,000.¹

3.10 The Centre for Independent Studies has, for some time, consistently argued that the tax free threshold should be raised, to take account of both inflation and the taxpayer's requirement for a basic level of 'subsistence' income. In evidence to the Poverty Inquiry, Professor Peter Saunders, Director of Social Policy Research at the Centre for Independent Studies, put this argument as follows:

I think it is an outrage that we tax people as soon as they hit \$6,000 of income when our welfare floor is \$12,500 of income. Presumably, our notion of what the absolute basic subsistence level is must be \$12,500 yet we start taking money away from people as soon as they earn \$6,000. Then we say, 'Good heavens, they are in poverty. We need to give them welfare.' So we are taking money out of one pocket and putting it into the other. I think the best solution to that is to raise the tax threshold back to where it was in 1980. If you had indexed the tax thresholds in 1980, we would now have a personal income tax threshold of \$14,000 before you paid a cent of income tax, not \$6,000.²

Income Tax and 'Bracket Creep'

3.11 The Committee received considerable evidence in relation to bracket creep, and in particular in relation to its impact on low and middle income earners. 'Bracket creep', as commonly used, in fact describes two different phenomena. The first arises from the impact of inflation upon constant income tax thresholds:

The cost of goods and services ... to consumers increases over time due to inflationary pressures. Such pressures drive increases in salary and wages so that consumers have the same buying power. However, as salary and wages increase, many consumers "creep" into a higher tax bracket under the current marginal tax rates. As a result, the effective tax rate of taxpayers increases, thereby reducing the effectiveness of their wage increase. Bracket creep leads to the situation that a consumer whose wage increases is linked to inflation will have a decreased buying power.³

3.12 The second arises from 'creeping' within tax brackets:

1 *Transcript of Evidence*, Davidson, 29 July 2003, p. 38.

2 Senate Community Affairs References Committee, *Transcript of Evidence*, Saunders, PR, 27 May 2003, p. 444.

3 Submission 61, Institute of Chartered Accountants in Australia, p. 19

Consider the following brief example: A taxpayer earning income [of] \$40,000 pays income tax of \$8980, representing an average tax rate of 22.45%. If the taxpayer earns \$45,000 they pay income tax of \$10,555. This represents an average tax rate 23.46%. This example demonstrates tax rate creep within brackets – without the taxpayer moving from the 30% tax bracket, their average tax rate goes up by more than 1%.⁴

3.13 These two phenomena result in what one submission described as 'covert increases in income tax revenues'.⁵ They result in wage earners maintaining their real gross wage, but facing higher levels of income tax.

3.14 The Committee received a range of evidence highlighting the impact of bracket creep on taxpayers and on government revenues. The Institute of Chartered Accountants stated that '*Taxpayers Australia* have estimated that one million taxpayers in Australia have moved into a higher tax bracket since the reduction in the marginal tax rates on 1 July 2000'.⁶

3.15 The Shop, Distributive and Allied Employees Association (SDA) stated in its submission that 'at least 250,000 workers moved into higher tax brackets during the period 1998-99 to 2000-01. The ranks of the over \$50,000 jumped from 16% of tax payers in 1998-99 to 19% in 2000-01'.⁷ In evidence, the SDA stated that 'since the GST came in, bracket creep has added approximately \$3 billion annually to government revenue'.⁸

3.16 A recent report by the Melbourne Institute in conjunction with *The Australian* gave the following detailed assessment of the impact of bracket creep:

If the [A New Tax System (ANTS)] tax reform would have included a policy to annually index tax thresholds by the CPI (corrected in 2000/01 for increases due to the introduction of GST in the ANTS package), then by 2005/6 the total personal income tax collected would be \$3.8 billion lower than it would be if there were no further increases in the tax thresholds other than the ones that took place in the last 2003/04 budget. This amount is calculated from the difference in total income tax under the two systems (a cost of roughly 4.3 billion dollars for the government) and is then adjusted for the difference in total rebates (a saving of roughly half a billion for the government). This \$3.8 billion is the dollar amount of bracket creep, expressed in first quarter 2004 dollars, and represents what it would cost to compensate the Australian tax payers for the extra amount of tax they

4 Submission 70, CPA Australia, p. 13

5 Submission 65, Southside Chamber of Commerce, p. 3.

6 Submission 61, Institute of Chartered Accountants in Australia, p. 19

7 Submission 44, Shop, Distributive and Allied Employees Association, p. 23.

8 *Transcript of Evidence*, Blandthorn, 28 July 2003, p. 3.

would pay in 2005/06 *as a result of inflation* as measured by the CPI since 2000/2001.⁹

3.17 While most of the evidence before the Committee saw bracket creep as a problem, this view was not unanimous. ACOSS stated:

Some argue that even if middle income-earners do not face high tax rates now, they will do so in the near future, due to the effects of income tax "bracket creep". These commentators raise the spectre of average wage earners being taxed at marginal tax rates of 42% or 47%.

As we argued above, this does not mean they will pay 42% or 47% on all of their income, only a small proportion of it. Low inflation rates have taken much of the sting out of "tax bracket creep", and there is no pressing need to reduce income tax just three years out from a \$12 billion a year tax cut.

In any event, average wage earners rarely face the top two marginal tax rates, or do so on just a small part of their income, because tax thresholds are raised from time to time to prevent this from happening.¹⁰

3.18 A number of those submissions which were concerned about bracket creep proposed solutions. The most common solution was to index the income tax thresholds to inflation. The Institute of Chartered Accountants, for instance, stated:

While there would be a major cost in indexing marginal tax rates, it should be noted that from 1 January 2000 Canada indexed its marginal tax rates without major detrimental effects to their revenue. Additionally, the cost of indexing marginal rates will be greater, the higher the inflation rate. Australia's inflation rate is currently at one of its lowest ever rates and so there is no better time than now to make this change.

Further, commentators argue that indexing marginal rates makes revenue planning difficult, as it is dependent on movements in inflation. However capping the increase if inflation goes beyond a certain percentage could avoid such a concern. For example, the marginal tax rates are indexed to CPI capped at 5% if CPI increases above this figure.¹¹

3.19 A related solution was suggested by CPA Australia, which would combine indexation with changes to the structure of the thresholds and the rate of taxation at each threshold:

CPA Australia submits that there are major efficiency gains to be achieved from lowering the income tax rates across the board in conjunction with a targeted rebate for low-income earners. Particular attention should be given to the marginal tax rates faced by middle and upper income earners. Consideration should be given to reducing the number of income tax

9 Buddelmeyer, Dawkins, Freebairn and Kelb (2004) *Bracket Creep, Effective Marginal Tax Rates and Alternative Tax Packages*, the Melbourne Institute, p.3.

10 Submission 85, ACOSS, p. 9.

11 Submission 61, Institute of Chartered Accountants in Australia, p. 20

brackets from the current five to three. Such a flattening of the personal tax rate scale would reduce bracket creep. Further, bracket creep could be completely fixed by indexation. All of these measures would provide taxpayers with greater incentive to work, save and invest.¹²

3.20 Finally, the Womens Action Alliance argued that the best solution was to index tax thresholds to average weekly earnings:

Women's Action Alliance believes that some form of tax indexation needs to be introduced, preferably based on a proportion of average weekly earnings, (eg: the tax free threshold applies to 15% of AWE, and so on up the scale).

This would provide a reasoned basis for the calculation of taxation, by recognising that, at a certain proportion of AWE citizens should not be required to pay tax, while at the other end, over a certain proportion (eg 175%) the top tax rate should apply.¹³

3.21 The 2004/05 budget reduced the impact of bracket creep for some voters by lifting the thresholds at which the 42% and 47% income tax rates apply. However, the income tax rates remain fixed rather than being indexed.

Effective Marginal Tax Rates

3.22 A large number of submissions before the Committee discussed the impact of high effective marginal tax rates (EMTRs) on low income earners. The prominence of the EMTR issue in this inquiry reflected its prominence within wider contemporary tax debates where it is seen, in the Committee's observation, as one of the most important issues to be dealt with in any reform of the tax/welfare system.

3.23 The term 'Effective Marginal Tax Rate' measures 'the percentage of a one dollar increase in income that is lost to income tax and income tests on government payments and services.'¹⁴ Intuitively, it is a somewhat misleading term, because the higher EMTRs result from the withdrawal of benefits rather than the application of additional taxation. Ultimately, the question is, if a taxpayer earns an additional dollar, how much better off are they, once the payment of tax and reduction of social security benefits are taken into account?

3.24 A recent report by the Melbourne Institute of Applied Economic and Social Research gave the following example:

Take the example of the jobless couple with two children. If one member of the couple secured a full-time job with a low wage rate of \$11.80 per hour - \$472 for a forty-hour week - the family's net after tax income would

12 Submission 70, CPA Australia, p. 13

13 Submission 53, Women's Action Alliance, p. 2.

14 Submission 101, Department of the Treasury, p. 18.

increase by only \$144.31 per week. The effective marginal tax rate on the wage income earned would be 69 per cent.

Why is this? First, they would pay \$65.10 in income tax. In addition they would have their income support payments reduced, losing \$173.65 of NewStart Allowance and \$127.05 of Parenting Payment. They would gain an additional \$38.11 in Family Tax Benefit, but in total the net loss of assistance would be \$262.59, a much larger effect than the \$65.10 income tax.¹⁵

3.25 Evidence before the Committee suggested that in some cases the EMTRs faced by people moving from welfare to work in Australia can be prohibitive. ACOSS provided the following table highlighting some taxpayers who face prohibitively high EMTRs:

Characteristics of tax-payer	Effective marginal tax rate on the next dollar of earnings (%)	Main reasons for this high marginal tax rate
Unemployed adult on Newstart Allowance	75%	Income test for Newstart Allowance, income tax at 17%
Low income family with one child in day care	70%	Income tests for Family Tax Benefit (Part A) and Child Care Benefit, income tax at 30%
Low income family with children aged 15 and 17 years	78%	Income tests for Family Tax Benefit (Part A) and Youth Allowance, income tax at 30%

Notes: "Low-income family" in these examples refers to families with incomes of around \$30,000 to \$40,000 per year.¹⁶

3.26 The Government of Queensland noted that 'High EMTRs, by reducing the return from earning additional income, possibly discourage low income earners from working more hours or acquiring further skills to enhance their employability, productivity and thus their standard of living.'¹⁷ UnitingCare stated that 'it is not commonly realised that many Australians on income support payments face effective marginal tax rates of more than 80%.¹⁸

3.27 The St. Vincent de Paul Society stated:

For the lowest income Australians, those receiving Unemployment or Parenting Payments and totally dependent on government benefits, when

15 Buddelmeyer, Dawkins, Freebairn and Kelb (2004) *Bracket Creep, Effective Marginal Tax Rates and Alternative Tax Packages*, the Melbourne Institute, p.13.

16 Submission 85, ACOSS, p. 22.

17 Submission 97, Queensland Government, p. 2.

18 Submission 74, UnitingCare, p. 1

seeking to move from welfare to work (a most desirable objective), suffer effective marginal taxation rates of between 60% and 110%, where even the richest person in the country who actually declares their income (and that is unlikely) would pay only 47%.¹⁹

3.28 Mr Tomas Nilson put the issue in these terms:

Ideally, we should have a progressive taxation system, but currently Australia's taxation systems combine to create what is effectively a regressive tax system, where the effective marginal tax rate for people on very low incomes can be much higher than the top actual marginal tax rate of 48.5%. In some instances the loss of welfare payments and other payments such as Austudy mean that a person can face effective tax rates of more than 100%. In other words, a family's total income can actually decrease if a member of that family finds work. This situation is extremely undesirable.²⁰

3.29 The SDA gave a summary of those most likely to be affected by high EMTRs, drawing on analysis from the National Centre for Social and Economic Modelling:

41% of couples with children and 36% of sole parents have EMTRs of 40% or above. In contrast only 18% of single people without children are in the same position. Clearly high EMTRs are more likely to impact on families with children.

If one looks at the situation of individuals with earnings it is even clearer that high EMTRs affect families. Of couples with children 54% have EMTRs above 40% and 79% of sole parents have EMTRs above 40%. 20% of couples with children and 51% of sole parents have EMTRs above 60%.

74% of all individuals with high EMTRs have at least one child aged under 16 years.²¹

3.30 The Department of the Treasury, while acknowledging the potential for high EMTRs to be an issue, considered that the issue has been largely dealt with by current policy:

One measure of the impact of taxation on income is the concept of the 'effective marginal tax rate' (EMTR). EMTRs measure the percentage of a one dollar increase in income that is lost to income tax and income tests on government payments and services. While high EMTRs are thought to provide a disincentive to earn additional income, it is not generally possible to isolate fully the actual influence of EMTRs on workforce participation.

With the introduction of *The New Tax System*, the Government reduced effective marginal tax rates (EMTRs) for low income families. The lowest

19 Submission 64, St Vincent de Paul Society, p. 11.

20 Submission 50, Nilson, p. 4.

21 Submission 44, SDA, p. 24.

marginal tax rate was reduced to 17 per cent, and taxpayers that had previously experienced 34 per cent and 43 per cent marginal tax rates had their top tax rate reduced to 30 per cent. Changes in tax thresholds also meant that the vast majority of Australian taxpayers were in the very broad tax bracket from \$20,001 through to \$50,000. At the same time, the income test taper rate on family payments for low income families (Family Tax Benefit (Part A)) was reduced from 50 per cent to 30 per cent, and the income test taper rate on pensions was reduced from 50 per cent to 40 per cent.

Although high EMTRs can still occur as a result of interactions between the tax and social security system, studies have shown that only a small proportion of the population experience them. A recent NATSEM study found that in 2002, since the introduction of *The New Tax System*, only 8 per cent of people faced EMTRs in excess of 60 per cent, and only 1 per cent faced EMTRs in excess of 80 per cent. NATSEM estimated that in 1997, under the previous tax system 3 per cent of people faced EMTRs in excess of 80 per cent, including 1 per cent who had EMTRs in excess of 100 per cent.²²

3.31 However another Commonwealth department, the Department of Family and Community Services, still sees high EMTRs as a problem:

Many people in paid employment now receive social security and pay income tax at the same time (a situation sometimes referred to as 'churning'). As a consequence, many households experience simultaneous income test and tax withdrawals from their overall income as their private income rises, producing discouragingly high effective marginal tax rates (EMTRs).²³

Policies to address high EMTRs

3.32 Submissions and witnesses provided the Committee with a number of means of addressing the problem posed by high EMTRs. These included:

- income tax credits;
- eliminating the 'stacking' of income tests for social security benefits;
- raising the tax free threshold and lowering the tax rate for low income earners; and
- consolidating the means tests for all forms of assistance;

22 Submission 101, Treasury, p. 18, footnote omitted.

23 Submission 98, Department of Family and Community Services, p. 17.

3.33 The proposal to raise the tax free threshold has been discussed above, and income tax credits will be discussed in the next section. The 'stacking' and consolidating of means testing can conveniently be considered together.

3.34 The Committee considers that use of income test thresholds for social security benefits is an appropriate way to direct these benefits to those in need. The concept behind income test thresholds is that, once a recipient is in receipt of a certain income, their entitlement to (and need for) the benefit is progressively withdrawn. The rate at which the benefit is withdrawn is intended to strike a balance between rewarding the recipient for working, and reducing the benefits payable, to allow that money to be directed to other, more needy recipients.

3.35 However the current system does not take account of the concurrent withdrawal of several forms of benefit. Stacking of income tests occurs when several different forms of benefit have income test thresholds which are very close to one another, or identical. The result may be that by crossing the threshold, the recipient begins to lose from all of those forms of benefit. This, in turn, upsets the balance between rewarding work and reducing payments.

3.36 ACROSS raised the issue of stacking of income tests in its submission to a recent Government consultation process:

The worst poverty traps occur when two or more income tests stack together (eg Family Tax Benefit, Youth Allowance, Child Care Benefit) subtracting 60-100 cents from every additional dollar earned.²⁴

3.37 The Government of Queensland stated:

A shift toward social security targeting has resulted in 'income test stacking', where multiple income tests overlap each other and income tax bracket thresholds. This has led to an increased incidence of high EMTRs faced by families since the early 1980s.²⁵

3.38 An obvious example is Family Tax Benefit A, and the Child Care Benefit. Both of these benefits begin to reduce once the recipient's family income reaches \$31,755. Once a recipient's income crosses that threshold, for each additional dollar they earn, they lose 30 cents in income tax, 30 cents from FTB(A)²⁶, and a proportion of their child care benefit (this proportion is highly variable depending on their circumstances).²⁷

24 *Fairness and Flexibility: Reform of the Workforce Age Social Security Payments in Australia*, June 2003, p. 90.

25 Submission 97, Queensland Government, p. 3, footnote omitted.

26 Following the 2004/05 budget the 'taper rate' for Family Tax Benefit A reduced to 20 cents in the dollar, consequently reducing the EMTRs for FTB(A) recipients.

27 In addition, of course, they pay the medicare levy of 1% from this dollar, and if they have HECS, a HECS debt repayment of 4% would be payable in 2003/04, but not from 2004/05.

