Tax Policy Future Shock:

Arrivederci good tax design?

by

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ABSTRACT

This paper looks forward a decade and asks:

1. What are possible sources of future shocks to the Australian (and global) tax system?
2. What tax policy reforms might result from these shocks?
3. How might the resulting reforms impact tax compliance and tax administration?
4. What will this mean for good tax design?

The paper begins with a brief review of past tax reform trends both in Australia and internationally. Attention is then focussed on two shocks to the current tax system design – China's entrance into the global economy beyond the commodity trade, and the growth of the virtual world. The potential tax policy shocks arising from these changes are outlined along with implications for tax practitioners and tax administrators of any related tax reforms.

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1 INTRODUCTION

It is said that "if anything in life is constant, it is change". With change comes the need to review and renew – and tax is no exception to this. Economic, social and institutional changes – both domestic and international – require governments to be vigilant about their tax system design. In this paper we look forward a decade and ask:

1. What are possible sources of future shocks to the Australian (and global) tax system?
2. What tax policy reforms might result from these shocks?
3. How might the resulting reforms impact tax compliance and tax administration?
4. What will this mean for good tax design?

These questions can only be answered in context so this paper begins with a brief review of past tax reform trends both in Australia and internationally. With this background, we review the implications these changes have had for good tax design. Attention is then focussed on two major future shocks to current tax system design – the burgeoning e-world along with the emergence of the virtual world; and the re-ordering of in-world trade flows with the entrance of China into the global economy. What then are likely to be the tax policy responses to these shocks? What will be the implications for tax practitioners and tax administrators of these reforms?

2 PAST TAX REFORM TRENDS

The major issues which have been driving tax reforms both domestically and internationally over the past decade have been:[1]

- the need to raise revenue in an internationally competitive environment;
- a focus on restoring economic efficiency (and reducing distortions, especially work disincentives);

[1] For a more extensive discussion of this issue, see OECD(2006, chapter 2)

- maintaining fairness (with changing income distribution and increasing income dispersion);
- improving compliance by reducing complexity and avoidance and evasion; and
- attempts to resolve policy choices including:
    - Revenue requirement vs economic efficiency;
    - Equity-efficiency balance;
    - Complexity of the tax system vs revenue needs and equity; and
    - External pressures for harmonisation/competition vs domestic fiscal autonomy and demands.

Assessing the source of future stresses and strains on the current tax system is most simply demonstrated through a brief SWOT analysis of the current tax systems in developed economies.

Strengths

1. Income taxes (personal and company) are relatively broad based.
2. GST/VAT consumption taxes are widely applied to a base broader than the previous single stage consumption taxes (eg Wholesale and Retail Sales Tax).

Weaknesses

3. In recent years the GST has become vulnerable to evasion and fraud, stimulated by greater ease in the flow of goods and services and the high rates imposed in some jurisdictions.
4. Complexity
    a. Income taxes: Both personal and company income taxes are complex.
    b. Sub-national taxes are often economically inefficient and lack harmonisation.
5. Compliance costs are high for some low revenue taxes that are designed to address tax system integrity concerns (eg FBT), even if administrative costs appear modest (ie the burden lies mostly with the tax collector and less with the tax administration).

Opportunities

6. Some tax bases remain relatively unexploited including:
    a. Wealth taxes.
    b. Environmental levies.
7. International and intra-national data exchange in the form of acquisition/ sharing/ mining/ warehousing is in its infancy. Much more remains to be done with the use of international business and personal tax file numbers.
8. Technological advancements are yet to be fully exploited such as hardware/software solutions to tax administration and compliance problems.

Threats

9. Increasing tax competition:
    a. Increasing factor mobility across international frontiers has exposed income taxes to greater tax competition and increased scope for evasion.
    b. Intra-national tax competition (ie inter-state) is a significant threat to State tax systems and to national tax system efficiency.
10. Widening tax gap (or revenue integrity):
    a. Cross-border commodity trade and capital flows in an open economy environment pose major challenges to tax systems of the future.
    b. Non-observed economy (including the cash economy) is a growing cause of concern to governments around the world and is resulting in considerable collaboration between tax authorities.

11. Less robust revenue growth and stability.
    a. Personal income tax system:
        i. Ageing population: This will see a decline in labour supply and increased pressure on the tax system to deliver revenue to meet growing expenditure demands.
        ii. Highly mobile capital: Growing intra- and internationally mobile capital has significant implications for the taxation of capital.
        iii. Deductions: The presence of high marginal tax rates creates an incentive for taxable income deductions and has the potential to erode the tax base.
    b. Company income tax:
        i. Vulnerable to economic cycles (especially to commodity price cycles in resources based economies).
        ii. Exposed to tax competition and cross border issues.
    c. Petroleum excise (which is a significant revenue source) is at risk with growing energy scarcity.

