Australian taxation system analysis essay sample

Economics

There is a definition of tax in the Webster’s Dictionary–“…a compulsory payment of a percentage of income, property value, sales price, etc. for the support of a government”. In theory the collection of taxation should be fair, simple, efficient and neutral.

Australia inherited a convoluted and complex taxation structure from its British Colonial past. Australia’s economy has become more dynamic, efficient and productive over recent decades. However, the tax system has only adapted slowly to these changes. In particular, Australia’s high personal tax rates and low thresholds are uncompetitive by international standards.

Comparing the Australian Income tax system with the Eastern Europe (e. g. Russia), this paper provides an analysis and discussion of the Australian Income tax reform has become complex, inequitable, difficult to understand and almost impossible to implement effectively.

Introduction

“ The hardest thing to understand in the world is the income tax.” 1

The primary purpose of income taxation is to raise revenue for the governments. The criteria of equity, simplicity, efficiency and neutrality are the traditional criteria used to evaluate how effectively a tax system carries out its purpose of raising revenue. Since 1901 successive Australian Governments have struggled to find the “ perfect” tax system to achieve those targets.

Nowadays, there are two main types of income taxation system. One is a progressive tax system which the Australian Income taxation system is; the other is a flat tax system which the Eastern Europe (e. g. Russia) uses. Comparing with the Eastern Europe, the Australian Income tax system does not have only one single rate and has hundreds of deductions, credits, exclusions, etc. The Australian Income tax system can not produce the desired results. It sinks further into the mire of confusion, clouded by deception and self interest. Following is the brief review.

1. Fairness or Equity

The tax matter–fairness is an ideal exceedingly difficult to define and harder still to measure. The objective view of fairness is a matter of perspective, one person’s viewpoint varies form another.

There is one concept of equity-vertical equity: taxpayers in different positions treated differently, the further implicit assumption being that the wealthier should bear a greater burden than the poor. Usually someone with an income 10 times higher than another would pay 10 times more. To most people, this is the essence of fairness. Under the Australian Income tax rates–the progressive tax rates(five rates for the residents, four rates for non-residents, and the top tax rate recently is 47%), someone with an income 10 times higher would pay 10 times more. It is obvious that this target of fairness can not be achieved by the progressive tax rates but it can be accomplished simply in Eastern Europe by a flat rate.

There is another concept of fairness. Under “ horizontal equity”, taxpayers in similar positions should be treated the same. Australian current system violates this principle because one’s tax liability depends not just on the amount of income, but the form of that income (wages vs. business income) and the amount of tax deductions, exclusions, credits and exemptions to which one is entitled. Complexities immediately occur: two taxpayers with the same income may be in entirely different social positions. One may be a single male who carries no debt or dependants and the other a married woman with a disabled husband and three children, and servicing a mortgage. Clearly the affordability of the two taxpayers is enormously different, though the apparent income is identical. The government response was to introduce a “ rebate” system whereby both taxpayers are assessed at the same rate but the more ‘ burdened’ taxpayer to receive “ rebate” to reduce the final tax payable.

The family rebate system has evolved extensively and has been used as a social welfare and grant system ever since. As of 2001 such rebates have been termed tax offsets and range from subsidies for living in remote localities, zone allowance, to child care assistance. Payments to pensioners as a Government Grant to offset the inflationary impact of the GST where also made through the taxation system in 2001.

Finally, there is a question of fairness in Australian tax system that imposes differently high income tax rates on a minority. In a recent article in the National Tax Journal, Professor James Buchanan, a Nobel laureate, argued that the most “ politically efficient” system of taxation “ would involve a flat-rate, proportional tax on all sources of income, without deduction, exclusion or exemption.”

2. Simplicity

At least since Adam Smith, simplicity in taxation has been considered a virtue. By simplicity we mean not only that the tax system is conceptually easy to understand, but also that the cost of complying with its requirements is low.