3.39 It can be seen that as a result of this income stacking, the EMTR on dollar number 31,755 is 30% (i.e. income tax), while the EMTR on dollar number 31,756 is somewhere in excess of 60%²⁸. It is suggested that if these tests were not 'stacked' but rather were graduated: if, for instance, the threshold for Child Care Benefit were set at \$38,000, this would reduce the size of the increase in EMTR which occurs at \$31,755.

3.40 A study by NATSEM²⁹ in 1998 suggested that another way to deal with this issue would be to control the overall EMTR at any particular income level by consolidating the income tests for all forms of benefit, and then structuring the 'free area' (i.e. the income range within which the full benefit is payable) and the taper rates (i.e. the rates at which the benefit reduces, once the income threshold has been passed). This would bring all of the thresholds and taper rates within one system, where their impact on the recipient could be managed, preventing income test stacking which may result from various benefits being considered in isolation. However, this proposal was presented in conjunction with an argument for income tax reform, and the introduction of a system of tax credits. It also included the following noteworthy caution:

Policy solutions to alleviate high effective marginal tax rates are inevitably about tradeoffs between, for example, the level of the effective marginal tax rate and the range of income affected, between horizontal and vertical equity, between targeting and the level of disincentives. There is no perfect solution to the interface of tax and social security – just judgments about where to strike a balance between competing objectives.³⁰

Income Tax Credits

3.41 One potential solution to the problem posed by high EMTRs is the introduction of a system of income tax credits, also referred to as a 'negative income tax'. This proposal has been the subject of widespread discussion since the mid 1990s.

3.42 Essentially, a system of income tax credits would provide a certain number of 'credits' to each taxpayer (or, possibly, each family). The number could then be varied according to their circumstances (for example the number and age of children in the home, the presence of people with disabilities, or veterans, or other circumstances targeted by policy). These credits would then be redeemed against the taxpayer's tax obligations, reducing the amount of tax paid. If the number of credits held by a taxpayer exceeded the amount of tax payable, they would receive 'negative tax', that is, they would receive a payment through the tax system.

28 After the 2004/05 budget, this would be somewhere in excess of 50% due to the reduction in the Family Tax Benefit A taper rate.

29 Keating & Lambert (1998) *From Welfare to Work: Improving the Interface of Tax and Social Security*, NATSEM Discussion paper no. 35, October 1998.

30 Keating & Lambert (1998) *From Welfare to Work: Improving the Interface of Tax and Social Security*, NATSEM Discussion paper no. 35, October 1998, p. 21.

3.43 A flat rate of tax is often discussed for such a system (though it is not inherently necessary). With a flat tax in place, the progressive nature of the tax system would be preserved because tax credits would represent a much lower proportion of a high income earner's tax obligation, and a much higher proportion of a low income earner's tax obligation.

3.44 This system could be applied in several ways. At its most radical, the system could replace the current social security system altogether, delivering all forms of welfare benefits through the tax system. Keating and Lambert described this proposal in the following terms:

The simplest but most radical reform of the tax-transfer system to ensure a single marginal rate of tax would be to replace the whole system with what is commonly called a negative income tax. This would involve a set of universal tax credits, which could be varied – as now – according to the number of children a recipient had and any other identified needs, and a flat rate of tax levied as a percentage of taxable income above a threshold, which could be set as low as zero.³¹

3.45 A less radical form of income tax credits could see the system targeted to low income earners, and used to 'smooth out' the high EMTRs associated with the transition from welfare to work. There are a number of variables which could be used to target this system: varying the recipients, the base tax rates, and the number of credits. Dawkins et al observed that such systems make more sense than the radical proposal, which they described as 'not likely to be feasible'³²:

Alternative systems, which involve the tapering out of tax credits, variable tax rates, and some selectivity in who receives tax credits make the idea of a negative income tax look much more feasible.³³

3.46 A further refinement of this targeted option is the use of *earned* income tax credits, where the issue of tax credits is not universal, but is earned in some way. This is the system in use in the UK, US, and Australian schemes outlined below. In the US and UK schemes, the tax credits are earned by being in work, and earning a low income. They therefore provide an incentive to enter the workforce, but limit that incentive to those on low incomes. Under the Australian scheme, credits are earned by having a low income, whether the recipient is in paid work or not. In all of these systems the credits, once earned, are used to reduce the recipient's remaining tax obligations.

31 Keating & Lambert (1998) *From Welfare to Work: Improving the Interface of Tax and Social Security*, NATSEM Discussion paper no. 35, October 1998, p. 4. For clarity, it should be noted that Keating and Lambert did not endorse this radical version.

32 Dawkins, Beer, Harding, Johnson and Scutella (1998) "Towards a Negative Income Tax system for Australia," *The Australian Economic Review* vol 31, no. 3, p. 254.

33 Dawkins, Beer, Harding, Johnson and Scutella (1998) "Towards a Negative Income Tax system for Australia," *The Australian Economic Review* vol 31, no. 3, p. 254.

Examples of earned income tax credit schemes

The UK Working Tax Credit and Child Tax Credit

3.47 The UK's Working Tax Credit and Child Tax Credit schemes are interrelated tax credit schemes which replaced a range of pre-existing social security benefits.³⁴ The working tax credit is available to people who are in work for at least 16 hours per week (at least 30 hours for single people 25 and over). The credit varies according to income. An annual credit of £3000 is available to eligible recipients with an annual gross joint (i.e. family) income of £5000 or less. The amount of the credit tapers off, and becomes zero at an annual gross joint income of £15000. Additional tax credits are available for working parents who require full time child care, up to 70p for every £1 spent.

3.48 The Child Tax Credit is a benefit designed to assist parents to support their children. It is payable in addition to the Working Tax Credit, and is very similar in design. A family with an annual income of £5000 is entitled to annual credits of £1990 if they have one child, £3435 if they have two children, and £4880 if they have three children. If the Working Tax Credit is added in, these three families receive £4990, £6465 and £7880 respectively in total tax credits. The Child Tax Credit is extended to higher income earners than the Working Tax Credit, and cuts out completely at £60,000. Higher rates of tax credit are received in the year following the birth of a baby.

The US Earned Income Credit

3.49 The US Earned Income Credit scheme provides income credits to taxpayers who have earned income of less than US\$33,692 (for families with children) or \$US11,230 for single taxpayers without children, and who meet a number of other criteria related to residence and investment income. The threshold is then adjusted for married couples filing their tax returns jointly, and for households including more than one child.³⁵

3.50 The amount of credits available *increases* up to a peak as the taxpayer's income (and therefore their tax obligation) increases, up to a peak, then declines again until it reaches zero at the relevant income threshold. Thus, if a single taxpayer with one child, earns \$10,000 per annum they receive the full tax credit of \$2,547.

34 Information from this section is from the UK Inland Revenue website (www.inlandrevenue.gov.uk) and in particular from the publication *Child Tax Credit and Working Tax Credit – An Introduction*.

35 *Earned Income Credit*, US Department of the Treasury, Internal Revenue Service Publication 596.

However if they earn \$5000, their tax credit is \$1,709, and if they earn \$20,000, it is \$1541, in both cases less than the peak amount.³⁶

The Australian 'Working Credit' Scheme

3.51 Since September 2003, a form of income tax credits have operated in Australia on a much smaller scale than the schemes in the USA and UK. The 'Working Credit' Scheme formed part of the *Australians Working Together* package, and commenced in September 2003. It is targeted to zero income earners and very low income earners. Under the scheme, taxpayers accumulate a balance of tax credits for each fortnight that their income (excluding income from Centrelink) is low. The following table shows the rate at which credits accumulate:³⁷

Fortnightly Income	\$0	\$10	\$20	\$30	\$40	\$47	\$48+
Fortnightly Credits	48	38	28	18	8	1	0

3.52 A maximum of 1000 credits can be accumulated. When a credit-holder moves from welfare to work, the credits can be used to increase the amount of income they can earn before their Centrelink payment begins to reduce. One credit is equal to one dollar of additional income which may be earned, over the relevant threshold.

Difficulties with tax credit schemes

3.53 The biggest difficulty for the implementation of tax credit schemes is their cost. The study by Dawkins et al cited above found that for the 'radical' tax credit scheme, with all social security payments replaced by tax credits, a universal tax credit allocation and a flat tax, the flat tax would have to be 57% in order to maintain revenue neutrality. The authors note that 'such generous systems tend to be expensive and produce a high marginal tax rate ... this suggests that such a system is not, at present, likely to be acceptable politically.'³⁸ However, the Committee noted that a number of the other scenarios modelled by Dawkins et al required less onerous tax rates in order to meet revenue neutrality.

36 US Department of the Treasury, Internal Revenue Service Publication (2003), *Instructions for completing Income Tax Form 1040A*, 2003 Earned Income Credit (EIC) Table, pp. 45 – 49.

37 Table adapted from Centrelink (2003) *Building and Using your Working Credits*.

38 Dawkins, Beer, Harding, Johnson and Scutella (1998) "Towards a Negative Income Tax system for Australia," *The Australian Economic Review* vol 31, no. 3, p. 246.

3.54 As a general rule, the Committee observes that the cost associated with tax credit schemes depends upon the parameters of the scheme. Elements such as the following would all be important:

- the manner in which credits are obtained;
- the thresholds which apply to the accumulation of credits;
- the way in which other factors (such as children and disabilities) affect credit entitlement;
- the manner in which entitlement to credits tapers at higher income levels; and
- the underlying income tax system

3.55 Wider policy settings may also have an impact on the cost and efficacy of a tax credit scheme. The Department of Family and Community Services, citing an OECD study, stated:

the choice of a particular approach to making work pay and its likely effectiveness depends upon the other institutional and social policy settings in place. These include the level of minimum wages, the distribution of incomes, the nature of the family assistance and income support systems, prevailing labour market conditions and so on.³⁹

3.56 The Committee therefore considers that it is not a foregone conclusion that tax credit schemes will be prohibitively costly. Any judgment regarding the costs or public acceptability of a proposed scheme must be made once the details of the scheme are known.

3.57 Finally, the Committee agrees with CPA Australia's observation that 'tax credit systems ... are not a panacea or silver bullet to the problem of poverty traps.'⁴⁰ Under the current system, the challenge for policy makers is to find a solution which balances the provision of support to those in need with support for workplace participation, the costs of the welfare system, and the revenue needs which must be met by the tax system. If a comprehensive tax credit scheme were introduced, the need to successfully strike this balance would remain – all that would change would be the policy 'levers' available to do so.

The Goods and Services Tax and other regressive taxes

3.58 A range of submissions argued against the use of regressive taxes, charges and levies. A tax is described as 'regressive' if it 'takes a smaller proportion of income as the taxpayer's income rises.'⁴¹ As a result, any tax or charge which has a fixed

39 Submission 98, Department of Family and Community Services, p. 10.

40 Submission 70, CPA Australia, p. 16.

41 *Economics A-Z*, www.economist.com

price, regardless of the taxpayer's income, can be described as regressive, because the fixed price is a large proportion of a low income earner's income, and a small proportion of the high income earner's income.

3.59 The most common example discussed in submissions and evidence was the Goods and Services Tax (GST). The SDA described the regressive nature of the GST in the following terms:

The GST, excise, state and local taxes are by their very nature regressive. They do not take into account at all or sufficiently the capacity of a person or family to pay so they impact disproportionately on low-income families.⁴²

3.60 In its submission, the Society of St. Vincent de Paul stated:

Clearly the GST was heavily skewed in favour of the wealthy. This package adds a net percentage increase in the value of goods and services, regardless of the income of the purchaser.⁴³

3.61 In evidence, Mr John Wicks from St Vincent de Paul described the GST as follows:

The GST, above all, was a cruel ruse on low and middle income Australia, imposing a known regressive tax on them with ridiculously low levels of compensation whilst at the same time giving substantial gains in both direct compensation and lower prices for a wide range of luxury goods to the wealthy.⁴⁴

3.62 The GST was regarded by submitters as regressive for two reasons. The first, described above, is that the GST on a particular item is the same whether the item is purchased by a person with a high, middle or low income. The second reason is that low income earners are more likely to use most of their income for consumption (as opposed to saving or investment). As a result, a larger proportion of their transactions are likely to attract GST, thus exacerbating the regressive nature of the tax. Professor Cameron Rider and Ms Miranda Stewart, in their submission, stated:

The Goods and Services Tax, even with the basic food exemption, is regressive because low-income people spend all of their income, while high-income people save some income (or buy investments) and are thus not taxed by the GST on their savings.⁴⁵

3.63 The Southside Chamber of Commerce reported a similar finding from its own research:

42 *Transcript of Evidence*, Blandthorn, 28 July 2003, p. 3.

43 Submission 64, St Vincent de Paul Society, p. 9.

44 *Transcript of Evidence*, Wicks, 28 July 2003, p. 33.

45 Submission 76, Rider & Stewart, p. 2, fn.3.

The study also showed that the effects of the GST were regressive in that the less people earned the more they had to pay proportionally in tax. This was because all of their income was expended on living expenditure whereas the GST applied to the far lesser proportion of an affluent person's incomes spent on living expenses represented a lower percentage of total income.⁴⁶

3.64 As indicated in a number of the quotations above, the New Tax Package (which introduced the GST) included a package of measures intended to compensate low income earners for the regressive effects of the GST. The Society of St Vincent de Paul described those measures as 'ridiculously low'⁴⁷, while the Womens Action Alliance said:

While recognising that the package of assistance implemented at the time [the GST was implemented], particularly the Family Tax package, has gone some way to alleviate these burden for many families, WAA is concerned that there has been no authoritative research to assess the actual impact on families in real terms.⁴⁸

3.65 The society of St Vincent de Paul has proposed the following solution to the high incidence of the GST upon low income earners:

The St Vincent de Paul Society proposed the use of a smart card, that would have allowed poor households (on a graduated scale depending on income) a total exemption for all GST payments.⁴⁹

3.66 The GST is not the only regressive tax within the Australian tax system. Mr Paul Kenny, Senior Lecturer in Taxation Law at Flinders University, stated:

...in the 2001 income tax year, income tax accounted for 56.5% of total Commonwealth, State and Council taxes ... Indirect tax, though, constituted the other 43.5% of taxes. These indirect taxes include: the goods and services tax, taxes on financial and capital transactions, excises and levies, gambling taxes, insurance and motor vehicle taxes. These taxes are regressive since one's effective tax rate falls as one's ability to pay rises.⁵⁰

3.67 The Society of St Vincent de Paul drew attention to regressive taxes in the form of levies:

There are over \$100 billion of levies. These levies are widespread and they exist at both Commonwealth and State levels. Generally, these are not progressive. These include a wide array of agricultural levies (chickens,

46 Submission 65, Southside Chamber of Commerce, p. 9.

47 *Transcript of Evidence*, Wicks, 28 July 2003, p. 33.

48 Submission 53, Womens Action Alliance, p. 1.

49 Submission 64, St Vincent de Paul Society, p. 12.

50 Submission 89, Kenny, p. 1, fn. 2.

sheep, beef, sugar), as well as air fares, airports, insurance, emergency services, casinos, motor vehicle registration, stamp duty, driver's licenses, wine equalisation, etc. All of these fixed charges feed into the production costs of goods and services and thence trickle down to low and middle income earners in the prices they pay.⁵¹

3.68 It is important to note that tax expenditures can be regressive in the same way as taxes. This occurs when the size of the tax expenditure available is higher for high income earners than for low income earners. An example presented in evidence was the 30% rebate for private health insurance, which is regressive in that the rebate is 30% regardless of the means of the recipient, and is further regressive in that those on high incomes are more likely to be able to afford the remaining 70% of the private health insurance premium. Catholic Health Australia outlined this issue:

With private health insurance the poor pay the same amount as the rich but the relative impact on the poor is greater. And the argument that only the well off subscribe to private health insurance is false; many battlers, low income, elderly, disadvantaged, those on low incomes with children subscribe to it. The impact of queuing for needed health care, on low income workers in terms of their employment opportunities for example, is relatively greater than for those on high income who can afford to jump the queue. There may be scope to address equity objectives through a tiered system of premiums based on income and assets assessments.⁵²

3.69 They present as one remedial option a graduated system of rebates to make this system more progressive:

Increase the rebate to say 40% for low income earners and the elderly, and reduce the rebate to say 0% for high income earners so that its impact is more progressive rather than regressive. This would be designed to capture high income earners who may be subscribing to low cost private health insurance products for the sole purpose of avoiding the Medicare levy surcharge contribution.⁵³

3.70 The Committee noted, however, that while the private health insurance rebate may be regressive, it is one of a number of measures relating to the provision of health. High income earners pay a higher amount in terms of their medicare levy, if they do not take private health insurance they will be subject to a surcharge (which does not apply to low income earners) and, finally, by obtaining private medical treatment, patients reduce the pressure on the public health system, for the benefit of those patients who do not have private health insurance (including those who, as low income earners, may be unable to afford private health cover).

51 Submission 64, St Vincent de Paul Society, p. 9.

52 Submission 78, Catholic Health Australia, p. 13.

53 Submission 78, Catholic Health Australia, p. 13.

Impact of taxation on workforce participation

3.71 Concerns about workforce participation have underpinned almost every issue raised in Chapters 2 and 3 of this report. High effective marginal tax rates, the availability and cost of child care, difficulties associated with bracket creep, the operation of the Family Tax system, and the operation of the HECS scheme all have an impact upon the rewards received by a taxpayer who moves from welfare to work.