While the Australian tax system has its strengths, it also clearly has major challenges, particularly in an environment of increased global and domestic competition. This is a situation common with most other countries. The challenge going forward will be ensuring the maintenance of a 'good' tax system which includes minimising economic inefficiencies arising from the imposition of taxation, equity in the distribution of the burden, robustness to ensure revenue needs are met, simplicity of administration and transparency of operation to ensure certainty of liability. The problem is that simultaneous achievement of these goals is not possible as trade-offs between these principles inevitably arise. For example, an income tax is not a simple tax, but it has significant revenue raising potential. Hence a move to say, taxes on consumption might achieve simplicity, but at a revenue cost. Additionally, a consumption tax would make it more difficult to achieve equity. It is these trade-offs that make the design of a tax system a complex matter.

Moreover, any one tax system cannot be considered independent of not only other taxes imposed by different levels of government within the same country, but also those tax systems imposed by other countries with whom they trade.

The difficult question is however, when we look forward what criteria will be attracting most attention. In effect, in the 1990s and earlier, equity was given particular prominence evidenced by the progressive nature of the personal income tax, the introduction of the imputation system of company taxation (which also has efficiency benefits) and the removal of food, health and education from the base of the GST. As we entered the 21st century, increasing attention was given to the issue of economic efficiency both in terms of company and personal income tax design.

In relation to company tax, this saw the broadening of its base and the reduction of its rate to 30% in 2001-02 through the removal of tax preferences. In the case of the personal income tax, attention was focussed on addressing the efficiency impact of a progressive tax rate schedule, particularly the high marginal tax rates on those with income between one and two times average weekly earnings (AWE). The response was twofold: firstly by taxing selected taxable income sources concessionally (ie capital gains contributions to superannuation) and secondly, by increasing the tax thresholds which effectively decreased the marginal tax rate for those with between one and two times AWE. What was not directly addressed was the incentive to negative gearing investment in shares and residential accommodation. However, reduced marginal tax rates will act to reduce this incentive.

The all-important question then is what will be the future direction of tax reform in the light of the new global and domestic challenges. And given this focus, what does it mean for our goal of having in place a 'good' tax system.

3 CHALLENGE 1: THE E-WORLD MATURES….AND THE VIRTUAL WORLD ENTERS

Moving towards an intangibles-based electronic market environment from a tangibles-based market, challenges many of the concepts we have come to know and accept. In fact, the whole concept of what is a market and what constitutes a transaction is changing. With this change comes a need to rethink concepts which until now been relied upon to form the basis of taxation rules. Not to do so is to risk potentially serious implications for Internet commerce in general, and taxation revenue in particular.

For the past decade the focus has been on addressing the challenge to legal tax concepts arising from the growth in the e-World but now, we must address the emergence of the virtual world. This section outlines how these two developments will continue to open up a new frontier of challenges for domestic and international tax systems.

3.1 e-World

The emergence of the e-World over recent years has challenged the traditional building blocks of the tax system including the concept of residency for persons, the notion of permanent establishments for business, the valuing of transactions and the integrity of information flows.

3.1.1 Residency shifting by persons

Using the Internet, one person can effectively live and work in any number of jurisdictions. Telecommuting using the Internet is now simple, easy and cheap. In the past, the concept of residency for individuals was based on where they were *physically* resident for the majority of the year (so-called 183 day rule). This was designed to indicate a person's allegiance to a country through their participation in the social and economic activity of that country.

This concept of residency is fine in a situation when a person crosses international boundaries and there are clear records of a border-crossing. But what happens if there is no record of a border crossing and the person does not spend much of their Internet time in the jurisdiction in which they are physically located. Using the Internet, such a situation is relatively easy to perceive.

In this case, there is only a weak link between a person's physical location and the jurisdiction in which they are electronically resident - so who in this case has the greatest claim on this person's income? The trouble is that current tax rules are unsympathetic to the new sophisticated methods of working and deals with this situation in an arbitrary and inefficient way.

The challenge for tax laws is to define a more flexible concept of residency capable of accommodating work practices which are globally based and where physical location is meaningless. A 'facts-and-circumstances test' has been proposed as a solution to this problem. Here, a person is taxed not on the basis of location but on the basis of the facts surrounding their situation.

For the taxation authorities, this poses a whole new challenge. It means that the Internet commuter should be taxed in the country to which they commute, not the country in which they are resident. While this seems reasonable at first blush, the economist would argue that part of the purpose of taxation is to fund the benefits and infrastructure available to a person in their country of residence.