The Australian Income tax system fails both tests. The Australian income tax system uses two acts concurrently, the ITAA 19362 and the ITAA 19973, is sufficient evidence that the legislators appear to have taken the reverse view of simplicity. The principal cost is the time we must spend keeping records, filing forms and paying the tax. A government study estimated that Australians spend some billions hours per year just doing that.

True simplicity requires more than simple forms; it requires a simple tax system as well. Creating a simple tax system requires stripping away unnecessary exemptions, deductions, credits and exclusions. It means stripping away unnecessary rates and unnecessary levels of taxation. It means moving the point of collection as close to the source as possible. And it means moving any necessary complexity away from individuals and toward businesses, which are better equipped to deal with it.

The Australian Income tax system seems so complicated. It has hundreds of deductions, exemptions, credits and exclusions. Such as in the ITAA 1936, S 23 (o) exemptions to gold producers and deductions for capital items related to drought reduction measures taken by primary producers, and in the ITAA 1997, S 8-1 provides the general deduction and S 12-5 contains a checklist of specific deductions.

While in the Eastern Europe, the flat tax achieves all of these goals, and it significantly simplifies the tax system. The lower rate of a flat tax encourages compliance with tax laws, which increases revenue. Because of the flat tax's decreased rate, there is less of an inducement to evade taxes. In addition, the elimination of complicated exemptions, credits, and deductions makes it more difficult to take advantage of the tax shelters that exist under current laws.

3. Efficiency and neutrality

This principle was not applied to the taxation system but rather to the impact of the Taxation system on the economy. That is the impact of tax should not influence economic decisions as to the production or consumption of goods or services.

All taxes impose a cost on the economy over and above the amount of actual revenue collected. Economists call this the excess burden or deadweight cost of the tax system. It is in addition to the compliance cost.

Although all taxes impose some deadweight cost, the magnitude of the cost varies enormously depending on how the tax system is structured. Two different tax systems raising the same amount of revenue can impose significantly different burdens on the economy. At the low end the flat tax which is used in the Eastern Europe is the head tax or poll tax. Since every taxpayer is liable for a specific dollar amount of tax, there are no penalties for those who work, save and invest. At the other end is the steeply progressive income tax, under which the same income is double and triple-taxed. This is the tax Australia has now.

In the Eastern Europe the flat tax achieves the goal by eliminating distortions in the tax base and the rate structure and eliminating the tax bias against saving and investment. And without progressive tax, taxpayers are no longer pushed into a higher tax bracket by inflation. For example, Russia applied its flat tax in 2001, and revenue has jumped an average of 35 percent annually. A large part of this dramatic trend has been traced to a sharp increase in compliance, an important benefit of a flat tax regime. Statistics concerning Russia's actual GDP are somewhat trickier as a result of a large so-called " shadow economy," but reasonable estimates hold that Russia's real GDP will grow from the equivalent of $500 billion in 2002 to over $1 trillion by 2008.

Conclusion

Opposite to the progressive tax which Australia uses, the flat tax is a simple, fair, efficient, and effective model for tax reform. The increased incentive to work and invest combined with revenue growth and economic competitiveness makes it an attractive alternative to the complicated tax systems currently in place in Australia. It is sensible that Australia should seek fundamental change in its own tax system in order to avoid falling further behind in the race to attract foreign direct investment. Developments in the Eastern Europe provide Australia with one working model of what serious tax reform could do for economic growth. Australia should not delay in enacting meaningful tax system reform.

Footnotes

1. Albert Einstein, Swiss-German-USA physicist, 1879-1955

2. the Income Tax Assessment Act 1936

3. the Income Tax Assessment Act 1997

References

Books:

1. R L Deutsch, Fundamental Tax Legislation, 2005, 13th edition

2. Michael Kobetsky, Ann O’Connell & Miranda Stewart, Income Tax, 2005, 5th edition

Article:

Ryan Kool, the Flat Tax: A Worthy Competitor in the Global Economic Game, Sep 14, 2005

Websites:

1. http://www. alga. asn. au/policy/finance/austax/9. why. php

2. http://www. ato. gov. au/

3. http://www. press. uchicago. edu/Misc/Chicago/555607in. html