3.72 While workforce participation has therefore been a constant theme in this report, the Committee considers that this issue should not just be considered on a piecemeal basis. Submissions and evidence before the Committee suggested that one of the most important features of the Australian tax/transfer system should be that it promotes, facilitates and rewards workforce participation. UnitingCare, for instance, stated that 'providing practical pathways back into employment is one of the key planks of empowering individuals and addressing social exclusion, benefiting all Australians.'⁵⁴

3.73 The Senate Community Affairs References Committee, in its poverty inquiry report, put this issue in the following terms:

Unemployment, particularly long-term unemployment, is the most significant cause of poverty and disadvantage in the Australian community. In the immediate post-war years through to the mid-1970s, Australia, like most advanced Western countries, maintained very low levels of unemployment. Since the mid-1970s the achievement of full employment has progressively lost ground as a policy priority, with the consequence that large numbers of Australians have been denied this basic right to work. As a consequence, unemployment and underemployment have remained at unacceptably high levels for over two decades and this has led to major social and economic costs for the community.

Unemployment has serious economic, social and emotional impacts. Unemployment puts severe financial and emotional stresses on families and leads to a loss of self esteem and social status. These can lead to family conflict and separations; to psychological and physical health problems; to homelessness and to a range of disadvantages for children growing up in these families. The effects of unemployment, however, reverberate beyond the jobless – unemployment reduces economic output and national income and the wider community is adversely affected with further demands placed on governments via the social security system and on the charitable sector.⁵⁵

3.74 The observations of the Community Affairs Committee highlights the view that the benefits from workforce participation are not restricted to the economic benefits associated with earning a wage. This view was also expressed in a number of

54 Submission 74, UnitingCare, p. 1

55 Senate Community Affairs References Committee, *A hand up not a hand out: Renewing the fight against poverty*, p. 55.

submissions to the current inquiry. The Department of Family and Community Services, for instance, stated:

Individuals choose to work for many reasons – because they wish to be self-reliant and contribute to their own support, for the social engagement work offers, and to ensure a more secure economic future for themselves and their children. The participation preferences of individuals are also influenced by individual capacity and opportunities.⁵⁶

3.75 A number of submissions put the view that the tax system, as currently structured, hinders job seekers. The Australian Chamber of Commerce and Industry, for instance, stated that income tax dampens personal initiative:

At the most basic level high marginal income tax rates act to discourage personal initiative and effort. With impaired incentives to work harder, seek promotion or augment their human capital through vocational training, there is a corresponding reduction in the willingness on the part of employees to undertake these activities.

[...]

The effect on the broader economy is detrimental. Reduced workforce participation results in lower GDP per capita, while a less skilled workforce means decreased productivity. This adds up to a lower standard of living for all Australians.⁵⁷

3.76 The Country Women's Association of NSW identified payroll tax as a significant impediment to employers creating new jobs (and, consequently, an impediment to potential employees moving into those jobs).⁵⁸ While payroll taxes are levied by states and territories, not by the Commonwealth, the CWA's submission is an important reminder that Commonwealth taxes form only one part of the overall tax burden upon those moving from welfare to work, and that the state and territory tax systems may also facilitate or inhibit workforce participation.

The tax system and retirement from the workforce

3.77 Just as the decision to move into the workforce is heavily influenced by the individual's economic circumstances, so too is the decision to retire from the workforce. In particular, a worker's decision on when to retire from the workforce is likely to be influenced by their eligibility for superannuation or a pension, and the difference in income associated with moving from the workforce to retirement.

3.78 The current direction of policy is to encourage older workers to remain in the workforce as long as possible. The recent Treasury discussion paper *Australia's Demographic Challenges* explains why this is so:

56 Submission 98, Department of Family and Community Services, p. 6.

57 Submission 104, ACCI, p. 3.

58 Submission 62, Country Women's Association of NSW, p. 5.

The Australian Government's Intergenerational Report (IGR) projects that over the next 40 years, the proportion of the population aged over 65 years will almost double to around 25 per cent. At the same time, growth in the population of traditional workforce age – 15 to 64 – is expected to slow to almost zero.

Over time, the ageing of our population will result in a greater demand for Age Pensions and health and aged care spending. And the need to keep up with changing technology and community expectations of accessing the most advanced diagnostic tests and medical treatments is putting ever increasing demands on health spending.

The Government's preferred solution to this challenge is to implement policies designed to grow the economy more quickly. A larger economy will provide us with higher incomes, improved living standards and better enable us to meet the costs associated with our ageing population.

The best way to achieve higher economic growth is via increases in labour force participation and productivity.⁵⁹

3.79 The Committee considers that the taxation system has a role to play in this area. Tax policies which promote continued workforce participation, reward work, and reduce the rewards associated with earlier retirement, will assist the policy objective outlined above. In its submission to this inquiry, Treasury stated:

By international standards, the participation rate in Australia among women generally and mature aged is low. The structure of the tax and retirement income systems (as well as the income support system and other policies) should take account of their impacts on labour force participation.⁶⁰

3.80 One tax policy which rewards retirement is the Senior Australians Tax Offset. In its submission, the Department of Family and Community Services outlined the scheme:

The value of the Senior Australians tax offset means that qualifying single self-funded retirees and age pensioners have an effective tax-free threshold of \$20,000. These people pay no income tax until their taxable income exceeds \$20,000. The effective tax-free threshold for a couple on equal incomes is \$32,612.

In addition, the Medicare levy threshold for senior Australians was lifted from its 1999-2000 rate of \$13,550 to \$20,000 so that a senior Australian is exempt from the Medicare levy until he or she has taxable income above that amount.⁶¹

3.81 Witnesses before the Committee pointed to this issue as one which may be a target for reform:

59 Treasury, *Australia's Demographic Challenges*, p.1.

60 Submission 101, Department of the Treasury, p. 18.

61 Submission 98, Department of Family and Community Services, p. 26.

The third pressure (on the tax system) is the future cost of the privileged tax treatment of retirees. For example, the senior Australians tax offset offers retired couples a tax free threshold of \$30,000, five times that for other taxpayers, and it does not cut out completely until that couple earns almost \$60,000 a year. The cost of tax concessions like this will escalate as the population ages, yet as far as we are aware, it has not even been modelled.⁶²

3.82 In response to a question from the Committee about whether this form of preferential tax treatment for retirees was likely to result in 'generational rage', the same witness stated:

Most younger and middle aged people have not fully cottoned on to the effective tax free thresholds of many retirees. As they do, that problem will emerge and so they should be outraged. But I come back to an earlier point. If the retired population and the future retired population—those currently over 50, for example—want a guarantee of decent services, be it health or aged care, they are going to have to be prepared to forgo some of these excessively generous and costly tax concessions. As there are more of them in the population, governments will not be able to afford both. In that sense, it is in the interests of the retired population to reconsider some of these generous tax concessions that they receive. Unfortunately, it is largely a vocal, organised and well-off minority who command the floor in public debate around taxation and income support for retired people. Until that changes, those changes will be difficult to achieve.⁶³

3.83 However, this view was not unanimous, and the above evidence was immediately countered by another witness, who stated:

... two of the features which I think are part of that low tax scenario on the self-funded retiree that Senator Watson just referred to are neither concessions nor generous but simply fair and reasonable things to do. One of them is the taxation treatment of the undeducted purchase price. That is not a concession; it is simply a matter of preventing double taxation or taxing something which is a return of the person's own capital rather than true income. Another feature is the 15 per cent rebate arrangement, which again is neither an act of generosity nor a concession but simply a recognition that 15 percentage points of tax was paid at the time the money went into the superannuation fund either in the form of employer contributions or 15 per cent taxed earnings. So that 15 per cent rebate is not generous and not a concession. It is a recognition of tax that has already been paid.⁶⁴

3.84 Indeed, much of the evidence presented to the Committee called for more, rather than less, generous tax treatment of superannuation. The Institute of Chartered Accountants took up the issue raised above by Professor Covick:

62 *Transcript of Evidence*, Davidson, 2 December 2003, p. 11.

63 *Transcript of Evidence*, Davidson, 2 December 2003, pp. 23-24.

64 *Transcript of Evidence*, Covick, 2 December 2003, p. 24.

Superannuation is taxed twice on entry (the additional being the surcharge) while in the fund and on exit. Four separate taxing points cannot be efficient.⁶⁵

3.85 The Association of Superannuation Funds of Australia argued:

The relative tax advantage accruing to superannuation has decreased in recent years with both cuts in personal income tax rates and an increase in the number of individuals subject to the superannuation contributions surcharge.

This decrease in the tax attractiveness of superannuation has been particularly in regard to contributions, but less so in absolute and relative terms in regard to superannuation investment earnings.

ASFA suggests that a reform priority should be removing or reducing the tax on contributions. If the contributions tax were completely removed, it would reduce the retirement savings target by 2 or 3% of wages, making it considerably easier and more achievable for individuals. So instead of having to save 15% of wages to fund an adequate retirement income, individuals would only have to save 12 or 13%.⁶⁶

Wealth taxes

3.86 There was an argument from some submitters that a 'wealth tax', either in the form of an additional tax bracket or as an independent tax, should be imposed on those with very high incomes. The SDA outlined the rationale for this proposal:

Australia is now estimated to have more than 100,000 millionaires, and the number of people with estimated incomes of more than \$1 million has more than doubled in just five years to about 600. The richest 10 percent of our families have 44 percent of the wealth.

[...]

There is a strong argument for the imposition of a wealth tax on those with substantial wealth.

A wealth tax would reduce the wealth gap and help fund the establishment of greater vertical and horizontal equity in the system.

In some ways Australia has an unfair taxation system. There are still loopholes which can be exploited to allow some high earners and businesses to pay less than their fair share of tax.⁶⁷

3.87 Another submitter, Mr Loris Hemlof, suggested a 5% tax on personal wealth in excess of \$80,000.⁶⁸

65 Submission 61, Institute of Chartered Accountants in Australia, p. 29.

66 Submission 108, Association of Superannuation Funds of Australia, p. 2.

67 Submission 44, Shop, Distributive and Allied Employees Association, p. 28.

68 Submission 93, Hemlof, p. 2.

3.88 UnitingCare suggested the introduction of 'estate and gift duties at a level that at least captures major asset transfer by Australia's wealthiest 10 percent of taxpayers.'⁶⁹

Conclusions

3.89 It is clear from the evidence before the Committee that the structure of the income tax system is seen as a significant challenge for low income earners in Australia. There are arguments that the tax free threshold (and, indeed, all of the income tax thresholds) is set too low, and that bracket creep (both within and between brackets) results in tax increases by stealth.

3.90 Evidence pointed to the major challenge posed by high effective marginal tax rates for people attempting to move from welfare to work. These effective marginal tax rates may be prohibitive, and are at least discouraging. A number of options exist to address high EMTRs, including the introduction of tax credits and the elimination of 'stacking' of income tests.

3.91 Further, evidence pointed to the impact of regressive taxes on low income earners. These taxes, charges and levies do not take account of ability to pay, and therefore constitute a much larger proportion of the income of a low income earner.

3.92 All of these issues, together with those discussed in Chapter 2, have an impact on workforce participation. Evidence supported changes to the tax system which will maximise workforce participation, particularly given the future costs which will be associated with Australia's ageing population.

69 Submission 74, UnitingCare Australia, p. 2.

CHAPTER FOUR

COMPLIANCE AND THE CASH ECONOMY

4.1 The effectiveness of the Australian tax system in collecting revenue fairly and equitably depends very much upon the extent of compliance with the system. If taxpayers and businesses wish to, and are able to, avoid paying their fair share of taxes, then the system will be distorted into two groups: those who are able to find ways around paying their tax, and those who must pay additional tax to compensate.

4.2 In this chapter, the Committee discusses various issues relating to tax avoidance, including the existence and operation of the illegal 'cash economy.' This chapter is divided into three major sections:

- the context of compliance
 - tax as a social responsibility;
 - resentment at those not paying their fair share;
- vehicles for avoidance and barriers to compliance;
 - trusts as a vehicle for tax avoidance;
 - contracting and subcontracting arrangements as a vehicle for tax avoidance;
 - tax system complexity as a barrier to compliance;
- the cash economy
 - the size of the cash economy;
 - the cash economy and social security fraud;
 - the operation and effectiveness of the Cash Economy Task Force.

The context of compliance

Social responsibility: paying taxes is the right thing to do

4.3 At the heart of the issue of compliance is the simple proposition that paying tax is an important social duty. The Australian Tax Office (ATO) explains to new taxpayers that 'Taxes that are paid to the Commonwealth Government are used to

provide services to the community such as health, education, defence, roads and railways, social security and welfare.¹

4.4 Sir Nicholas Montagu, head of the UK Board of Inland Revenue, visited Australia and met with the Committee during its deliberations. The UK is currently engaging in a major campaign to emphasise taxpaying as a social obligation or 'badge of citizenship'. During a public lecture, Sir Nicholas stated:

Tax morality is not a new idea, but I think it is one which is often neglected. It is about duties. It's about the link between taxes and the public goods which they provide I think that the argument on morality starts with the purposes of the tax system, and that is essentially to pay for the spending objectives of the democratically elected government, and to do so in a way that either directly furthers, or at the very least does not impede, their wider aims.²

4.5 Oliver Wendell Holmes, a former US Supreme Court Justice, encapsulated this concept neatly in the often-quoted remark that "Taxes are what we pay for a civilised society."

4.6 If it is accepted that payment of taxes is a social responsibility, then it follows that avoiding or evading tax is socially irresponsible. Those avoiding paying their tax claim the benefits of the public goods provided by taxation, without contributing to them in accordance with their means. It also follows that emphasising taxpaying as a social responsibility may be one way of increasing compliance.

4.7 An entire field of research, variously described as 'tax psychology', 'tax morality' and 'tax ethics', has emerged to study the social factors which lead to tax avoidance and tax compliance. In a previous report, this Committee noted that this body of literature:

... increasingly recognises that regulatory enforcement is only one, and not necessarily the most effective way of achieving a desired outcome. Or, putting the point differently, it recognises that tax planning and paying behaviours arise out of particular contexts and cultures. Understanding and addressing the political, social and psychological background of those behaviours may assist agencies to promote compliance far more effectively, than an approach which relies purely on the threat of enforcement or punishment.³

4.8 The Committee remains committed to that view. A number of submissions to this inquiry, particularly those from private individuals, supported the view that many

1 Australian Tax Office, *Entering the Australian Tax System – What You Need to Know*, p.4.

2 Sir Nicholas Montagu, *Tax Morality: Paying Tax as a 'Badge of Citizenship'*, Speech to the National Institute of Economics and Business, Canberra, October 2003.

3 Senate Economics References Committee, *Inquiry into Mass Marketed Tax Effective Schemes and Investor Protection* (February 2002), p. 18.

taxpayers see paying tax as a social duty, and are often quietly proud of the fact that they pay their taxes. Mr Gary Lang, for instance, stated:

Contrary to the views of most Governments, most people realize that taxes are unavoidable and a necessary component of our economy. I personally would not mind paying more taxes provided that I could see direct benefits. Where everyone gets annoyed and frustrated is when we see so many areas within Government both state and Federal ... where tax money is wasted.⁴

4.9 Mr Jock McIlwain stated:

I am a 76 year old self funded retiree who believes that, despite the current taxation system, I have accumulated sufficient capital, through frugality, rigid savings and careful investment, to see out my own and my wife's remaining years. We will not be a burden on current taxpayers and have not and will not seek or require any assistance from the welfare system. We both pay tax.⁵

4.10 Mrs Helen Booth stated that 'on the whole most fair minded Australians want a fairer more equitable system where we can be assured that the funds are put [to] good use for services that we will all benefit from.'⁶

4.11 Mr Colin Smith stated that 'I have been a PAYE⁷ taxpayer all my working life' but noted that 'I have always known that the tax system has never been a fair and equitable form of taxation. The rich get richer and the poor get poorer.'⁸

4.12 Recent evidence seems to indicate that a growing number of Australians are happy to pay tax, and would in fact forego tax cuts, or even support tax increases, in order to facilitate government spending in areas important to them:

One longstanding and legitimate criticism of public opinion research that finds support for higher public spending is that such research rarely asks the voter to consider the fiscal costs – usually tax rises – of such spending. Our findings here deal with this criticism directly by asking respondents to indicate their willingness to pay more tax for more spending for a range of public services. Our results show quite overwhelming support for a tax increase if it is modest and spent on Medicare and/or public education. And we find the proportion of Australians who unconditionally oppose a tax increase to improve services in the three social service areas of health, schools and welfare benefits is actually small – 19 percent of the electorate ... our findings do indicate that the public is more likely to consider tax increases to pay for improved services than it has in the recent past. For

4 Submission 45, Lang, p. 1.

5 Submission 7, McIlwain, p.1.

6 Submission 9, Booth, p. 1.

7 'Pay As You Earn', a previous descriptor for income tax.