A reasonable question to then ask is if an Internet commuter became unemployed, which country would support them and when they move from the PC in their room in their house, who should pay for the public services they subsequently consume. In this context, the 'facts-and-circumstances test' has problems since it flies in the face of one of the primary purposes of taxation - the provision of benefits which accrue to those physically located in a region.

Furthermore, the sheer complexity and difficulty in governments deeming residency on Internet commuters would inevitably prove problematic. For example, what if I have four PCs in my office in Sydney and simultaneously work with other groups around the world. Does this mean I have four jobs and happen to be resident in four different countries.

Just as the residency test for individuals has problems, so too does the 'facts-and-circumstances test'. In the end, a simple solution might be a system of income withholding taxes on flows between countries - but this also no doubt will have its own set of problems, such as what is income and what are sales. Also, what do we do if a person living in Australia telecommutes to work in Hong Kong and is paid via a Bermuda bank account? Tax system integrity therefore becomes a real issue and it is here that the management and monitoring of information flows becomes vital (as noted below).

3.1.2 Permanent establishment shifting by businesses

A permanent establishment (PE) is a location where a business enterprise is wholly or partially carried on. This concept is important in determining a company's business income tax liability in a country. However, carrying on business via the Internet challenges the whole concept of a PE and therefore how we should determine the business income of an enterprise. In Article 7 of the OECD Model Treaty, an enterprise of a contracting state is generally exempt from taxes on profits derived from business carried on in the *other* contracting state unless those profits are attributable to its PE located in that *other* contracting state.

Article 5 in the OECD Model Treaty defines business premises that are PEs as[2]:

1. a place of management;
2. a branch;
3. an office;
4. a factory;
5. a workshop;
6. a mine, an oil or gas well, a quarry or any other place of extraction of natural resources

It would appear that some form of permanent physical presence characterises each of these cases. What then about a website? Lets call this an electronic establishment (EE). Does a website have a permanent physical presence? If it does it can be extremely elusive. Such sites can be moved, replicated and masked with considerable ease. After all, these EEs are nothing more than binary code stored on some electronic retrieval device (a computer). An EE therefore challenges the concept of a PE, since while an EE might for a fleeting moment be akin to a PE, the EE is mobile in seconds and can replicate itself in just as little time.

[2] Arnold and McIntyre (1995), p 105 and http://www.eis-usa.com:8080/emtc/webemtc.htm?%20ln=OECD%20USER

What if a country offers itself as an EE (tax) haven by refusing to share information flows through its internal boundaries with other countries or provide information on who are the owners of the websites operating within their borders? The information chain then will only be as strong as the weakest link. This weak link is the scope the new technology offers for straight out tax evasion and challenges tax system integrity.

3.1.3 Value shifting with Intranets

Another situation where the Internet poses a major challenge to tax system integrity is through the growth of Intranets. Intranets are intra-company or private secure networks which operate on the same protocols as the Internet but where access is limited to those permitted access by the organisation who maintains the Intranet. The challenge for the taxman from Intranets comes from the scope they provide for organisations to rearrange their internal structure and cost sharing arrangements across international frontiers to minimise their global tax liability.

Through Intranets, firms can mask the extent of any transfer pricing by engaging a service companies (maybe just a website) in a low tax country or use Internet and Intranet based telecommunications to work-share around the world in a way that the tax authority would find difficult to monitor or dispute. In fact, collaborative activities via the Internet and Intranets could easily become a major vehicle for shifting tax burdens across international frontiers.

Unless an electronic trail is kept of all activities undertaken on the Intranet, then tax authorities are likely to confront potential enforcement problems. However, even if a trail is kept, who is to say that the activities are genuine as there is only an electronic trail, not a paper trail or any electronic signatures attached to the transactions.

3.1.4 Masking information flows

A common concern in the above discussion is the scope for the internet to be used to avoid or at worst, evade tax liability. The problem for governments is that their investigative and enforcement powers are typically restricted to national boundaries – unless other nations also cooperate. Monitoring Internet activity is difficult and probably impossible for any one nation – especially if encryption techniques improve and get beyond the reach of government agencies.

The real challenge to tax authorities is that the Internet offers everyone a cheap and easily accessible way of getting beyond the reach of government. A few tax evaders are probably acceptable and inevitable in any system, but systematic evasion (and avoidance) is not tolerable and it is this threat that has focussed tax authorities around the world. There are various levels at which this problem can be examined.

In the late 1990s there was considerable hope held out by some for the replacement of the little remaining cash in our wallets by stored value cards (SVC). This technology was extensively trialled around the world (eg Mondex and Digicash) and applied to both the real economy and to cyberspace transactions using PCs and special devices connected to PCs. The problem for tax authorities is that SVCs could be topped up with funds from a bank or from another person or business SVC, with the result that these cards became independent of any paper trail. Governments universally were worried by these developments – especially the tax man. Ultimately, governments eliminated SVCs as a risk by regulating them out of existence by limiting how they could be used and the value that could be stored on them.

