Should Australian Taxpayers Lodge Annual Tax-Returns?

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1. Introduction

One of the issues canvassed in the Australia's Future Tax System Consultation paper (Henry Review) is potential simplification of tax administration.[1] In particular the Henry Review indicates that a spectrum of policy options exist relating to individual tax returns. These policy options range from the ATO providing some (more) pre-filled information in individual tax returns to individual tax returns being abolished. To its credit, the Henry Review recognises that the abolition of individual tax returns would involve substantial administrative and policy change.[2] The Henry Review does, however, indicate some reforms that could be undertaken that would reduce the burden of lodging individual tax returns for some individuals.[3]

> The ATO currently pre-fills some data into individual's electronic income tax returns, making it easier for many individuals to complete their returns. With appropriate policy changes it may be possible to increase the amount of pre-filled data.
>
> For example, introducing a standard tax deduction in place of work-related expenses and replacing the tax deductions for eligible gifts with a co-contribution to gift recipients would potentially mean that some individuals would need only to confirm the data in their pre-filled tax return at the end of an income year. Greater at-source withholding, complemented by policy settings that obviate the need for further assessment of tax, might further reduce the need for individuals to lodge returns.

The Henry Review isn't alone in making this type of argument. Chris Evans of the University of New South Wales made a similar argument in 2004, while Andrew Leigh of the Australian National University wrote on this in 2007. Many other countries already operate similar type individual tax regimes. New Zealand and the United Kingdom, for example, are only two of 36 countries that have this type of system in place.

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In this paper I evaluate the arguments for and against this type of tax regime particularly in light of the Australian tax system. It is not immediately clear that Australia should adopt a no-return tax system, while the benefits are easily understood; they may not be as large as is generally presumed. Furthermore, a change to a no-returns policy is not a substitute for tax simplification and should only be considered after simplification has already occurred. To the extent that a no-returns policy would generate additional fiscal illusion, it is possible that a no-returns policy would inhibit tax simplification.

In the next section, I set out what a no-returns policy might look like and the various options. In section three I set out the benefits and costs of a no-returns policy and in the fourth section I consider some Australian evidence that may inform our views of the benefits and costs of a no-returns policy. A brief conclusion follows.

2. What is a No-Returns Tax System?

At present all Australian taxpayers are required to lodge an annual tax return. This document is quite complex and provides the Australian Tax Office (ATO) with information concerning the taxpayer's tax affairs. Given reporting on tax matters from employers, financial institutions and corporations the ATO should, in most instances, already know a lot, if not all, of the information that taxpayers report. A no-returns tax system would take advantage of this information symmetry and would have the ATO send a statement to the taxpayer setting out the details of their tax affairs. If the taxpayer agrees that the details are correct they would sign the statements and lodge it with the ATO. The ATO would then either send a refund cheque or an invoice to the taxpayer. This type of no-return system is known as a Tax Agency Reconciliation system. It is this type of no-returns system that is usually advocated for Australia.[4]

The alternative no-returns tax system is known as an Exact Withholding System. In this type of system the tax authorities work very hard to ensure that exactly the correct amount of tax is withheld throughout the year leaving the taxpayer with no outstanding tax liability at the end of the year. Of course, the taxpayer should also not be entitled to a refund under this system either. There are two types of Exact Withholding Systems, a cumulative system and a final withholding system. The cumulative withholding system attempts to withhold the exact amount of tax at each pay-point throughout the year, while the final withholding system makes adjustments to the last pay in the year to achieve the correct tax payment over the year. These types of tax system are not as impractical as they may sound – the United Kingdom operates a cumulative exact withholding system while Germany and Japan have final withholding tax systems.[5]

3. Benefits and Costs of a No-Returns Tax System

The primary benefit of a return-free system is the reduced tax compliance burden. In addition to the need for careful record-keeping, taxpayers expend time and effort when filling out tax returns. Andrew Leigh suggests that the time could rather be spent working, or even relaxing. His argument is that the time saved not filling out a tax return would be equivalent to an additional public holiday.[6] This is based on the widely accepted estimate that the average person takes 8.5 hours to fill out their tax return.[7] Of course, most Australians do not fill out their own tax return but employ an accountant or tax agent to do so on their behalf. The direct costs of tax compliance would include the record-keeping costs, opportunity cost of filling out the tax return and the cost of employing an accountant to do so.

There are also indirect costs of filling out a tax return. There may be significant emotional costs associated with dealing with tax matters. Many taxpayers may feel anxiety when confronted by somewhat complex tax documentation and the associated explanatory notes. Even those taxpayers who wish to fully comply with the tax systems demands may be anxious that they have committed some or other error. It is not clear, however, whether these costs are significant or how widespread they may be. To some extent they may be subsumed into the direct costs associated with employing an accountant.

An additional benefit revolves around tax simplification that may occur when introducing a no-returns tax policy. I return to this point below.