8 Submission 34, Smith, p. 1.

policies to remain focussed only on cutting taxes appears to misread the public mood.⁹

4.13 While the Committee recognises that some of the respondents to the survey discussed in this quotation may have been tax avoiders or those with smaller tax responsibilities (who therefore have little to gain from tax cuts), it remains the case that support for social spending exceeded support for tax cuts even in the groups most likely to be paying PAYG taxes.¹⁰

	Social Spending	Depends	Reduce Taxes
Working full time (n=1608)	46	22	32
Working part time (n=539)	49	24	27
Household duties (n=384)	41	30	29
Retired from paid work (n=811)	56	22	22
Full time student (n=115)	60	21	19

4.14 The view that tax should be complied with as a matter of social responsibility also extends to compliance by the business community. The Ralph Review of Business Taxation discussed tax avoidance by businesses in the following terms:

Tax avoidance may be characterised as a mis-use or abuse of the law rather than a disregard for it. It is often driven by the exploitation of structural loopholes in the law to achieve tax outcomes that were not intended by the Parliament but also includes manipulation of the law and a focus on form and legal effect rather than substance. The way things are done in order to take advantage of structural loopholes, or dress up or characterise something to satisfy form but not substance can also stamp an arrangement as avoidance. Tax avoidance represents a serious threat to the integrity of the tax system and to the revenue. It is also a form of subsidy from those paying their fair share of tax according to the intention of the law to those shirking their similar obligations.¹¹

9 Breusch & Wilson (2004) "After the Tax Revolt", *Australian Journal of Social Issues*, Vol 39 No. 2 May 2004.

10 Adapted from Breusch & Wilson (2004) "After the Tax Revolt", *Australian Journal of Social Issues*, Vol 39 No. 2 May 2004, Table 4.

11 *A Tax System Redesigned*, July 1999 p. 243.

Resentment at those not paying their fair share

4.15 Some of the witnesses cited in the previous section, and the excerpt from the Ralph Review of Business Taxation, canvassed the issue of fairness in the system. When a taxpayer evades their tax responsibilities, the need for taxation does not disappear – it is redistributed among those who *do* pay their taxes appropriately. This results in substantial resentment among those paying their fair share. Such resentment was clearly evident from submissions before this Committee. The Southside Chamber of Commerce, for instance, stated:

Some people are altruistic, high minded, ethical, disciplined, conscientious and generous citizens. Others are self-obsessed, cynical, amoral, malcontent, cunning and predatory opportunists. Most people are somewhere in between, most respect the law, a few think they'll get caught if they don't, and a few more again defiantly flouting it.

[...] it is human nature to resent it when other people are undeservedly given preferential treatment.

The obvious tax minimisation activities of the affluent are an affront to the hard working people who must endure the inequities of a patently inequitable tax system without such recourse to relief.

Their silent resentment is building and building.¹²

4.16 A number of submissions suggested that this resentment increased the likelihood that a taxpayer would also seek unfairly to avoid their tax responsibilities. The St Vincent de Paul society noted that 'when people can see patently that wealth is not being taxed and is not paying its fair share, you will never get compliance from the majority of the population who regard tax evasion as fair game.'¹³

4.17 Mr Paul Kenny, Senior Lecturer in Taxation Law at Flinders University, stated:

If the tax system and its administration are seen to press heavily on some but lightly on other taxpayers in essentially the same circumstances, with essentially the same tax paying capability, then the confidence of the citizenry in the fairness and justness of the system, of their government, erodes. Cynicism grows apace and a race not to be left out of the tax minimisation derby, by hook or by crook, infects the body politic.¹⁴

4.18 Sir Nicholas Montagu from the UK Board of Inland Revenue indicated that this phenomenon is not unique to Australia. He stated that tax avoidance:

12 Submission 65, Southside Chamber of Commerce, p. 18.

13 *Transcript of Evidence*, Wicks, 28 July 2003, p. 44.

14 Submission 89, Kenny, p. 14, quoting Pederick, W (1984) 'Fair and square taxation in Australia'.

... undermines the integrity of the tax system by being perceived to be unfair by taxpayers who want to pay their fair share. Eventually it becomes corrosive by persuading those people that they too should pay less.¹⁵

4.19 As a result, it appears that increasing compliance, and so increasing the perceived fairness of the tax system, pays a double dividend: additional tax revenue from those evading or avoiding their tax obligations, and a decreased likelihood that other taxpayers will seek to avoid their tax obligations.

Vehicles for avoidance and barriers to compliance

Trusts as a vehicle for tax avoidance

4.20 A substantial number of submissions criticised the use of trusts as a vehicle for tax avoidance. There are a wide range of trusts under Australian law. While some submissions did not specifically identify the form of trust which concerned them, in most cases it can be assumed that they were referring to *discretionary trusts*. Discretionary trusts are those in which 'trustees choose which beneficiaries will receive distributions of income or capital, and how much each will receive.'¹⁶

4.21 The most prominent concern expressed about the use of trusts is that taxpayers may use them as a conduit of funds, thereby avoiding a PAYG liability on those earnings.

4.22 The St Vincent de Paul Society expressed this concern in the following terms:

There are many valid reasons for setting up trusts. We do not challenge the concept. Trusts do, however, bring with them certain tax consequences, usually mitigation of tax liability. Those who establish trusts solely for the purpose of tax mitigation do so to avoid carrying their fair share of the burden of society, leaving it to others. We would like to see this practice regulated out of existence.¹⁷

4.23 Mr Thomas Nilsson expressed the following concerns:

The vast majority of trusts are set up with the primary purpose of avoiding tax that should be paid by high income earners and thereby transferring the burden on to the rest of us. It is these trusts that are typically referred to as 'legitimate family trusts'. In reality, There are almost no trusts in Australia established for legitimate purposes.

[...]

The current opportunity for family trusts to be used as a means of tax avoidance should be abolished immediately by the Commonwealth. This

15 Sir Nicholas Montagu, *Tax Morality: Paying Tax as a 'Badge of Citizenship'*, Speech to the National Institute of Economics and Business, Canberra, October 2003.

16 Board of Taxation *Taxation of Discretionary Trusts*, November 2002, p. 6.

17 *Transcript of Evidence*, Wicks, 28 July 2003, p. 33.

step is an absolute must in preserving the integrity of Australia's taxation system and ensuring the Commonwealth's continuing ability to provide services to the Australian public.¹⁸

Current tax arrangements for discretionary trusts

4.24 Under current arrangements, a trust is not a taxable entity in its own right. Instead, 'it is the beneficiaries who are ultimately entitled to receive and retain the trust income who are taxable on it. The trustee is generally taxed only on the balance (if any) to which no beneficiary is immediately entitled, or to which a beneficiary is immediately entitled but which the beneficiary cannot immediately receive ...'¹⁹

4.25 The beneficiaries of the trust therefore pay PAYG tax on any income from the trust to which they have a present entitlement:

The beneficiary's share of the net income is aggregated with other assessable income of the beneficiary subject to Australian tax and, after taking into account all deductions, the total taxable income is taxed at the rate applicable to the beneficiary.²⁰

4.26 Where trust income is not distributed to beneficiaries, the trustee becomes liable for taxation. A number of circumstances (such as the infancy or bankruptcy of the beneficiary) may result in this occurring. If, however, the income is to be retained by the trust because no beneficiary is presently entitled to receive that income (if, for instance, the trustee of a discretionary trust has not determined that such an entitlement exists), then the income is taxed at the top marginal tax rate of 47%.²¹ This rate is regarded as a punitive tax rate, and was introduced in order to address the use of trusts as vehicles for tax minimisation.

4.27 Consequently a taxpayer does not obtain a tax benefit by leaving income, to which they have a present entitlement, in the trust (as it will be assessed as part of their income whether actually received or not). Nor do they obtain any benefit if the trustee retains income in the trust rather than distributing it (as it will usually be taxed at the top marginal tax rate).

4.28 The Board of Taxation reviewed the taxation of discretionary trusts in 2002. In particular, it considered whether trusts should be taxed as companies. It concluded that the current arrangements are adequate, though it made some suggestions for technical amendments. The Board paid particular attention to the use of trusts as vehicles for tax avoidance. It noted:

18 Submission 50, Nilsson, p. 6.

19 *CCH Master Tax Guide 2004*, ¶6-060, p. 179.

20 *CCH Master Tax Guide 2004*, ¶6-110, p. 185.

21 *Income Tax Assessment Act 1936*, s. 99A. Note that the Commissioner has the discretion to allow the trust's income to be assessed under the normal progressive income tax rates (s.99) if it would be unreasonable to tax the earnings at the full marginal rate.

Critics of [the current] tax model argue that flow-through tax treatment allows for the tax-free distribution of amounts that are untaxed due to tax abuse. For example, if the trustee fails to include an amount of income in the trust's tax return, the amount would remain untaxed if distributed to a beneficiary, presuming the beneficiary also fails to include it in a tax return. Consequently, critics suggest that trusts allow for the benefit of such tax abuse to be passed on to individual beneficiaries.²²

4.29 The Board concluded that rather than amending the tax system to tax trusts in another way, 'tax abuse should be addressed at its source through better enforcement action to limit tax abuse opportunities.'²³

4.30 The Committee agrees with the Board's view that there does not appear to be a *systemic* problem with the taxation of trusts. Rather, there may be a problem with individual trustees or beneficiaries seeking to use trusts to avoid tax, and in the Committee's view this conduct should be prosecuted in the normal manner.

Trusts and income splitting

4.31 Another argument raised in evidence before the Committee related to the use of trusts to split income, in order to take advantage of the progressive PAYG tax scale. Catholic Welfare Australia outlined this concern:

A primary mechanism by which high income individuals can reduce their normal taxation liability is through the use of trusts. The basic principle is that income is split between individuals in a family trust and tax paid when the income is distributed to the beneficiary. This can be used to reduce the taxation liability substantially. There are clearly some cases where the nature of the activity involved might justify a trust model. However, there seems little reason why taxpayers who would otherwise face normal income tax rates should be able to avail themselves of this concession.²⁴

4.32 ACOSS regarded this form of income splitting as one of its 'seven deadly tax rorts'²⁵ and claimed that it costs \$800 million annually in revenue.²⁶

4.33 One option to address this issue may be to adjust the taxation of trusts to prevent income splitting. However, the Committee observed that the concern among witnesses and submissions is not income splitting *per se*, but the inequity inherent in a situation where income splitting is only available to those who are able to conduct their affairs through a trust. Therefore, another option for dealing with this issue may

22 Board of Taxation *Taxation of Discretionary Trusts*, November 2002, p. 13.

23 Board of Taxation *Taxation of Discretionary Trusts*, November 2002, p. 14.

24 Submission 83, Catholic Welfare Australia, p. 7.

25 *Transcript of Evidence*, Davidson, 29 July 2003, p. 28.

26 Submission 85, ACOSS, p. 18.

be to allow income splitting of family unit taxation on a universal basis. This issue was discussed in Chapter 2.

Contracting and subcontracting arrangements

4.34 The Construction, Forestry, Mining and Energy Union (CFMEU) raised the issue of the tax system rewarding self-employment ahead of the more traditional employer/employee relationship. Its submission stated:

At the centre of the problem is the tax advantage inherent in declaring oneself a contractor for the purposes of employment, and thereby obtaining an ABN, as opposed to being an employee, for the purposes of tax. This is so because contractors, subcontractors, own-account workers, etc. are not subject to the PAYG system in the same way as employees [...] In this way [...] contract workers are able to significantly reduce their tax liability, and employers are able to reduce their labour on-costs and various other statutory obligations. This is a growing problem in the building and construction industries.²⁷

4.35 The reason for this trend, according to the CFMEU, is that the contractor/subcontractor relationship provides substantial advantages for employers, who are able to cut their own costs, providing lower rewards (typically, lower ancillary or non-wage benefits) to workers on the basis that the tax advantages of self-employment will compensate:

By engaging workers as 'independent' subcontractors, employers create for themselves a comparatively low cost structure in comparison to other employers that engage workers as employees. This is because employing contract labour eliminates the obligation to pay various entitlements under awards, including redundancy and superannuation. Instead, contractors are often paid an all-in rate. Firstly, while all-in rates vary from market to market, they rarely reflect the full value of what the worker should be receiving under industrial awards and legislation. Secondly, as suggested above, employers who use bogus subcontract arrangements avoid other obligations such as Payroll Tax, Fringe Benefits Tax, Workers Compensation premiums and superannuation (although workers compensation and superannuation is occasionally paid on behalf of the worker). Employers using these arrangements also save on administrative costs such as the hiring of payroll staff and book keeping.

Meanwhile, those workers engaged by such employers often accept the situation because of a perceived tax advantage, or the fear of facing unemployment.

If workers received in their hand the same level of remuneration under subcontract arrangements as do employees, there would be an absolute uproar from those workers. It is the tax savings which workers receive

27 Submission 103, Construction, Forestry, Mining and Energy Union, p. 1.

from this contrived arrangement that keeps them from complaining about loss of employee entitlements.²⁸

4.36 According to the CFMEU, the growing number of construction industry workers who are self-employed does not represent a desire to avoid taxation. Rather, the contractor/subcontractor relationship is progressively replacing that of employer/employee:

Employment sections of local newspapers are full of advertisements that require applicants for building and construction employees to have their own ABN, to the extent that it is increasingly impossible to hold a job as a tradesman on award conditions.²⁹

4.37 This issue has been considered by various inquiries in recent years. The Ralph report on business taxation, for instance, stated:

It is clearly inequitable that some taxpayers should be reducing their tax liability by using interposed entities to alienate income while other taxpayers also deriving personal services income, including ordinary wage and salary earners, pay the correct amount of tax. In addition to the tax consequences, income alienation can result in highly remunerated individuals being able to reduce their taxable income to a level that entitles them and members of their families to a range of income-tested government payments. Alienation can also enable these individuals to avoid a range of other obligations such as higher education contribution charges, Medicare levy and superannuation surcharges and child support payments.³⁰

4.38 Associate Professor Owen Covick gave an outline of how this form of income alienation, combined with abuse of the trust laws, can result in taxpayers avoiding tax and claiming welfare benefits to which they have no genuine entitlement:

When you have that latter category, the self-employment families, you can often arrange your affairs so that personal services income which would be tending to push a particular individual into the higher echelons of the marginal personal income tax scale no longer does so and flows into the hands of other members of the family who are lower down in the marginal income tax scale, therefore averaging down your personal income tax responsibilities.

If you exhaust all the possibilities of low income or otherwise low income members of your family being in the lower echelons, you can then tuck some money away into company structures, pay the company tax on that income and then roll it forward and worry about how you get it out some time later. So I think you will find that among small businesses or families with self-employment as their main source of personal services income in Australia, typically they operate with a structure where there is a family

28 Submission 103, Construction, Forestry, Mining and Energy Union, pp. 2-3.

29 Submission 103, Construction, Forestry, Mining and Energy Union, pp. 1-2.

30 *A Tax System Redesigned*, July 1999 pp. 287-8.

trust, a company which is the trustee of the family trust and a second company, which is one of the beneficiaries of the family trust. The company which is one of the beneficiaries of the family trust therefore acts as a bit of a sump, where any money which might otherwise be attracting unattractively high marginal personal income tax rates or causing you problems with means testing arrangements can go and sit in this company and never appear on anybody's individual personal income tax return or anybody's details they are required to fill out on a means testing form.³¹

4.39 The CFMEU submission requested further inquiry into this issue. That call was supported by the round table discussion convened by the Committee on 2 December 2003. This issue will therefore be discussed further in Chapter 6, as one area in which the Committee proposes a future, more focussed inquiry.

Complexity and Compliance

4.40 The Committee received some evidence that the complexity of the tax system, particularly for individual taxpayers undertaking self-assessment, inhibits compliance. Mr Roy Barber, for instance, stated:

...sixty years ago I could fill in my tax form in a matter of thirty minutes.

The present system is beyond me, and I now have to see a taxation consultant.

Over the years my income situation has not changed all that much.

The booklet covering the guidelines is, to me, confusing and I give up.

Couldn't a simple system be introduced whereby a tax payer can fill in a simple form with the basic information ...³²

4.41 Mr Colin Smith provided similar views:

The tax system is that complicated that you would have to be a Rhode's Scholar to work out what it means, but to a lay-person it means nothing. No wonder the accountants and tax consultants get it wrong. There are so many different interpretations.³³

4.42 The submission from Treasury indicated that it considers that the tax system should aim for simplicity, which would reduce compliance costs and increase compliance:

A simple tax system should provide clarity, consistency and stability. While all taxes impose compliance costs on taxpayers, an effort should be made to minimise them. Greater complexity tends to impose higher compliance costs on the community and higher administrative costs on tax authorities,

31 *Transcript of Evidence*, Covick, 2 December 2003, p. 9.

32 Submission 2, Barber, p. 1.

33 Submission 34, Smith, p. 1.

both in terms of monetary costs and the time and effort spent complying with the tax system.

Clarity means that taxation provisions should be sufficiently clear for taxpayers to understand the tax implications of their actions. Taxation policy should be internally consistent as well as being consistent with broader economic policy. Stability requires the direction of policy to be well articulated and understood, so that taxpayers have confidence that the broad direction of policy will be maintained.³⁴

4.43 The Committee is aware that the Australian Taxation Office is undertaking an ongoing project relating to compliance with the tax system. This project, which is outlined in the ATO publication *Making it Easier to Comply*, includes a number of measures designed to assist individuals to deal with the complexity of the tax system. For instance, the ATO has improved its website to provide more accessible information, and tools such as tax calculators, to assist individuals to determine their tax obligations. The ATO has also recognised the importance of simplicity in its correspondence with taxpayers:

We will continue to improve the way we correspond with you. You will notice some changes, such as letters and notices that:

- are easier to understand and clearly explain calculations and required actions/obligations;
- are concise and relevant to your circumstances; and
- notify you of any changes in obligations.³⁵

4.44 In a research paper presented as a submission to the Committee, Dr. Margaret McKerchar gave an assessment of the level of complexity within the tax system and its impact on individuals, based on survey data:

Complexity was said to have arisen wherever a personal taxpayer reported any difficulty in completing his or her own tax return for the year. In Australia, the method by which this is normally done is by the use of an instructional booklet provided by the ATO, known as *TaxPack* (128 pages in length in 2000). [...] Almost 50 per cent of the relevant respondents reported that they had not experienced any problems completing their tax return.