The key to tax system integrity is the paper trail which would have been lost with SVCs. The solution governments preferred was the extensive and rapid adoption of credit and debit cards

managed by the large financial institutions who could report such transactions to the tax authorities. But what about the case of less reputable financial institutions, particularly those dealing with tax havens? Successful large scale tax evasion often has at its centre the involvement of countries prepared to set themselves up as tax havens. This complicity could also extend to providing a low (or zero) tax regime for those involved in the e-World.

While tax havens have always been with us, what is different now is that the Internet makes them accessible to the masses. The response of governments over the past eight years has largely been coordinated by the OECD which having identified 38 jurisdictions as tax havens, at the end of 2007, 35 jurisdictions had made commitments to transparency and effective exchange of information, while three, Andorra, the Principality of Liechtenstein and the Principality of Monaco, have not, and are considered uncooperative jurisdictions by the OECD's Committee on Fiscal Affairs[3].

This 'name and shame' approach combined with the threat of denial of access to the world's banking system has clearly been a powerful incentive for these tax havens to exchange taxpayer information with OECD countries. While ever access to the world's financial institutions is necessary for trade in goods and services, there is every possibility that the e-World will remain within the traditional tax net. Clearly the real imperative for success is the free exchange of information between all tax authorities around the world.

3.2 Virtual World

While the challenge of the e-World has been seen off by tax systems and tax authorities, the new challenger has been the growth of the virtual world. A virtual world is a computer-based simulated environment that users inhabit and interact with virtual representation of themselves ('avatars') and others. The world they inhabit is usually represented in the form of two- or three-dimensional graphical representations inhabited by avatars and which, in some cases, allows for multiple users who interact[4].

A tax literature has now developed around the legitimacy of taxing activity in the virtual world and the implications[5] of such an action. Revenue agencies are also investigating the tax administration implications of these virtual worlds and link across to impact on in-world activity. At first glance one might presume this pursuit fanciful – but a particularly interesting aspect of these virtual worlds is the sophistication and depth of their virtual economies. The cross-over between the real and virtual world comes in these worlds such as Second Life[6] which have currency exchanges where users can trade real-world currencies for virtual-world currency and vice versa. This drawing of a direct link between actual currency and virtual-world goods and services have a corresponding real-world monetary value. The means that virtual-world goods arising from virtual-world activities can create real-world wealth. The incentive is to undertake activities that maximize wealth.

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[3] See http://www.oecd.org/document/57/0,3343,en_2649_33745_30578809_1_1_1_1,00.html
[4] See http://en.wikipedia.org/wiki/Second_Life
[5] See http://papers.ssrn.com/sol3/papers.cfm?abstract_id=980693
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=969984
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1097793
[6] See http://secondlife.com/;

Camp (2007) explores the federal income tax implications of the creation and growth of Second Life, arguing that it possesses all of the same economic characteristics as real-world goods and services and therefore results in the production of taxable income, especially where a user's Second Life activities spill over into their in-world activities. However, it is still early days in this literature and just as there was a call for a moratorium on the taxation of internet activity in the early days of the internet, this is also the case with taxing virtual world activity. It is still in its formative stage and not a real challenge to tax system integrity – so probably do not expect too much excitement in this domain just yet.

4 CHALLENGE 2: IN-WORLD TRADE RE-ORDERING … ENTER CHINA AND INDIA

Just as the virtual world is offering up new challenges and the e-world is becoming settled, the dynamics of in-world trade is being transformed. While the direction and nature of trade flows has been relatively stable over recent decades, what should not be forgotten is that the fortunes of nations have long been inextricably linked to their trading activity. In the 18th and 19th centuries, the Portuguese and Spanish built empires around their trading activities as did the Dutch and British. In the 20th century it was the US in the post-WWII era and Japan in the 1960s who build their economies firmly around trade. Now, in the early part of the 21st century, it is China that has built its fortunes around trade and is soon to be joined by India.

With the change in trade flows comes change to the operation of the global financial system as inevitably finance follows trade. With these in-world flows of goods and finance comes pressure for change to accommodate the new order. In the case of China, the different ways of doing business pose potential challenges to tax systems. While China's tax law might formally exist and accord with western tax principles, in practice the secondary role of the law in defining relationships between individuals and business has the potential to challenge tax system integrity both in China and across international frontiers. A growing body of literature[7] has developed around highlighting the quite distinct difference between western and Chinese society, extending this to its impact on tax system design.

In Chinese society, networks of individuals are far more important than independent individuals. The links within these networks are based around bonds built for the mutual benefit of individuals. These are not only economic but social and are informal, not being based upon law. The problem for tax design is that these relationships are not transparent. The literature refers to these relationships by the Chinese name, 'guanxi'. While western culture is based on the use of strict contracts and legal mechanisms, Chinese culture instead relies on trust and guanxi and it is not uncommon for these cultural norms to override the law[8] and formal institutions. The result is that modern Chinese enterprises – private or state owned – are founded on business networks rather than independent firms or individuals. As a result, the assets of the business effectively belong to the network rather than the individuals participating in the network. Complicating matters is that these networks transcend national frontiers[9].

[7] See Sharkey(2004, 2006, 2007, 2008)
[8] See Wank(1999) and Gold, Guthrie, et al. (2002).
[9] See Chan(2000) and Menkhoff and Gerke(2002).

If the structure of Chinese society and markets are markedly different from that elsewhere in the western world, then western based tax and legal concepts will not be effective in dealing with China based commerce or where China trades with other western countries. In effect a different tax model needs to be applied – one which can accommodate this informal network based business activity. Such a model might be a presumptive tax regime which is based on taxing indicators of taxable activities rather than taxing directly those activities taxable under the law.

The challenge for western economies is that these Chinese networks run seamlessly across national frontiers. Through migration significant Chinese business communities now exist within most South East Asian states as well as in Australia, New Zealand USA, Canada, and in parts of South America and Europe. The strength of the Chinese network has been its ability to integrate into host nations. These networks can also embrace local businesses if they complement or strengthen the current activity of the network. Further strengthening the Chinese network has been ease of transport and modern communications and its ability to be sustained and grow in states lacking centralised order.

So what does this mean for western tax systems? That western legal concepts do not have ready application in the Chinese business environment which with growing trade with China and increased Chinese investment in Australia has the potential to challenge some of the basic building blocks of our western tax system. In particular, who are the legal owners of the assets of the business, to whom to attribute income generated by the business, and how to value the transactions undertaken by the business – to name but a few. One could conjecture that with development Chinese business will increasingly adopt western approaches but despite major upheavals amongst the Chinese people around the world over the past millennium, their culture has survived and thrived – and the recent rise of China is unlikely to result in any change their well-established cultural and social norms.

5 SHOULD NATIONAL GOVERNMENTS BE CONCERNED?

Tax systems need to be capable of adapting to and meeting the challenges which confront them in an ever changing world. The two challenges outlined above are just two of many which will confront tax systems over the coming decade – with changes to the taxation of the environment being probably the biggest other single challenge. However, focusing our attention only on those coming from the emergence of the new trading environment, the important question now is just how these developments are likely to impact on the future design of our tax system.

5.1 Global or Schedular Personal Income Tax?

The current Australian personal income tax is a global income tax – all income sources are summed and taxed under one tax rate schedule. In contrast, a schedular income tax is one where different income sources are taxed under their own schedule. This is indirectly what happens at present with capital gains, fringe benefits and superannuation contributions, and directly in the case of fringe benefits which are taxed at a flat rate in the hands of employers.

Earlier discussion highlighted the growing evidence over the last decade of declining tax rates on capital income at the personal level – due in no small part to the increasing mobility of capital. The advantage of schedular taxes is their simplicity, transparency, and ability to be imposed at rates which minimise the economic distortion when uniform tax rates are applied to all income when it would be more efficient to set rates at levels which reflect the sensitivity of the tax base to tax rates.

With global completion for scarce capital and labour resources over the next decade this trend towards tax rates being adjusted – nominally or effectively – to yield differential rates on different income sources designed to minimise economic distortion, will continue. The net result of this pressure to introduce non-uniform (economically efficient) tax rates is likely to be a system where:

- personal capital income is taxed at reduced (differential) rates, probably at levels lower than the corporate level;
- self-employed are taxed at reduced rates, at least at rates comparable to incorporated businesses;
- highly mobile skilled workers are taxed at concessional rates and ultimately, (for equity reasons) all high income individuals at low flat rates;
- interest income is taxed using withholding taxes;
- fringe benefits are taxed either in the hands of individuals (a move away from the current schedular approach) or at reduced rate;
- capital income losses are quarantined (effectively eliminating negative gearing) or at least capping losses in some way;
- income deductions such as work-related expenses (WRE) are abolished or at a minimum, replaced with either some alternative rebate arrangement (to remove the incentive for high income earners to claim greater deductions) or making a WRE tax offset available to all employees.

Moreover, if economic activity morphs into virtual worlds (which are untaxed) or if the new global economic order fundamentally challenges the roots and branches of our tax system, then there could be pressure to move past schedular systems to presumptive taxes where proxies of the taxable base are taxed. However, the latter approach, if it occurs, will in large part be an admission of failure of the tax system, especially tax administration.