For those respondents who had completed their own return and had encountered problems, questions were asked to determine the most common cause(s) of complexity and of the most difficult problems encountered. [...]

The most common problem reported was in understanding the instructions in *TaxPack*. In terms of level of difficulty, the more serious problems were attributed to the rate of change in tax rules, understanding the instructions

34 Submission 101, Treasury, pp. 9-10.

35 Australian Taxation Office, *Making it Easier to Comply*, July 2003, p. 32.

in *TaxPack* and other written material provided by the ATO, and the time taken to complete the return form. In terms of respondents' three most difficult problems, *TaxPack* was ranked the most common major problem by more than double any others. Complexity of rules and understanding other written material from the ATO were ranked as the next two most difficult problems. The time taken to complete the tax return and the rate of change followed. The use of technical language did cause problems, but this was ranked as being a minor concern.

It was concluded that the principal cause of complexity, in this context, was ambiguity. To address this cause, the ATO had included ever increasing amounts of detail in material prepared for the use of personal taxpayers. Due to both the volume of material and its rate of change, taxpayers found that understanding the information provided took up too much time. The most constructive means for addressing ambiguity appeared to be the development of clear and simple rules, with less detail and less exceptions. This should reduce both uncertainty and the time taken for personal taxpayers to complete their returns.³⁶

4.45 The Committee approves of the efforts undertaken by the ATO to simplify taxpaying for individuals (and, indeed, for other taxpayers). However, the ATO should note Dr. McKerchar's finding that too much explanatory material can in fact increase, rather than decrease, the complexity of the system.

The cash economy

4.46 The term *cash economy* refers to economic activity which takes place outside the tax system for the purpose of avoiding tax liabilities. This may include, for instance, cash payments made by consumers which are then not reported as taxable revenue; it may also include cash payments to employees made outside their formal wage structure. The Cash Economy Task Force outlines activity within the cash economy as follows:

For the tax system, the major risk arising from the cash economy is business revenue not being reported. This can occur when entities:

- are completely outside the taxation system – they are not registered and do not report activity;
- have engaged with the system sufficiently to become registered, but do not report revenue as required – they do not lodge activity statements or tax returns; or
- fulfil basic registration and lodgement requirements, but do not report all their revenue.³⁷

36 Submission 38, Taxpayers' Research Foundation, Attachment A, McKerchar, M *Complexity, Compliance and Fairness: A study of personal income taxpayers in Australia*, pp. 10-12.

37 Cash Economy Task Force, *The Cash Economy under the New Tax System*, September 2003, p. 1.

Size of the cash economy

4.47 During this inquiry, the Committee held one hearing specifically in relation to the cash economy. The Committee questioned Centrelink, the Australian Transaction Reports and Analysis Centre (AUSTRAC) and the Australian Tax Office, and none of these agencies was able to indicate the size of the cash economy. In evidence, officers from Treasury stated:

We have observed various academic studies in relation to the cash economy and, as you would know from that discussion, it is anywhere between three and 15 per cent. What we would say is that we have a substantial risk to address in relation to the cash economy regardless of size. The range in the academic studies shows that it is very difficult by its nature to estimate the cash economy. What we can help you with is the impact of activities. Obviously we do monitoring within particular industries where we are having a focus, and we can go into some more detail around that about what we are observing in terms of the effectiveness of our strategies.³⁸

4.48 Officers from Centrelink stated:

We have not attempted to extrapolate. [...] work on the size of the cash economy or the impact on welfare payments has not been undertaken. I have spoken to academics on this point, and it has not been done anywhere in the world.³⁹

4.49 AUSTRAC stated that 'the ability to form an opinion about drivers of the cash economy, the size of the cash economy and the nature of the cash economy is not really something that we would have.'⁴⁰

4.50 The Australian National Audit Office, in a 2002 report on the cash economy, broadly agreed with the view expressed by Treasury:

Estimates from various academic studies show that the cash economy may range from 3.5 to 13.4 per cent of gross domestic product (GDP). Using the 2000-01 GDP figure and assuming an effective tax rate of 23 percent, this gives a potential loss to taxation revenue for the year of between \$5.4 billion and \$20.7 billion.

However, the precise size of the cash economy, while warranting much debate, is of lesser importance than the fact that it exists, that it is significant and that there is some broad measurement of an increase or decrease in it. Even at the lowest estimate, it is a very large number.⁴¹

38 *Transcript of evidence*, Granger, 12 September 2003, p. 28.

39 *Transcript of evidence*, Lewis, 12 September 2003, p. 4.

40 *Transcript of evidence*, Ryan, 12 September 2003, pp. 17-18.

41 Australian National Audit Office, *ATO Progress in Addressing the Cash Economy*, Report No. 35 of 2001-02, March 2002, p. 24.

4.51 A recent study from the Centre for Tax System Integrity (CTSI) noted some of the challenges to estimating the size of the cash economy:

Gathering statistics about who is engaged in underground (or criminal) activities, the frequency with which these activities occur, and the magnitude of such activities, is crucial for making effective and efficient decisions regarding the allocation of a country's resources. Given that the individuals who are engaged in such behaviour do not want to be identified, it is difficult to obtain accurate information about the nature and extent of these underground activities. There is also little understanding about what motivates individuals to work in the shadow economy or to request such work.⁴²

4.52 However, the same report gave some general indications of the size of the cash economy in Australia, based on survey data. The data indicated that 6.0% of respondents had received cash in hand payments during the previous 12 months, while 14.4% of respondents had paid cash-in-hand for goods or services over the same period.

4.53 Those who had done cash-in-hand work had made approximately 8.82% of their official income in the cash economy, while those households which purchased cash-in-hands goods or services spent 5.85% of their incomes doing so.⁴³

4.54 The CTSI report extrapolated its data to suggest that the size of the cash economy was somewhere between 4.81% and 8.8% of Gross National Income (GNI).⁴⁴ However, two caveats should be noted. First, the CTSI itself suggested that these extrapolated results be treated with caution. Second, the results reflected the cash economy prior to the introduction of the New Tax System.

The cash economy and welfare fraud

4.55 The cash economy clearly has implications for the welfare system in addition to its implications for the tax system. Benefit recipients who fail to declare their full income may be able to claim benefits on the basis of their declared or official income, but may not be entitled to those benefits (or may be entitled to a lesser benefit) if their full income, including the undeclared amount, were to be assessed. Officers from Centrelink explained:

... the system of paying income support primarily depends on Centrelink being correctly advised of the circumstances of the person applying. One of these circumstances that we ask people about relates to income. Centrelink

42 Schneider, Braithwaite and Reinhart (2001) *Individual behaviour in Australia's shadow economy: Facts, empirical findings and some mysteries*, Centre for Tax System Integrity, p. 1.

43 Schneider, Braithwaite and Reinhart (2001) *Individual behaviour in Australia's shadow economy: Facts, empirical findings and some mysteries*, Centre for Tax System Integrity, p. 3.

44 Schneider, Braithwaite and Reinhart (2001) *Individual behaviour in Australia's shadow economy: Facts, empirical findings and some mysteries*, Centre for Tax System Integrity, p. 30.

has a system of data matching to identify cases where there is an anomaly between the information that Centrelink has been given by the person about their income and information we have from external sources. Where we get an anomaly, we investigate it. This can uncover cases where people have not declared all or part of their income. This element of our work is fairly significant in the work that we do for uncovering incorrect payment and fraud.⁴⁵

4.56 As it is very difficult to assess the size of the cash economy, it is also very difficult to assess the cash economy's impact upon the welfare system. However evidence suggests that Centrelink regards cash economy-related welfare fraud as a serious issue. Centrelink informed the Committee that 120 staff have been trained as investigators and placed in units which have the task of detecting and prosecuting welfare cheats in the cash economy.⁴⁶ Centrelink is also a participant on the Cash Economy Task Force, discussed below.

Cash Economy Task Force

4.57 The Cash Economy Task Force (CETF) is a key element of the Government's current approach to dealing with the cash economy. The task force is chaired by a senior officer of the ATO, and its membership includes representatives from other agencies including Centrelink and AUSTRAC, from academia, and from the business community (including micro and small business representatives, and a tax practitioner).

4.58 The CETF's principal task is to 'examine the cash economy with a view to determining what it is, what the likely compliance issues are, and to develop a view about what additional steps can be taken by the ATO.'⁴⁷ It provides advice directly to the Commissioner of Taxation.

4.59 Its most recent report, *The Cash Economy under the New Tax System*, was released in September 2003. It contained 38 recommendations for various changes to enhance the ATO's programs to target the cash economy. The ATO either agreed or agreed in principle with all 38 recommendations, and the Committee will observe the ATO's progress in implementing these recommendations.

Conclusions

4.60 The Committee concludes this chapter by returning to its opening assertion: paying tax is the right thing to do. It is necessary in order to fund the activities of government, and should be undertaken by all citizens and companies as a matter of social responsibility.

45 *Transcript of proceedings*, Richardson, 12 September 2003, p. 2.

46 *Transcript of proceedings*, Lewis, 12 September 2003, p. 3.

47 Australian Taxation Office, *Cash Economy Task Force, Terms of Reference*.

4.61 The various means of avoidance and evasion discussed in this chapter – whether through the use of trusts, the alienation of personal services income, or participation in the cash economy – all result in a redistribution of the tax burden away from those avoiding their responsibilities. They consequentially increase the burden on those who do pay their fair share.

4.62 While the ATO has a responsibility to ensure that tax procedures are as simple as possible, in order to assist people to comply with the system, it also has a responsibility to prosecute those who avoid their tax responsibilities.

CHAPTER FIVE

OTHER ISSUES

5.1 While a large amount of the evidence received by the Committee fell within the three broad themes of taxation on families, taxation on low income earners, and compliance, evidence on other issues was also received. This chapter will consider evidence in relation to:

- vertical fiscal imbalance;
- tax on alcohol; and
- debit taxes.

Vertical Fiscal Imbalance

5.2 *Vertical Fiscal Imbalance* (VFI) refers to the situation where there is a systemic imbalance between the revenue-raising capacity and the expenditure responsibilities of different levels of government. In Australia, the Commonwealth government raises significantly more money than it spends, and the State and Territory governments spend significantly more than they raise. As a result, there must be a system enabling Commonwealth revenue to be transferred to the States and Territories to meet their spending needs.

Origins of VFI

5.3 From Federation until 1942, State governments imposed income tax and company tax. From about the time of the First World War, the Commonwealth also imposed taxes in these areas. Taxes from the two levels of government were collected concurrently. During the Second World War, to fund the war effort, the Commonwealth Government determined that income and company taxes must rise. Introducing the Income Tax (War-Time Arrangements) Bill 1942, then Treasurer, the Hon. Joseph Chifley MP stated:

The Government believes that in this emergency it must have available to it the maximum taxable capacity of the nation. The whole of the taxable field is not available to the Commonwealth while State taxes are levied upon incomes at various levels. If a single income tax be imposed to raise revenue for the requirements of both Commonwealth and States, it will be possible to levy that tax on every section of the taxable field, and apply it to the nation as a whole on the basis of equality of sacrifice and equality of citizenship. [...]

Every honourable member who has occupied the position of Treasurer can testify that the differing rates of Commonwealth and State taxation form a maddening maze of figures which must be studied whenever the preparation of a budget calls for additional Commonwealth revenue. The

position has become so serious that strong and definite action must be taken by the Commonwealth to cut this gordian knot, if any simplification of Commonwealth and State taxes is to be achieved in the interests of the war effort.¹

5.4 The Commonwealth accomplished its purpose by raising income taxes to a high level, and by introducing (in the *State Grants (Income Tax Reimbursement) Act 1942*) a scheme whereby States which did not impose an income tax would be reimbursed for their lost revenue from the Commonwealth-collected income tax. The Commonwealth could not forbid the states from also collecting income taxes. However, the effect of the State Grants Act meant that no state would be better off by collecting an income tax.

5.5 In addition, as a war measure, the Commonwealth assumed control of all state apparatus (including staff and premises) for collecting income tax.

5.6 South Australia, Victoria, Queensland and Western Australia went to the High Court to test the constitutionality of the uniform tax scheme. The High Court found that the scheme was valid.²

5.7 More than a decade after the war ended, Victoria and New South Wales returned to the High Court, seeking a reconsideration of the uniform tax scheme, arguing that the scheme had been a war-time scheme which should have ended following the war. The High Court found that the scheme remained valid, and that 'the whole plan of uniform taxation has ... become very much a recognised part of the Australian fiscal system.'³ This remains the case today.

Previous attempts to address VFI

5.8 While uniform taxation may have become a recognised part of the Australian fiscal system, State (and Territory) discontent with VFI has also become a customary feature of it. The process by which the Commonwealth transfers revenue to the states has always been – and remains – a source of discord. A number of attempts have been made to deal with the ongoing difficulties created by VFI.

Early attempts

5.9 The Commonwealth Grants Commission was established in 1933 to assess claims for tied grants under s.96 of the Constitution. On the commencement of uniform taxation, it was also given responsibility for assessing and advising government on the appropriate distribution of the proceeds from the uniform taxation

1 House of Representatives, *Hansard*, The Hon. J. Chifley MP, 15 May 1942, pp. 1285-86.

2 *South Australia v Commonwealth (First Uniform Tax Case)* (1942) 65 CLR 373.

3 *Victoria v Commonwealth (Second Uniform Tax Case)* (1957) 99 CLR 575 at 601 per Dixon CJ.

scheme. It retains that role today, though the rules which guide its assessments have changed several times over that period.⁴

5.10 The initial formula was introduced in 1946, and determined that 'the base amounts in that year for each State shall be increased each year through a series of factors based on a State's total population, its density, schoolchildren and average wages.'⁵

5.11 That formula remained in place until 1959, when Prime Minister Menzies convened a Premiers Conference to consider options for a new funding formula. Victoria, in particular, felt it was at a disadvantage under the 1946 formula. The following exchange, from the *Sydney Morning Herald*, suggests the flavour of debates on this issue:

Mr Menzies [Prime Minister]: So far as you are concerned the tax reimbursements ought to be on a per capita basis?

Mr Bolte [Premier of Victoria]: Well, far nearer than it is now.

Mr Cahill [Premier of NSW]: You would disregard area in favour of population?

Mr Bolte: Not Entirely.

The South Australian Premier, Sir Thomas Playford, said that while population was an important factor so also was the size of the school population. Victoria had, proportionally, the lowest school population in the Commonwealth. This should be taken into consideration in the formula.⁶

5.12 The first Premiers Conference, in March 1959, failed to resolve the formula issue. Agreement was reached at a second conference in June. The Commonwealth agreed to change the nature of the grants from being 'tax reimbursement grants' and 'supplementary grants' (for smaller states) to a system of 'financial assistance grants' which would be increased as follows:

The financial assistance grants to each State after 1959-60 were to be increased in accordance with (a) annual increases in the State's population, (b) annual increases in the level of average wages of Australia as a whole, and (c) a betterment factor of 10 per cent to be applied to the increases in average wages (so that an increase of 3 per cent in average wages would be increased to 3.3 per cent).⁷

4 The Committee wishes to acknowledge the assistance provided by the Commonwealth Grants Commission Librarian in preparing this historical section.

5 *Sydney Morning Herald*, 6 March 1959, p. 3.

6 *Sydney Morning Herald*, 6 March 1959, p. 5.

7 Mathews and Jay (1972) *Federal Finance: Intergovernmental Financial Relations in Australia since Federation* Thomas Nelson, Sydney, p. 241.

5.13 After a Premiers Conference in 1965, the 'betterment factor' became more generous, increasing to 1.2 per cent and applying to the grant increases as a whole, not just the increases due to wage growth. In 1970, Commonwealth grants to the states increased still further: the betterment factor rose to 1.8 per cent, and the Commonwealth agreed to fund additional capital works, and to fund \$1 billion for state debt reduction.

New Federalism

5.14 By the mid 1970s, the States again argued that revenue from the Commonwealth was inadequate. In the 1975 federal election campaign, Prime Minister Fraser campaigned on a policy known as "New Federalism". The key element of New Federalism was a proposal to give each State a specified share of income tax receipts (as opposed to giving them a grant funded from those receipts), then eventually to allow the States to impose an income tax surcharge in their state (effectively a state income tax to be collected above and beyond the Commonwealth income tax). This system was unsuccessful, primarily because the Commonwealth did not lower its own income tax rate to make room for the state surcharges:

Much of the blame for the failure of the Fraser Government's attempts at fiscal reform must, however, rest with its faulty design of the tax sharing system. While this guaranteed the States a fixed share of personal income tax collections it simultaneously, by failing to reduce Commonwealth tax rates and therefore the level of shared tax revenues, permitted the States to avoid any necessity to impose income tax surcharges to make good the reductions in general revenue assistance which that action would have entailed. For their part, if the States had been sincere in their protestations about the need for a restoration of their taxing power, they would have insisted on the Commonwealth making tax room. But they found it politically more attractive to allow the Commonwealth to continue to impose taxation on their behalf and to reserve for themselves the right to argue about shares.⁸

The Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations

5.15 In 1999, as part of the development of the New Tax Package, the Commonwealth, States and Territories concluded an agreement known as the Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations ('the IGA'). The IGA is still in force.