5.2 Company income tax

If there is a growth of informal networks both within and across frontiers within which goods and services flows occur, then the basic building blocks of the company income tax could come under challenge. This might lead to the application of a presumptive company tax limited to the affected sector. Adopting this option would reflect both a failure of the tax administration as well as reflect the limited opportunities available to government in the face of information asymmetries in their dealings with taxpayers.

Even if governments can ensure enforcement through monitoring secondary data flows (such as through financial institutions) and therefore avoid the need for basic presumptive taxes, the pressure to reduce the (nominal and effective) company tax rate will be significant as Australia tries to compete in a highly mobile capital market for scarce capital.

While the base of the current Australian company tax is already broad, the question is whether it will be narrowed over the next decade through the introduction of accelerated depreciation regimes. In all likelihood, international tax competition will force some concessions to be introduced.

In relation to the company tax rate, there will be international pressure for the current rate of 30% to be reduced even if Australia is administering an imputation system while the rest of the world adopts the classical system. This is because the 30% rate for foreign companies operating in Australia with foreign shareholders is, for all intents and purposes, a 30% rate classical system of company income taxation. If other countries move to adopting rates of between 15% and 25%, Australia will confront considerable pressure to reduce its nominal rate.

Another issue which might arise over coming years is whether small business should be taxed at a rate less than 30%. Such an approach is finding application in some countries such as the UK but it is questionable whether such a system would be adopted in Australia given current concerns about tax minimisation through corporate structures, even at the rate of 30%.

In terms of administration, the issue here is one as to whether the imputation system will find itself replaced by a classical system with accompanying dividend income relief. While the pressure will grow for the adoption of a classical system (eg all EU countries must adopt such a system as part of membership), the refundable nature of franking credits to individual taxpayers and how these credits are used by superannuation funds and corporations means that such a change could not be undertaken quickly or simply and if introduced, would need a significant transitional phase to avoid adverse impact on shareholders and those dependent on dividend for income such as self-funded retirees. It is therefore unlikely that we might find a classical system adopted and if introduced, would need to be associated with substantial transitional provisions and significant dividend income relief.

5.3 GST

The e-World is borderless, as is the virtual world. So too can be trade across frontiers which occurs through non-transparent networks. In today's world, there are no longer customs officials checking to see if the correct tax payable on the flow of goods, services, capital and capital income, has actually been paid. Now goods and services stream across frontiers unmonitored and often free of their legal tax liability. A once-important attribute of the GST/VAT tax regime was its ability to manage cross-border trade, ensuring exports exited tax free and imports entered a country with the appropriate tax liability. Today, the integrity of current GST/VAT tax regimes is under threat[10] from carousel fraud, the growth of the non-observed economy and the impact of new technologies.

In response, new strategies need to be put in place to counter the effects of these developments. For example, the EU is considering wider application of the reverse charge rule under the VAT – where the purchaser bears the responsibility for paying the VAT on their purchases – and has already implemented the origins principle in relation to imports into the EU from non-EU countries. The latter is being achieved through businesses in non-EU countries selling into the EU to being registered for VAT as if they were resident in the EU and collecting VAT on their EU sales. In the case of growing VAT fraud, increased attention is being given to better understanding the impact of VAT fraud on VAT collections through estimating VAT gap (Warren and McManus 1996, 1995).

It could be argued that the threat to EU VAT regimes will not occur in Australia because Australia still has well defined border entry points and that its GST rate is low (10% vs the EU average of around 18%). However, for Australia, it is inevitable that the GST rate will rise as revenue demands of government increase and income taxes are cut. It is in this new higher GST rate environment that Australia's GST will – like that in the EU – come under threat and to which Australia will need to respond – but by then we will have the benefit of the EU response.

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[10] See the IMF website at www.imf.org which contains many papers on VAT such as
http://www.imf.org/external/pubs/cat/longres.cfm?sk=21122.0 (VAT and Trade);
http://www.imf.org/external/pubs/cat/longres.cfm?sk=20975.0 (VAT Attacks);
http://www.imf.org/external/pubs/cat/longres.cfm?sk=20215.0 (VAT Fraud).

6 SHOULD SUB-NATIONAL GOVERNMENTS BE CONCERNED?

Up until now we have focussed largely on the implications of these new challenges to tax system integrity for national governments and national tax collectors. However, there are also potentially significant implications for sub-national jurisdictions from the growth in new avenues for trade and economic activity.

The tax systems of State governments are clearly under threat from the e-World and the virtual world. There are developments out there on the Internet which will have major implications for the way States collect their revenue. The first wave of this challenge came from the growth of Internet banking and gambling. Taxes on financial transfers are highly susceptible to avoidance simply by relocating the financial activity legally. For the Australian States, this was a major factor behind the demise of FID (Financial Institutions Duty) and BAD (or Debits Accounts Tax).

For gambling taxes, the challenge has been the huge growth in online gambling. If such institutions are based in tax havens (or even low tax jurisdictions), competition with State gambling becomes an issue of concern. The UK has already experienced the exodus of its high street gambling offices to tax havens which only returned when gambling taxes were reduced following a major review and a consequent reduction in tax rates[11].

Where State taxes are not vulnerable is where they are imposed on real property – and it is here that the property tax and property transfer duty are less vulnerable. Where there is pressure on States is in harmonising their tax systems to minimise the incentive posed by differential tax rates.

Clearly, the e-World offers the challenge of increased tax competition for both State and national governments. Considerable pressure will therefore exist to harmonise both the base and rates of taxes not only across jurisdictions in a country, but across countries.

7 WHAT DOES THIS MEAN FOR THE TAX ADMINISTRATION?

Some 73% of Australian personal income taxpayers use tax agents to lodge their personal income tax returns and 79% get a tax refund[12]. In the case of businesses, 95% use a tax agent. As noted previously, none of the major tax reforms likely over the coming decade can be expected to remove the need for the majority of taxpayers to lodge an annual tax return. While ever there are a significant number of income deduction claims lodged each year by most taxpayers, a complex array of special tax rebates and tax offsets, the lack of any interest income withholding tax regime, and the use of the tax system to deliver (or provide an annual reconciliation for) welfare payments, then tax returns will continue to need to be lodged. As a consequence, the most that we can expect is for the pre-population of tax returns by the ATO, a response which is already in train.

An alternative is to remove all income deductions and offsets, but this is unlikely. Moreover, even if implemented, it would not necessarily work (as now acknowledged in NZ) when persons hold down multiple jobs and a progressive tax schedule is imposed. A solution might be to move towards a cumulative PAYE system rather than Australia's non-cumulative approach – but this would be

[11] See http://www.hm-treasury.gov.uk/consultations_and_legislation/consult_amld_index/consult_amld_summresp.cfm
[12] See page ATO Compliance Plan 2007-08 <http://www.ato.gov.au/content/downloads/87592_CP_Main.pdf>

highly complex in a system in an environment where taxpayers have many deductions and hold multiple jobs[13].

The real change for the tax administrator of the future will be the challenge of keeping abreast of aggressive tax planning and tax minimisation opportunities available to residents (whether onshore or offshore) through the new technology.

For businesses, the last decade has seen the introduction of whole new system of tax administration focused around the Australian Business Number (ABN) and the introduction of the Pay As You Go (PAYG) system. The great strength of the PAYG system is that it is based around a single identifier, the ABN, which offers tax administrators (Commonwealth, State and local) scope to address tax compliance issues, particularly issues like the growth of the non-observed economy. Over the coming decade Standard Business Reporting (SBR)[14] will come to the fore, built on TFN and ABN data, such that all government agencies, Commonwealth and State, use a similar platform for communicating with taxpayers which will act to maintain integrity in the tax system.

Complementing SBR must be greater international exchange of information between tax agencies around the world, a trend exemplified by the actions of the OECD against tax havens (as noted above). Only comprehensive and real time data exchange in the new e-World will be capable of keeping the tax man abreast of developments which have the potential to undermine the integrity of tax systems and therefore bring into question their equity and efficiency.

8 SHOULD WE MOVE TO A TWYC *BACKUP* SYSTEM?

While an economist is excited by the prospect of a rapidly growing e-World (virtual or otherwise) if integrity is not able to be maintained, then the resulting system may fail the tests of a 'good' tax system. If the tax system should be redesigned to not hinder the development of the e-World but still be enforceable, then the question is what would it look like in an environment where tax laws are not enforceable and a large group of potential taxpayers play a *catch-us-if-you-can* game.

In this case, the tax system would probably have to be far more pragmatic in design than the tax rules currently enforced. The basic principle which should probably underlie these rules would be the principle of *tax-what-you-can* (TWYC). A problem here is ascertaining where the line is to be drawn in the sand by the taxation authorities. That is, what do they chase to include in the base and what do they overlook? This would be a very different way of thinking about tax design than the approach today.

Quite clearly, there are few taxes which are not in some way challenged by the adoption of the TWYC rule. In Australia, income, consumption and wealth taxes would all need to be rethought. However, not to act would inevitably result in increasing, and probably make impossible, tax enforcement problems for tax administrators. The interesting question to pose is to ask: "If the current tax system *falls over* in the face of new challenges, what might a *backup* system look like?"