5.16 The key features of the IGA are:

- provision of all revenue from the Goods and Services Tax (GST) to the States and Territories;

8 Mathews and Grewal (1997) *The Public Sector in Jeopardy: Australian Fiscal Federalism from Whitlam to Keating*, Centre for Strategic Economic Studies, Melbourne, p. 305.

- cessation of Financial Assistance Grants;
- removal of a range of State and Territory taxes, including debit taxes and some stamp duties; and
- a promise by the Commonwealth to maintain the level of Specific Purpose Payments (SPPs, tied grants made under s.96 of the Constitution) to the States and Territories.

5.17 Clause 8 of the IGA reads:

8. The Commonwealth will distribute GST revenue grants among the States and Territories in accordance with horizontal fiscal equalisation (HFE) principles subject to the transitional arrangements set out below and other relevant provisions of this agreement.⁹

5.18 Horizontal fiscal equalisation was described by Garnaut and FitzGerald as:

Arrangements within a federation to reduce or eliminate difference in the fiscal ability of States to carry out the functions for which they are responsible.¹⁰

5.19 While the IGA refers to 'horizontal fiscal equalisation principles' it does not actually define those principles. This has been a driver for continued discord among the States and Territories. The New South Wales Government submission to this inquiry, for instance, stated:

New South Wales has long argued for reform of Australia's system of horizontal fiscal equalisation. Currently the subsidy from New South Wales to recipient States is about \$1.2 billion, compared with an equal per capita distribution of GST revenue grants. This is equivalent to 11 percent of own-source State tax revenue. The NSW Government believes that the subsidies resulting from the current system are too large, are not well justified, and place too high a burden on the donor States. This burden is not expected to ease, with projections made by the South Australian Treasury, on behalf of all States, indicating that the subsidy from donor to recipient States will increase by over 80 percent over the next ten years.¹¹

VFI and this inquiry

5.20 New South Wales, Queensland, South Australia, Tasmania and Victoria all made submissions to this inquiry dealing with VFI. The Premier of Victoria, in his submission, outlined a number of concerns which he said are shared by all States and Territories:

9 *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* (April 1999) cl. 8.

10 *Review of Commonwealth-State Funding, Final Report* (August 2002) p. 231.

11 Submission 55, NSW Government, p. 7.

- *the impact on public policy development.* There is an incentive for States to develop public policy with regard to potential grant share implications, to the detriment of efficient and productive outcomes;
- *the unsustainable and inconsistent level of detail required by the current equalisation system.* The current equalisation process requires extraordinary amounts of data. The resources involved in collecting this data are a significant cost to all States, and often detract from efficient and effective delivery of services;
- *the lack of transparency within the current system.* The level of detail of the current system and the complexity of its methodology reduce transparency; and
- *the inefficiencies created by specific purpose payments.* Specific purpose payments impose considerable administrative costs on both the Commonwealth and the States. They also blur accountability between levels of government and reduce the flexibility of States in providing services.¹²

5.21 The final issue raised by the Premier of Victoria, the current administration of Special Purpose Payments (SPPs), was also a concern for a number of other States. The Treasurer of Tasmania stated:

...a consistent theme of recent SPP negotiations is the positioning of the Commonwealth to withdraw funding as GST revenues to the states increase. This has taken the form of tightening the amount of SPP funds available either through overt reductions in funding over time, or through inadequate indexation of the funding base. The systematic reduction of SPP funding across the board calls into question whether the states will in fact be better off financially, notwithstanding the receipt of Commonwealth transfers tied to the expected growth over time in GST revenues.¹³

5.22 The Premier of South Australia made similar comments:

The Commonwealth should commit to ensuring that SPPs are maintained in real terms from year to year. However the commitment needs to go further than that. If the Commonwealth maintains SPPs in real terms but increases the matching requirements associated with these SPPs it is effectively appropriating State revenues for Commonwealth policy purposes. Another danger is that the Commonwealth can effectively shift responsibilities to the States. There are a number of examples where the Commonwealth has encouraged States to set up jointly funded programs but then ceased their funding after 2 or 3 years. The State is then faced with making up the shortfall or cutting back or cancelling the program.¹⁴

5.23 The Queensland Government stated:

12 Submission 88, Premier of Victoria, p. 3.

13 Submission 46, Treasurer of Tasmania, p. 2.

14 Submission 109, Premier of South Australia, p. 3.

Although the Commonwealth undertakes in the IGA not to reduce SPPs as part of the new tax arrangements, there are from time to time statements made by Commonwealth Ministers that States should use GST revenue to fund areas of expenditure currently funded by the Commonwealth through SPPs to the State. GST revenues will genuinely benefit States if the additional revenues are available for States to improve service delivery to their communities. This will not be possible if the additional revenue is diverted to fund additional expenditure responsibilities transferred from the Commonwealth to the States.¹⁵

Local Government Issues

5.24 Considerations of VFI usually focus on the Commonwealth, the States and Territories. Local Governments are in an unusual position, as their authority, their responsibilities, and their powers to impose taxes and charges, are all delegated by the States and the Northern Territory.¹⁶ However, in recognition of the role played by local government in Australian communities, the Commonwealth provides Financial Assistance Grants to the States and Territories, in order that the States and Territories can pass them on to local governments. These grants totalled more than \$1.5 billion in the 2004 budget.¹⁷

5.25 The Australian Local Government Association, in its submission to this inquiry, argued that the current arrangements are unsatisfactory. Its submission stated:

There is an urgent need to reform the current tax sharing arrangements between the Commonwealth and local government. The next stage of intergovernmental financial reform must address the relationship between the Commonwealth and local government as a matter of urgency.

A stable, robust tax sharing arrangement linked to a growth tax would enable local government to strengthen itself as an institution, and improve service delivery to communities.

Any new funding methodology must be based around the notion of an entitlement to tax sharing rather than Commonwealth grant provision.¹⁸

5.26 The Municipal Association of Victoria also sought direct funding from the Commonwealth, but is content with the current administrative arrangements, whereby the funding is in the form of Financial Assistance Grants:

15 Submission 97, Queensland Government, p. 16.

16 A referendum in 1988, which sought to recognise local government in the Commonwealth Constitution, was unsuccessful. The proposal obtained less than 40 per cent support in each State and Territory. The ACT, as a city-state, is in the unusual position of having no local government, in the sense that the Territory government carries out the functions normally carried out by local government.

17 2004 Budget Paper no. 3.

18 Submission 90, Australian Local Government Association, p. 7.

Local government must have access to a tax transfer from the Commonwealth in order to provide adequate services and develop local and regional resources. This tax transfer must take the form of a general purpose payment in recognition of local government's general competence. The current process for enabling this tax transfer, the [Financial Assistance Grants] system, provides an appropriate method of facilitating a tax transfer from the Commonwealth to local government that is sensitive to the state variations in local government roles, responsibilities and asset profiles.¹⁹

Tax on alcohol

5.27 Taxes have a long history of being used to increase the cost of certain activities which public policy regards as undesirable, or undesirable in excess. This has led, for instance, to relatively high taxes on cigarettes and tobacco products, alcoholic beverages, and gambling. The economic rationale for these taxes is that the taxed activities (drinking, smoking and gambling) create negative externalities, and that it is appropriate to obtain additional revenue to compensate for these externalities.

5.28 In this inquiry, submissions focussed on the tax treatment of alcohol. The Alcohol and other Drugs Council of Australia outlined the social and economic costs of excessive alcohol consumption in their submission, which included the following observations:

- alcohol misuse cost the Australian community over **\$7.5 billion** in 1998-9. This estimate included costs to the health care system, lost production in the workplace, road accidents, premature death and some aspects of alcohol attributable crime. It did not include the many costs associated with pain, suffering and alcohol-related depression and anxiety;
- It is estimated that in 1997 alone the misuse of alcohol resulted in 63,164 person-years of life lost (before 70 years), a total of approximately 3290 premature deaths and over 400,000 hospital bed days;
- The National Drug Strategy Household Survey found in 2001 that 31% of Australians 14 years and over reported being victims of alcohol-related anti-social behaviour in the 12 months preceding the survey. This is twice as many who reported being victims of anti-social behaviour related to all other drugs;
- A Victorian report in 1988 found that alcohol was definitely or possibly involved in 53% of several thousand reported incidences of family violence; and

19 Submission 63, Municipal Association of Australia, p. 14.

- It is estimated that between 1990 and 1997, 31% of all driver and pedestrian deaths on Australian roads were alcohol related.²⁰

5.29 The Winemakers Federation of Australia, on the other hand, pointed out the contribution made by the wine industry to the national economy, including exports in excess of \$2.1 billion annually, employment of more than 30,000 people, and nearly \$1 billion spent by winery visitors engaging in wine tourism.²¹

5.30 The current system for taxation of alcohol is quite complex, but in general, beverages other than wine are taxed on the basis of their alcohol strength, while wines are taxed on their volume. Additionally, alcoholic beverages attract GST.

Wine equalisation tax

5.31 Wine Equalisation Tax (WET) is a 29 percent value added tax introduced as part of the New Tax Package, to offset the withdrawal of wholesale sales tax. As it is a value added tax, the amount of WET depends on the value of the wine, not its alcohol content. Consequently, premium wines attract a larger amount of WET and cheaper wines (such as cask wines) attract a lesser amount of WET.

5.32 While the Winemakers Federation of Australia did not express concern regarding the operation and level of the WET²² the Alcohol and other Drugs Council of Australia expressed concern that the relatively low tax on cask wine contributes to alcohol abuse:

As highlighted earlier, Australian studies have clearly shown that consumption of cask wine (and standard beer) is more closely associated with higher levels of violence, injury and illness than other alcoholic beverages.

Excessive cask wine consumption is a major problem in some Aboriginal communities. In the Alice Springs region, a population of less than 35,000 people consumed over 1.2 million litres of cask wine in 1998. That was equivalent to over 5,500 four-litre casks a week. Since most of the population did not drink cask wine, these data indicate harmful consumption by drinkers of cask wine.

The current system allows a male drinker to consume a daily intake that is considered, by the National Health and Medical Research Council, to be high risk for long-term harm for only \$2.94 (7 or more standard drinks) and a female drinker to do so for just \$1.60 (5 or more standard drinks) if drinking from a 4 litre wine cask.

The current situation also disadvantages small Australian premium wine producers, many of whom concentrate on the innovative and higher quality

20 Submission 67, Alcohol and other Drugs Council of Australia, pp. 5-6. These bullet points are an excerpt from a longer list. References have been omitted.

21 Submission 80, Winemakers Federation of Australia, *passim*.

22 Submission 80, Winemakers Federation of Australia, p. 6.

end of the market, in their ability to compete in the overall wine market. The WET may actually be discouraging innovation and production of premium wines and encouraging mass production of lower quality wines. This in turn encourages over-consumption of cask wine, which currently represents a high proportion of all wine sold.

The introduction of the WET has served no real policy purpose other than to protect the interest of cask wine producers (mostly large multinational companies) at the expense of Australia's premium wine producers. It is also at the expense of the health and well being of many disadvantaged communities where the price of cask wine is a primary factor influencing the amount of alcohol consumed.²³

5.33 The 2004 budget introduced a measure to rebate the first \$290,000 of WET for each producer in Australia (that is, the WET on the first \$1 million of sales).²⁴ This may offset some of the advantage the previous WET arrangements gave to cask wine, because most of the WET rebate will be captured by small regional producers, who often produce low-volume premium wines rather than high-volume, low-quality cask wines. However, these budget measures do not increase the price of cask wine, so their impact on consumption of cask wine remains uncertain.

Tax on ready-to-drink mixed spirits

5.34 Currently, low alcohol beer and mid-strength beer are taxed at a concessional rate. According to Australian Associated Brewers, this (combined with improvements in the taste of low alcohol beers) has resulted in an increase in low alcohol beers to the point where 'now a quarter of all beers sold are lower alcohol.'²⁵

5.35 The Alcohol and other Drugs Council of Australia proposed a similar scheme for ready-to-drink (RTD) mixed spirits, which have become popular among younger drinkers. In its submission, the Council stated:

From a public health perspective, low and mid strength products can play a significant role in the reduction of alcohol-related harm. However, low alcohol products have had very little market penetration among young drinkers and currently there is no financial incentive for alcohol manufacturers to promote and produce mid and low strength RTDs, which currently represent only 1% of the RTD market [...] The excise rate applying to low and mid-strength beer should also apply to [ready-to-drink mixed spirits] and apple ciders with the same alcohol content ...²⁶

23 Submission 67, Alcohol and other Drugs Council of Australia, pp. 10-11. References omitted.

24 2004 Budget Paper no. 2.

25 Submission 77, Australian Associated Brewers, p. 5.

26 Submission 67, Alcohol and other Drugs Council of Australia, pp. 12 and 15. References omitted.

5.36 In its October 2002 report on the provisions of the Excise Tariff Amendment Bill (No. 1) 2002 and the provisions of the Customs Tariff Amendment Bill (No. 2) 2002, the Senate Economics Legislation Committee observed:

The Committee also notes the importance of the excise system as a tool to influence drinking habits through price mechanisms. It accepts that excise on alcohol has a place in discouraging the consumption of high alcohol beverages by making low alcohol products more attractive through lower prices to the consumer. A similar excise regime to that of beer would be an incentive for wine and RTD producers to produce low alcohol drinks.

However, it was pointed out that changes in excise rates alone are not enough to control the abuse of alcohol. For example, the increase in the consumption of RTDs can be attributed to a number of factors such as a reduction in price. Additional factors that influence consumption are marketing and the general drinking patterns of specific groups in society. An example is the preference that young women have for spirits.

The Committee is also of the view that future changes to legislation that impacts on the taxation of alcohol should be preceded by a comprehensive inquiry into the taxation of alcohol products.²⁷

5.37 The Committee still considers that such a review would have significant merit.

Debit Taxes

5.38 A 'debit tax' is essentially a tax on bank transactions, particularly withdrawals and transfers. The Debit Tax Council describes the debit tax in the following terms:

The Debit Tax formula is simply an added percentage, one third of one percent (0.33%) is suggested, to the amounts withdrawn from all accounts held in trust by banking and financial institutions. This Tax, when cleared is instantly deposited through the Electronic Funds Transfer (EFT) system by way of the banking and financial institutions computers into the National Treasury at the end of each day.²⁸

5.39 The Committee received a number of submissions calling for the introduction of a broad debit tax by the Commonwealth.²⁹

5.40 Such taxes have been implemented in Australia. An example is the Bank Account Debits Tax, (BAD Tax), which is in the process of being phased out across

27 Senate Economics Legislation Committee, Report on the provisions of the Excise Tariff Amendment Bill (No. 1) 2002 and the provisions of the Customs Tariff Amendment Bill (No. 2) 2002, October 2002, p. 12.

28 Debit Tax Council of Australia. Attachment to submission 19, Carey.

29 See, for instance, submissions 4 (Turner), 12 (Ciesiolka), 13 (Canden), 19 (Carey) 25 (Bradford), 30 (Bishop), 35 (Jackson), 36 (Knowles), 37 (Fedczyna), 42 (Sugden), 43 (Glover), 68 (Wilson).

Australia. However, submissions to this inquiry sought to introduce a debit tax as the single form of Commonwealth taxation. They proposed that all other forms of Commonwealth tax be repealed, and the debit tax asserted in their place.

5.41 Supporters of the debit tax advance the argument that a debit tax, levied at a very small rate would generate immense amounts of revenue. Claims include the following:

- A 1% debit tax would bring in 3 times the revenue any government needs to get our nation out of trouble (\$520 billion per year), enough to run all current Government programs, and also generate many more jobs, pay off our foreign debt and improve our hospitals. It will also save billions in tax collecting costs.³⁰
- A debit tax of 1% ... would amount to revenue of \$300 billion annually. This compares favourably with the actual figure of \$187 billion using all its complexities and compliance costs.³¹
- ...it would almost triple government tax revenue.³²

5.42 Supporters argue that debit taxes would provide a range of advantages over current arrangements. A sample of these are as follows:

- No tax cheating or tax avoidance necessary or possible.³³
- because the tax is payable each time money changes hands, the rash of speculative investment which is rife today would not be profitable. Instead, more investment would be in the real economy which is jobs for everyone!³⁴
- multinationals would have to pay their fair share of taxation³⁵
- all employees would immediately have a larger take home pay packet, no income take deducted. More money to spend.³⁶

5.43 The Committee does not find merit in proposals for a debit tax. In order to explain the Committee's view, it is useful to consider what the Committee would describe as the two key debit tax myths: the 'myth of increments' and the 'myth of compliance'.