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[13] A non-cumulative PAYE personal income tax is one where each week, a person is taxed using a tax schedule which is 1/52th of the annual schedule. In contrast in a cumulative approach, in the first week of the financial year, the person has 1/52th of their schedule applied to their income and deductions then in the second week, their income and entitlements are summed for the past 2 weeks and 2/52th of the schedule is applied to this income. This process continues to that by the 52nd week, they have paid exactly the correct amount of tax due on their income given their deductions and other entitlements.

[14] See http://www.treasury.gov.au/contentitem.asp?ContentID=1165&NavId=

Below we outline some of the characteristics of a possible alternative system based on the TWYC rule:

1. *Residence based taxes*: A pragmatic approach to taxing individuals and businesses in the 21st Century might be to move to a system of residence based income taxes administered through a series of withholding taxes. This might be in the form of schedular income taxes where different income sources are taxed at source under different rate schedules.

2. *Tax tangibles*: While electronic data flows are elusive, not so with bulky goods and physical assets. Two taxes on tangibles should be considered.
   (a) Tax tangible consumption goods: Such taxes would be more difficult to escape by the taxpayer and easily identifiable by the tax collector. Such a tax would be a broad based VAT (or GST) but it could also be imposed on major durables in the form of a *use* tax.
   (b) Tax the stock of tangible assets: This could include property taxes, annual wealth taxes and succession and gift duties. Such taxes would be designed in part to tax the accumulation of wealth from income tax evasion or the adoption of a less than comprehensive income tax base.

3. *Consider a multiple rate VAT*: A multiple rate broad based VAT could be used to address VAT base erosion problems arising from not all goods and services being tangible. By taxing complements of intangible goods and services at higher rates, this problem could be partly remedied. However, much depends on the elasticity of demand for the different goods and the scope for substituting out of the relatively highly taxed goods. An example might be a higher VAT on DVD players because DVDs are imported duty free by many consumers.

4. *Tax internet service providers (ISP) on their turnover*: Some US States have imposed turnover taxes on ISPs. However, there is a poor correlation between ISP charges and the value of transactions undertaken by clients of the ISP and such taxes are likely stifle rather than encourage the growth of the Internet.

5. *Tax bit flows*: The European Commission is considering the introduction of a tax on bits of data[15] flowing over the Internet. The problem is that this approach lacks any discretion based on the nature of the flow and could hinder the development of the Internet.

6. *Foreign exchange regulation*: Governments might consider forcing all FOREX related transactions through official banks. Combined with draconian penalties on banks (such as losing their licence) for non-compliance, this could limit the scope for tax evasion via the e-World. However, this threatens the global moves towards deregulated markets and is a largely untenable solution. Moreover, with encrypted data flows, this may be pointless exercise.

7. *Tobin Tax*: This would be a tax which is levied on foreign exchange transactions. Such a tax has been the subject of considerable international debate since it was proposed by Nobel Laureate James Tobin over two decades ago. A primary goal of such a tax was to reduce speculative foreign exchange transactions. There are many criticisms of such a turnover tax, probably the most significant being that all countries will need to adopt it if it is to be in any way effective.

[15] There are 8 bits in 1 byte,1024 bytes in 1 kilobyte, 1024kilobyte in 1 megabyte and 1024 megabytes in 1 gigabyte.

The problem is that the TWYC tax system appears unattractive from an equity perspective and has an implicit admission that tax authorities can no longer manage to ensure integrity in their traditional tax systems. If anything, what the past five years has shown is that the western developed countries have taken head-on the challenge posed by the growth of the e-World – as well as the challenges arising from tax havens and the growth of the non-observed economy. It would be wrong therefore to expect governments to capitulate and move to a TWYC system – especially in the face of increasing demands on government to provide for an aging population.

9 ... AND NOW TO THE FUTURE

The important question now to ask is how government should respond to the new and emerging challenges posed by the maturing of the e-World, the growth of the virtual world and the expansion of networks across international frontiers which are far from transparent. In summary, over the next decade, expect to hear a whole lot more about:

- Simplification of the tax system through the introduction of withholding tax regimes such as low rate schedular taxes on income from capital;
- Reduced personal income tax rates designed to put incentives back into the tax system such as reduced rates on labour suppliers which are sensitive to tax rates (as with secondary earners in a family);
- Moves towards a classical system of company taxation accompanied by investor dividend relief in response to international tax competition, particularly for mobile capital;
- Changing the tax mix through the adoption of higher GST rates in return for personal income tax rate reductions accompanied by measures targeted at growth of VAT/GST fraud;
- Considerably increased information sharing between levels of government designed to ensure tax system integrity, both domestically and internationally.

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