30 Attachment to submission 25, Bradford.

31 Submission 35, Jackson, p. 2.

32 Submission 37, Fedczyna, p. 1.

33 www.debittax.com.au

34 Submission 36, Knowles, p. 1.

35 Submission 13, Camden, p. 1.

36 Submission 4, Turner, p. 1.

The myth of increments

5.44 One key argument put forward by supporters of debit taxes is that the tax as a percentage would be so small – usually a fraction of a percent – that it would barely be noticeable, yet over time it would result in the production of massive revenue. This myth is premised on a simple multiplication exercise, as follows.

5.45 Wholesale payments (including high value trading transfers) in the Australian banking system amount to around \$135 billion per day, or over \$49 trillion per year.³⁷ If this figure is multiplied by some commonly suggested debit tax rates, the following products result:

Debit tax rate (%)	Product (\$b) ³⁸
0.33	162.6
0.5	246.4
1	492.8

5.46 Total government revenue for the 2004/05 budget was estimated at \$193.2 billion.³⁹ So, even making the unlikely assumption of absolute compliance with the system, a tax rate of approximately 0.392% would be necessary to maintain parity with current revenue.

5.47 Unfortunately, most analysis of the debit tax stops at this point. A tax rate of 0.392% appears to be attractive, especially to taxpayers used to paying income tax rates. There is an assumption that the rate is so tiny, it would barely be noticeable. The Debit Tax Council's literature, for instance, cites as an advantage of the debit tax system the proposition that 'because of the very large amount of withdrawals, only a very small amount is required as debit tax.'⁴⁰

5.48 However, while the debit tax may indeed result in small percentages of tax being paid on individual transactions, an analysis on a 'per transaction' basis does not appear to be particularly useful. Governments, companies, and even individuals are much more likely to assess their tax contribution over the space of a full year, and in each full year they may have thousands of transactions. So, while the per transaction cost may be small, their annual tax bill may be large.

37 Payments System Board *Annual Report 2003* p. 6.

38 Rounded to the nearest \$100 million.

39 Budget Paper no. 1.

40 Attachment to submission 19, Carey.

5.49 As noted above, if a 1% debit tax were applied, and full compliance were achieved, the projected revenue (adopting the Debit Tax Council's formula) could hypothetically be \$492.8 billion annually. This would amount to nearly *two thirds* of GDP. Whether the \$492.8 billion dollars is collected in tiny increments or one lump sum is entirely irrelevant. The result is still a national tax bill amounting to two thirds of GDP.

5.50 This logic may be extended to companies. Proponents of the debit tax appear to consider that, because the debit tax is so small on a per-transaction basis, companies will not endeavour to avoid it:

[Multinational corporations] (and foreign investors) will be more than excited about this tax system as there will be no more company tax or income tax imposed on them and their shareholders.⁴¹

5.51 In reality, however, companies are also likely to consider their tax burdens on an annual basis. If debit taxes were levied directly upon companies, then the amount of tax paid would be reported annually, and would be likely to result in a significant figure (given that debit taxes would constitute the whole field of taxation). When the tax burden is considered annually, the fact that it is paid in tiny increments is irrelevant.

5.52 As debit taxes are collected from within the banking system, the 'tax bill' for companies would likely emerge in the form of increased banking fees, as banks seek to recoup the tax withdrawn from their system. However, whether the tax is paid directly or in the form of fees to banks, it is unlikely to escape notice.

5.53 Finally, it has been demonstrated that, even on a per-transaction basis, the amount of debit tax will often be significant. This is because the debit tax is a *cascading tax*. Every time money changes hands, another layer of debit tax would be added:

A Cascading Tax, such as the Debit Tax would be, causes the effective tax rate to increase, depending on the number of times a good changes hands before it is purchased. This is largely due to the cost of the Debit Tax being added after the profit margin is added. In the production [of a good as] simple as pencils it is estimated that at least five withdrawals would be made. With more complex production, even more withdrawals and profit margins would be included. [...] In the end, it is not the companies that are most affected, but the consumer.⁴²

5.54 In a modern, complex banking system, this cascading effect can add a substantial number of 'layers' of taxation for apparently simple transactions:

41 Attachment to submission 25, Bradford.

42 DeGroot (1998) *Australian Tax Policy – Reform is needed, but is a Single Debit Tax the answer?* Australian National Internships Program, p. 19.

To see how these transactions arise consider the following example: I draw a cheque for \$10 000 on my ANZ account to buy a car. The car dealer deposits the cheque with his Westpac account. Through the payments system Westpac presents the cheque to the ANZ and draws down its value against the ANZ's balances. That drawing down of funds is a new debit in the system. Now ANZ head office is going to debit the funds standing in the Canberra branch. To cover that the Canberra branch may have to draw down its balances elsewhere in the system. All of a sudden we now have 4 debits recorded. It gets even more complex if the car buyer draws on a Credit union which itself banks with the ANZ.⁴³

Conclusion

5.55 The fact that the debit tax on single transactions may be small is irrelevant to an assessment of the overall impact of the tax on the economy and on companies and individuals paying their tax. Simply put, the many small tax payments add up. They add up even more quickly when debit taxes 'cascade' as the transactions involved in the production of goods and the operation of the banking system combine.

The myth of compliance

5.56 Another major advantage proffered by supporters of debit taxes is that they would be impossible to avoid. This is simply not so. The Committee can observe three different methods which could easily be used to get around the debit tax. All three arise from the central principle of taxpayers seeking to reduce the amount of taxable activity they undertake (in this case, reducing their exposure to bank withdrawals and transfers).

The use of cash

5.57 If a debit tax were introduced, one likely outcome would be a substantial increase in the number of cash, in-kind and bartered transactions undertaken. Cash transactions would not avoid debit tax altogether, as the cash would still be taxed as it was withdrawn from the financial institution. However, once it leaves the financial institution, cash inevitably passes through a series of transactions before finding its way back to a bank. These transactions would be untraceable and unenforceable under a debit tax system. A study in 1998 made the following observation:

... companies ... may decide to keep cash on hand to pay employees, or ... pay through in-kind vouchers. In Woolworths' case, approximately 80,000 people are employed by the supermarket chain. If an employee earns the average wage of \$712 per week, an internal contract may be set up so that the employee receives \$612 in wages and \$100 of in-kind vouchers. If all employees received this, both Woolworths and the employees would save

43 The Committee is grateful to the Parliamentary Library for providing this example.

over \$1.3 million each year by not actually entering the money flow and encountering a debit tax.⁴⁴

5.58 Small businesses, particularly in the retail and services sectors, with ready access to cash payments, would almost certainly retain this cash instead of banking it. The cash could then be used to pay for business expenses (including wages). It would be effectively untraceable because, even under current circumstances, the Payments System Board acknowledge that 'the number and value of cash payments is very difficult to measure'.⁴⁵

Vertical integration

5.59 Another simple way for large companies to reduce their exposure to the banking system (and therefore to the debit tax) would be to decrease the number of transactions they conduct with outside companies. One excellent way to achieve this would be through vertical integration of their companies. If single corporations own the means of production, distribution and sale for their goods and services as far upstream and as far downstream as possible, then the 'transactions' between those business units can be managed through the company's own accounting and management structures:

Vertical integration would benefit both the companies, the subsidiaries, and the consumers by skirting around the money market using cash, in-kind or internal contracts.⁴⁶

5.60 On the other hand, if companies focus on their 'core' activities and contract with upstream suppliers and downstream customers who are external to the corporation, then every transaction, at every stage of production, will add a cascading layer of debit tax.

5.61 This tax-based pressure to integrate vertically may then reduce the competitiveness of companies, and of the economy generally, as suppliers will no longer need to innovate and compete to attract contracts – their customers will be in house, and the tax system will inhibit their customers from looking for other options.

Changes to banking behaviour

5.62 In the modern economy, where capital can flow quickly and easily around the world, one simple way for large corporations to reduce exposure to debit taxes would be to conduct banking offshore. In fact, faced with the massive increases in bank fees likely as a result of debit taxes, the banks themselves may find it attractive to conduct

44 DeGroot (1998) *Australian Tax Policy – Reform is needed, but is a Single Debit Tax the answer?* Australian National Internships Program, pp. 21-22.

45 Payments System Board *Annual Report 2003* p. 7.

46 DeGroot (1998) *Australian Tax Policy – Reform is needed, but is a Single Debit Tax the answer?* Australian National Internships Program, pp. 19-20.

their wholesale operations offshore. This behaviour would not completely avoid debit tax (as debit tax would still apply once funds were repatriated), but it may reduce the number of 'layers' of debit tax which apply as a result of wholesale transactions in the banking system.

Conclusion

5.63 The view that compliance is guaranteed under a debit tax system is unsubstantiated. In fact, tax avoidance under a debit tax system would be a relatively simple matter, with opportunities for avoidance at all levels from the largest companies (through vertical intergration and offshore banking) to the individual (by using cash).

5.64 Low levels of compliance would reduce the amount of revenue obtained under the debit tax. This would leave governments with two options – to raise the rate of debit tax, (thereby increasing the incentive for others to avoid paying it) or to introduce other forms of taxation (ending the notion of the debit tax as a universal taxation system).

Conclusion in relation to debit taxes

5.65 Despite being collected incrementally, debit taxes would be noticeable by companies and taxpayers. Debit tax would be simple to avoid, and would therefore generate an uncertain amount of revenue. The 'debit tax concept' has a range of supporters, and has been advanced from time to time for at least a decade. While the Committee expects that debit taxes will retain a certain amount of support, they do not provide a realistic basis for a taxation system.

CHAPTER SIX

ISSUES FOR FUTURE INQUIRIES

6.1 It will be clear from the preceding five chapters that the Committee's terms of reference for this inquiry were extremely broad. Submissions and evidence were received on issues as disparate as income splitting, tax credits, the social responsibility of paying taxation, and vertical fiscal imbalance. While the Committee, in this report, has endeavoured to provide an indication of the breadth of that evidence and the dynamics of the issues raised, the Committee came to the view that it does not have sufficient evidence on particular issues to enable it to make considered policy recommendations.

6.2 As a result, the Committee had two options. It could have re-opened submissions in relation to this inquiry, continuing to gather evidence until, eventually, sufficient evidence was received to enable broad policy conclusions.

6.3 This would have taken a long time – perhaps years – and success was not guaranteed. Alternatively, the Committee could report the evidence received in this inquiry, and recommend a series of more focussed inquiries, to be conducted by the Economics References Committee in the 41st Parliament. In late 2003, the Committee agreed to the latter option. The current report therefore sets an agenda for future reports, based on the issues raised in submissions to this inquiry.

6.4 On 2 December 2003, the Committee convened a round table of experts on taxation matters to consider the evidence presented thus far, and to establish which issues should be pursued by future inquiries. Participants in that round table were:

- Dr Bruce Bradbury, Senior Research Fellow, Social Policy Centre, University of New South Wales (appearing in a private capacity);
- Associate Professor Owen Covick, Associate Head, Faculty of Social Sciences, School of Business Economics, Flinders University (appearing in a private capacity);
- Mr Peter Davidson, Senior Policy Officer, Australian Council of Social Service;
- Professor Robert Gregory, Economics Program Head, Research School of Social Sciences, Australian National University;
- Professor Ann Harding, Director, National Centre for Social and Economic Modelling (NATSEM); and
- Associate Professor Neil Warren, Associate Director (Research), ATAX, Faculty of Law, University of New South Wales.

6.5 This chapter presents the issues which, based on the round table and evidence received during this inquiry, the Committee considers should form the basis of future references. They fall into three broad categories:

- Tax avoidance and the erosion of the tax base;
- The relationship between the tax system and the social security system; and
- Equity in the tax system.

Tax avoidance and the erosion of the tax base

6.6 In chapter 4, the Committee presented evidence in relation to compliance with the tax system. The round table agreed that this is a major issue which, in itself, justifies a substantial inquiry.

6.7 In chapter 4, the Committee referred several times to the fact that, when tax is avoided, the need for revenue does not disappear. Instead, it is redistributed among those who *do* pay their taxes. This redistribution is accomplished by holding tax rates at a higher level than would be necessary if higher levels of compliance were achieved. At the round table, Associate Professor Warren observed:

We play with the rates. We will push this threshold and we will play with that rate. But what is the rate on? The rate is on the base. What have we been doing with the base? We have been eroding the base. The capital gains tax changes erode the base. Negative gearing effectively erodes the base. All those actions effectively erode the base. If you need revenue but there are trusts, the growth of the self-employed and increased deductible expenses, what are you doing? Everything you are saying is eroding the base. What do you get if you erode the base? You raise the rate because you still want the same amount of revenue. It is like the old wholesale sales tax. The more the base lifts away, the more you ratchet up the rate and the more the base slips away.¹

6.8 Another almost inevitable policy consequence of a disappearing tax base is to impose taxes which are, structurally, much more difficult to avoid. These taxes may not be particularly efficient from either an economic or equitable point of view, but they do produce revenue. Professor Warren described this as a "tax what you can" approach:

A few years ago I wrote a paper saying that if we continue down this path we will have a tax-what-you-can system, or TWYC. [...] Basically, it is saying that if it cannot move out of your headlights, tax it. The states are on to this. What you have to realise is that the states are moving to a tax-what-you-can system. That means land taxes, property tax and stamp duty. As it sits, they tax it. If you change ownership of it, tax it. The states have moved

1 *Transcript of evidence*, Warren, 2 December 2003, p. 22.

into the taxing-what-you-can system. In a sense, that is what you are left with.²

6.9 The Committee supports the reference of an inquiry into tax avoidance, and the consequential erosion of the tax base. Such an inquiry could consider matters such as:

- the effectiveness of ATO programs to increase tax compliance;
- whether the ATO is targeting its compliance activities properly, or pursuing small taxpayers while failing to pursue large, corporate tax avoidance;
- what the policy options are for stabilising or increasing the tax base;
- whether the Commonwealth has responded to tax compliance issues with tax-what-you-can strategies; and
- whether those tax-what-you-can strategies, if used, have resulted in inefficiency and inequity.

The relationship between the tax system and the social security system

6.10 This general issue has been discussed throughout this report, and in particular in chapters 2, 3 and 4. The tax system and the welfare system have now become so intertwined that it is virtually impossible to make recommendations in one field of policy which do not impact upon the other. This inquiry has brought forward two issues in particular which justify more detailed investigation by the Committee: the use of tax expenditures, and the impact of effective marginal tax rates.

Tax expenditures vs grants

6.11 Chapters 2 and 3 described how some forms of welfare (for example, Family Tax Benefits A and B) are delivered as *tax expenditures*, that is, delivered in the form of tax foregone, rather than as funds collected and then paid out. From a political perspective, tax expenditures are attractive, because they make it appear that the government is collecting less tax, and they also make it appear that the government is spending a lower amount on welfare payments. Both of these outcomes are often considered to have electoral appeal.

6.12 Tax expenditures are not used only in welfare policy. For instance, reduced excise on some forms of fuel are effectively a tax expenditure, as are programs like the private health insurance rebate.

6.13 Tax expenditures, however, raise two significant questions. The first is whether they provide the most effective way to deliver benefits to recipients, or

2 *Transcript of evidence*, Warren, 2 December 2003, pp. 22-23.

whether they are simply employed for the abovementioned political reasons. The second is whether they are used as a means to minimise the parliamentary accountability of government. Budgetary scrutiny of tax expenditures tends to be less than scrutiny of other expenditure, because the budget process tends to concentrate on what governments do collect and spend, rather than what they don't collect or spend. During the round table, Mr Peter Davidson from ACOSS remarked:

The Treasury estimates we spend approximately \$30 billion per annum on tax expenditures of which around one-third are superannuation tax concessions. That is roughly 15 per cent of direct outlays. Yet there is a lack of serious budget scrutiny of these tax concessions. We have an expenditure review committee which goes through direct outlays line by line. There is no equivalent process for tax expenditures. As a result, tax expenditures, as distinct from direct outlays, are the main source of what we refer to as well-off welfare in Australia—that is, poorly targeted assistance.³

6.14 The Committee supports a reference into tax expenditures, which might consider matters such as:

- whether tax expenditures provide an effective and equitable way of delivering welfare to welfare recipients;
- whether tax expenditures are an efficient policy tool more generally (that is, whether tax expenditures can be effectively applied to areas other than welfare); and
- what institutional (and, if necessary, legislative) arrangements are necessary to place tax expenditures under the same level of scrutiny as other budgetary activities.

Effective marginal tax rates

6.15 The Committee has discussed the issue of effective marginal tax rates (EMTRs) at some length in chapter 3 of this report. EMTRs present a significant challenge to future tax and welfare policy. Simply increasing thresholds appears unlikely to do any more than suppress or delay the problem of EMTRs. It is clear, even on the evidence received in this inquiry, that more fundamental reform may be required.

6.16 At the round table, Professor Gregory indicated the difficulty of devising policies to deal with EMTRs:

To do something about them is impossible without hurting considerable numbers of people. The only way you can avoid that is to give everybody more money. When you add up the two million people that we have in various parts of the welfare system, even more money is just not possible. So any adjustment involves hurting a substantial number of people. That is

3 *Transcript of evidence*, Davidson, 2 December 2003, p. 12.

the major reason why the government has, as you may have noticed, gone extremely slowly on welfare reform.⁴

6.17 The Committee supports a reference into effective marginal tax rates, and considers that this should be the first new references to flow from this report.. Organisations such as NATSEM, who have been producing significant research in this area, could provide a significant contribution. Such an inquiry might consider matters such as:

- measuring the extent and incidence of high EMTRs in Australia;
- gauging their impact on taxpayer and welfare recipient behaviour;
- examining measures undertaken to deal with high EMTRs in other countries; and
- considering alternative tax structures which could be deployed to reduce the impact of high EMTRs in Australia.

Equity in the tax system

6.18 The issue of equity in the tax system underpins every issue discussed in this report, from family tax benefits to vertical fiscal imbalance. The question of how the tax burden is shared among taxpayers is fundamental to any tax system and, as noted in chapter 4, a breakdown in the perception of fairness in the tax system may lead to further compliance problems, and to a culture which promotes the avoidance or evasion of tax, rather than the acceptance of tax as a social responsibility.

Intergenerational issues

6.19 While term of reference (d) invites the Committee to consider 'the intergenerational consequences of the tax structure', this inquiry did not receive a substantial amount of evidence addressing intergenerational issues directly. Rather, the issue of intergenerational equity underpinned other areas in the report, particularly in chapter 2 (in the sections entitled 'is the tax system a disincentive to establishing a family' and 'Families, tax and HECS) and in chapter 3 (in the section 'The tax system and retirement from the workforce').

6.20 It is reasonable to assert that *all* tax policy will have an intergenerational impact, because decisions about where and how the tax burden applies, will inevitably have an impact upon matters such as labour force participation and decisions to have, or increase, a family. However, advice to the Committee during the round table suggested that intergenerational issues also merited discrete investigation. Mr Peter Davidson, for instance, suggested that developing intergenerational modelling tools should be a priority:

4 *Transcript of Evidence*, Gregory, 2 December 2003, p. 6.

I am becoming more and more concerned about the intergenerational issues. The Commonwealth at the moment has established some sort of cell based Excel modelling tool which underlays the sort of estimates that were in the Intergenerational Report. Obviously, that is an excellent starting point to look at what the future intergenerational transfers might be. However, if you were concerned about distributional impact, you would want to go to a much more sophisticated, dynamic micro-simulation modelling. In other words, once you are concerned about distributional impacts, you need to have models of individuals rather than the population aggregated into subgroups, which is what is done at the moment in that modelling. I would really again encourage the committee to recommend the development of more sophisticated decision support tools for analysing the intergenerational impact of taxes and transfers as well.⁵

6.21 A related issue, which might be considered by the Committee during such an inquiry, is the extent to which welfare dependency also has an intergenerational character. During the round table, Professor Gregory stated:

One project we are doing at my university which I think is very exciting is that we are now taking a big sample of children of welfare recipients who turn 16 and therefore become adults in their own right and see to what extent those children have an abnormal use of welfare. So we are looking at what you might call intergenerational issues. The preliminary work on that says that if your mother is a welfare recipient, you are four times more likely than anybody else to be on welfare yourself at 16, 17 and 18. When we try to adjust that for where you live and the sort of education you have, the ratio falls. But it is still very, very high.⁶

6.22 The Committee supports a reference into intergenerational aspects of taxation and welfare. Such an inquiry could examine:

- ways in which the tax system could support adults' decisions to have children;
- ways in which the tax system could maximise workforce participation ratios;
- ways in which the tax system can assist younger generations to acquire the same capacity to own significant assets (including, particularly, their homes) as the older generations possessed at the same stage of life; and
- the interaction between taxation and the decision to retire.

Self employed workers and wage earners

6.23 The Committee has discussed the issue of the tax treatment of self-employed taxpayers in some detail in Chapter 4 of this report. There appear to be two issues of real concern. The first of these relates to the apparently inequitable tax treatment of

5 *Transcript of evidence*, Davidson, 2 December 2003, p. 11.

6 *Transcript of evidence*, Gregory, 2 December 2003, p. 24.

two workers, doing the same work for the same gross income, on the basis that one of them is self-employed and the other is an employee. During the round table, Mr. Peter Davidson suggested that this should be addressed by treating both types of worker identically for tax purposes:

In theory, it should not be much different. So the solution to this wedge that is emerging between self-employed people and employees from a tax point of view is to treat them as similarly as possible. In theory, for example, self-employed people should not be able to claim a wider swag of work related deductions than employees. In theory, they should not have a capacity to split their earnings with a spouse. Those elements of the tax system could be reinforced.⁷

6.24 Professor Covick noted that there are two ways in which this might occur: by reducing the deductions available to self-employed workers, or by extending those deductions to employees:

In 1998 in the ANTS package, it was proposed to try harder to get people deriving incomes from trusts to have the personal services element treated exactly the same as if they were wage and salary earners. Whereas it ran into problems in that the community regarded it as an extremely harsh and unreasonable thing to do to people who were benefiting from the previous arrangements, one possibility would be to say, 'Well, if community perceptions are now such that that is regarded as fair and reasonable, why not say wage and salary earners can do it as well and allow all wage and salary households to have a notional trust and their wage and salary income getting the same types of benefits for both income tax and means testing arrangements as self-employed households routinely get through the present arrangements?' So you can either improve the comparability of treatment by trying to be as harsh to the self-employed as we are to the wage and salary earners who cannot get away from it, or if that is unconscionably harsh to the self-employed, why do we not regard it as unconscionably harsh to the wage and salary earners and bring them in the opposite direction?⁸

6.25 The second, though related issue, was discussed in chapter 4 following the evidence from the CFMEU. If, as a result of current arrangements, workers are effectively being forced into becoming self-employed, and thereby denied the rights attached to employment, then it is possible that equivalent treatment for both employees and the self-employed would reverse this trend. There would no longer be a tax advantage in being self-employed.

6.26 The Committee supports a reference into the tax treatment of self-employed workers. Such an inquiry could examine:

7 *Transcript of evidence*, Davidson, 2 December 2003, p. 14.

8 *Transcript of evidence*, Covick, 2 December 2003, p. 15.

- ways in which the tax treatment of employees and the self-employed would be brought into closer alignment, on a revenue-neutral basis;
- ways in which the income of self-employed taxpayers, which fluctuates dramatically, can be more successfully assessed for the purpose of assessing eligibility for welfare benefits; and
- ways to prevent the effective coercion of employees into becoming self-employed for the benefit of the employer.

Taxation of superannuation and other benefits to retirees

6.27 As discussed in chapter 3 of this report, there appear to be two opposite views regarding the appropriateness of the current tax regime for superannuation and post-retirement income.

6.28 On the one hand, there is a view that superannuation is taxed too harshly. For instance, in its submission, the Association of Superannuation Funds of Australia stated:

... even if the relative tax treatment of superannuation were considered by the Government to be about right prior to the reduction in personal income tax rates and changes to the capital gains tax in 1999, then subsequent to the changes, superannuation taxation is now heavier than desirable. It also can be argued that even prior to the changes made to personal income tax rates that the system of taxing contributions, fund earnings and benefits received involved too heavy a burden of taxation of superannuation.⁹

6.29 On the other hand, there is a view that retirees enjoy tax treatment which is far more generous than for working taxpayers on the same income. As noted in chapter 3, the Senior Australians Tax Offset was singled out for particular criticism.

6.30 The Committee supports a reference into the tax treatment of superannuation and retirement income. Such an inquiry could examine:

- whether the current process of taxing superannuation funds on entry to the scheme, during the period of investment, and then on payment from the scheme, can be justified;
- whether the superannuation surcharge imposes unreasonably high effective marginal tax rates on some higher income earners;
- whether the incurrence of tax expenditures in the form of tax concessions on superannuation is appropriate, and appropriately scrutinised; and

9 Submission 108, ASFA, p. 6.

- whether the Senior Australians Tax Offset provides retired taxpayers with an unfair tax advantage compared to working taxpayers.

Conclusion

6.31 The Committee considers that it would not be reasonable, on the basis of the evidence received during this inquiry, to make substantial or sweeping recommendations relating to tax policy. However, one role of the Senate Committee system is to facilitate public discussion on matters of national importance. In this report, the Committee has endeavoured to fulfil that role by setting out the evidence received as a contribution to current debates on tax policy, and by setting out an agenda for future inquiries into taxation issues.

Recommendation 1

The Committee recommends that the Senate should refer a sequence of taxation policy inquiries to the Senate Economics References Committee. These references may include the following areas, as well as any areas of importance which emerge in the course of the Parliament:

- **Tax avoidance and the erosion of the tax base;**
- **Tax expenditures and grants;**
- **Effective marginal tax rates;**
- **Intergenerational issues;**
- **Tax treatment of self-employed workers and wage earners; and**
- **The tax treatment of superannuation and retirement income.**

Recommendation 2

The Committee recommends that the first reference made in accordance with Recommendation 1 should be an inquiry into effective marginal tax rates in the Australian taxation system.

GOVERNMENT SENATORS' COMMENTS

While Government Senators consider that the Report contains much useful discussion and informative material, they do not assent to each of the conclusions. Government Senators are of the view that the reforms to the taxation and welfare systems instituted by the Howard Government have been the most effective and beneficial measures introduced by any Australian Government to address the issues canvassed in the report.

SENATOR GEORGE BRANDIS
Deputy Chair

ADDITIONAL REMARKS

SENATOR ANDREW MURRAY

AUSTRALIAN DEMOCRATS

This reference and report has been a most useful exercise for the Senate. In the development of public policy and political party guidance it is vital that Senators and their parties be as fully informed and as current as possible on these pressing issues of national interest. I have no doubt that the Report and its insights will influence outcomes in tax policy and debates in the future.

The Australian Democrats will use the Report in our own policy development and in Senate considerations of tax issues.

SENATOR ANDREW MURRAY

APPENDIX 1

SUBMISSIONS RECEIVED

Submission Number	Submittor
1	Mr Jim Geerlings
2	Mr Roy Barber
3	Mr Berry
4	Mr Roy Turner
5	Confidential
5A	Confidential
6	Contact Details Withheld
7	The McIlwains
8	Mr Claude Palmer
8A	Mr Claude Palmer
9	Mrs Helen Booth
10	Mr Danny Swartz
11	Mr Graham Mills
12	Mr Ciesiolka
13	Mr Chas Camden
14	Mrs Lesley Delaney
15	Mr Geoff and Mrs Kathy Hodskiss
16	Mr George Apap
17	Mr Lade
18	Mr Gary Jackson
19	Mr Carey
20	Ms Colleen Crowder
21	Mr John Parker
22	Mr William Veitch
23	Mr Trotman
24	Mr Klarin
25	Mr Stan Bradford
26	Mr John Glen
27	Mr Nicholas Tyler
28	Mr Arthur Butler
29	Ms Priscilla James
30	Mr Leo Bishop
31	Mr Jerome Appleby
32	Mr Brad Finegan
33	Mr Alan Booth
34	Mr Colin Smith
35	Mr David Jackson
36	Mr D A Knowles
37	Mr Michael Fedczyna

38 The Taxpayers' Research Foundation Ltd
39 Mr Gavin Moodie
40 Omega Alpha Pty Ltd
41 Federated Municipal and Shire Council Employees' Union
of Australia New South Wales Division
42 Mr Chris Sugden
43 Mr Peter Glover, Economic Consultant
43A Mr Peter Glover, Economic Consultant
43B Mr Peter Glover, Economic Consultant
44 Shop, Distributive & Allied Employees' Association
45 Mr Gary Lang
46 Government of Tasmania
47 Mrs Josephine Smyth
48 Mr Nick Renton
49 Mr Douglas Forbes
50 Mr Tomas Nilsson
51 Association of Independent Retirees (A.I.R.) Limited
52 Mr John Lee
53 Women's Action Alliance (Australia) Inc
54 Mr David Deane
55 NSW Government Submission
56 Tax Reform
57 Queensland University of Technology
58 Victorian Council of Social Service (VCOSS)
59 Festival of Light
60 The Western Australian Farmers Federation (Inc)
61 The Institute of Chartered Accountants in Australia
62 Country Women's Association of New South Wales
63 Municipal Association of Victoria (MAV)
64 St Vincent de Paul Society, National Council of Australia Inc
65 Southside Chamber of Commerce Inc
66 Contact Details Withheld
67 Alcohol and Other Drugs Council of Australia (ADCA)
68 Mr Graham Wilson
69 Mr John Phillips
70 CPA Australia
71 Real Estate Institute of Australia
72 Confidential
73 Mr Eric Hagen & Ms Rachel Tan
74 UnitingCare Australia and the Uniting Church in Australia
75 Clubs Australia & New Zealand
76 Professor Cameron Rider and Miranda Stewart, Senior Lecturer
77 The Australian Associated Brewers Inc
78 Catholic Health Australia
79 Lone Fathers Association (Australia) Incorporated
80 Winemakers' Federation of Australia

81	Australian Catholic Bishops Conference
82	Department of Health and Ageing
83	Catholic Welfare Australia
84	Business Coalition for Tax Reform
85	Australian Council of Social Service (ACOSS)
86	Endeavour Forum Inc
87	Tony and Veronica Addicoat
88	Premier of Victoria
89	Mr Paul Kenny
90	Australian Local Government Association (ALGA)
91	Local Government Association of NSW and Shire Association of NSW
92	Confidential
93	Mr Loris Erik Kent Hemlof
94	Mr S Piechocki, Professional National Accountant
95	Mr John Redgment
96	Institute of Actuaries of Australia
97	Queensland Government
98	Commonwealth Department of Family and Community Services (FaCS)
99	Mr Michael Andersson
100	Mr Ronald Patrick Winthrop
101	Treasury
102	Ms Hope Ashiabor
103	Construction Forestry Mining Energy Union (CFMEU)
104	The Australian Chamber of Commerce and Industry (ACCI)
105	Ms Judy Thallur
106	Mr Cameron Tampion
107	Dr Ed Boyapati
108	The Association of Superannuation Funds of Australia Ltd
109	The Premier of South Australia
110	Mr John F Sadnis
111	Mr Ned V Albion
112	Mr Barnaby Joyce BFA CPA

APPENDIX 2

PUBLIC HEARINGS AND WITNESSES

Canberra, 28 July 2003

BEARD, Mrs Jane Frances, Joint National President
Women's Action Alliance

BLANDTHORN, Mr Ian John, National Assistant Secretary
Shop Distributive and Allied Employees Association

DALTON, Mr Anthony Edward, Chairman, Social Justice Committee
St Vincent de Paul Society

FOSTER, Mr Christopher John, Assistant Secretary, Working Age Taskforce
Department of Family and Community Services

HATFIELD DODDS, Dr Steve, Research Director, Social and Economic Integration
CSIRO Emerging Science, and the Allen Consulting Group

HATFIELD DODDS, Ms Lin, National Director
UnitingCare Australia

JACKSON, Mr Wayne Smithers Brooks, Deputy Secretary
Department of Family and Community Services

LLOYD, Ms Rachel Elizabeth, Principal Research Fellow
National Centre for Social and Economic Modelling, University of Canberra

MEIN, Mr James Stephen, Executive Director, Board of Finance and Property
New South Wales Synod of the Uniting Church of Australia and Uniting Church
member of Combined Churches Taxation Group

TOOHEY, Mr Matthew Stephen, Senior Research Officer
National Centre for Social and Economic Modelling, University of Canberra

WHITECROSS, Mr Andrew William, Working Age Taskforce
Department of Family and Community Services

WICKS, Mr John Patrick, Vice President, National Social Justice Committee
St Vincent de Paul Society

WILSON, Ms Serena, Executive Director, Welfare Reform
Department of Family and Community Services

Canberra, 29 July 2003

DAVIDSON, Mr Peter Andrew Geoffrey, Senior Policy Officer
Australian Council of Social Service

GALLAGHER, Mr Philip Francis, Manager, Retirement and Income Modelling
Tax Analysis Division
Department of the Treasury

LONSDALE, Mr John Peter, General Manager, Tax Analysis Division
Department of the Treasury

McCALLUM, Mr Andrew George, President
Australian Council of Social Service

McGAHAN, Ms Madonna Mary, Director, Policy and Research
Catholic Health Australia

SULLIVAN, Mr Francis John, Chief Executive Officer
Catholic Health Australia

Canberra, 12 September 2003

GRANGER, Ms Jennifer Anne, Second Commissioner
Australian Taxation Office

LEWIS, Mr Guy Peter, Business Manager
Complex Investigation and Prosecution Support
Centrelink

MONAGHAN, Mr Michael, Deputy Commissioner
Serious Non-Compliance
Australian Taxation Office

RICHARDSON, Mr Phil, National Manager, Detection and Review
Centrelink

RUSSELL, Mr Barrie Thomas, Deputy Commissioner, GST
Australian Taxation Office

RYAN, Mr Paul Michael, Acting Deputy Director
Australian Transaction Reports and Analysis Centre

Canberra, 2 December 2003

BRADBURY, Dr Bruce William, (Private capacity)

COVICK, Associate Professor Owen Edgar, (Private capacity)

DAVIDSON, Mr Peter Andrew Geoffrey, Senior Policy Officer
Australian Council of Social Service

GREGORY, Professor Robert George, Professor
Australian National University

HARDING, Professor Ann, Director
National Centre for Social and Economic Modelling
University of Canberra

WARREN, Associate Professor Neil
Associate Director (Research), Atax, Faculty of Law
University of New South Wales; and
Research Director
Australian Tax Research Foundation