The costs of a no-returns tax system revolve around a shift in compliance costs away from individual taxpayers to their employers and the tax authorities. In particular the burden of accuracy is shifted onto the tax authorities. It is one thing to recognise that the ATO already has a lot of information about individual taxpayers; it is another to collate that information in a timely and credible manner for use in an annual process. At present the ATO has several years in which it can review a tax return and compare that to information it already holds. Under a no-return tax system, they would have a few months in which to undertake that task for the entire taxpaying population. While the legal obligation to provide accurate information to the ATO would remain unchanged, i.e. the burden is on the taxpayer, the fact that the ATO could be sending taxpayers incorrect information could undermine tax morale throughout the economy. The information technology start-up costs for such a system are likely to be very high.

When comparing the start-up of such a system with countries that already have that system it is important to remember that many countries have had these systems in place for a long time. The administration of the tax system would constrain some aspects of complexity, and would have evolved as the complexity of the tax system evolved. By contrast, the introduction of such a system after the complexity of the tax system had evolved would involve substantial 'reverse-engineering' that adds to the implementation costs.

The introduction of a no-returns tax system could contribute to greater levels of fiscal illusion.[8] This occurs when the tax authorities deliberately create misconceptions about the tax burden in order to minimise taxpayer resistance to higher levels of taxation. For example, an argument against lowering taxes is that government spending may fall as a consequence. Yet the Australian experience is that tax revenue has increased even though taxes, especially on high-income earners, have declined over the past few years. According to ATO Statistics, in 1996-97 the top 25 percent of taxpayers paid 60.8 percent of net personal income tax while in 2006-07 the top 25 percent of taxpayers paid 66 percent of net personal income tax. The argument here is that a no returns tax system would create an 'invisible' tax system that was 'out of sight and out of mind'.

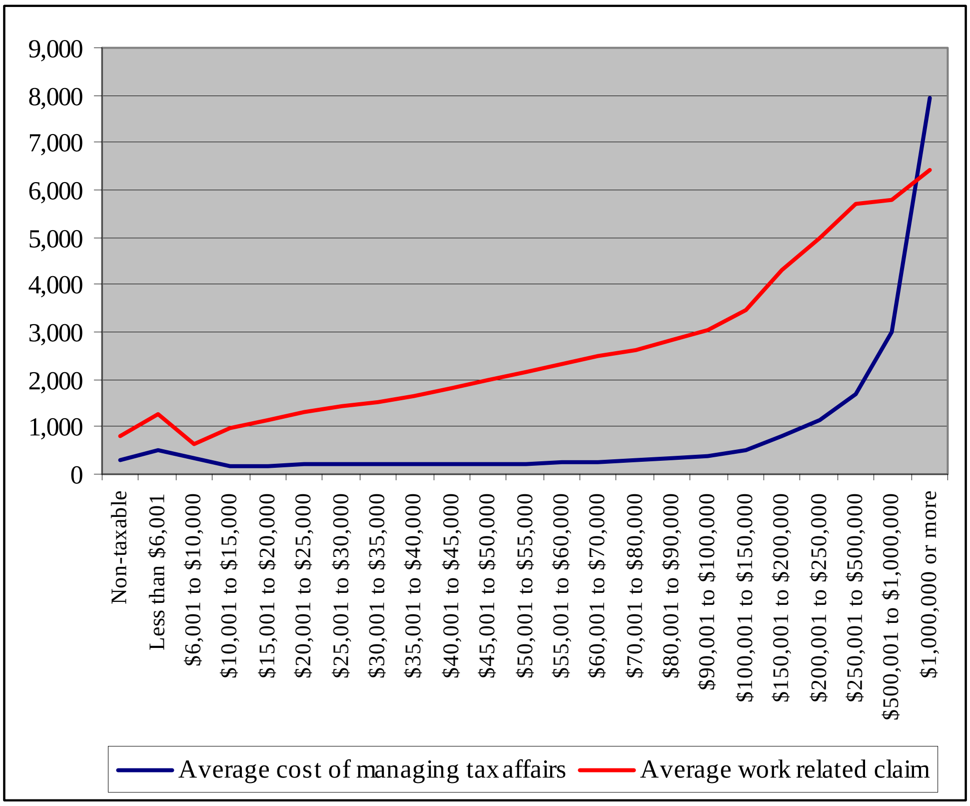
There is the common argument that taxpayers like receiving refunds.[9] Many economists are suspicious of this argument because it implies that taxpayers are irrational. Afterall, even if receiving a rebate is a form of forced savings it does constitute making an interest-free loan and with a little self-discipline taxpayers could still save some money and earn interest if they place those same funds into the bank. There is another explanation, however, for this behaviour. Refunds reduce the size of the tax base. It is generally accepted by most economists that the more comprehensive the tax base the lower the tax rate needs to be to raise a given amount of revenue. Consequently, from an economic perspective most economists would argue for broad bases and low tax rates. Geoffrey Brennan and James Buchanan – the 1986 economics Nobel laureate – have argued that taxpayers do not always trust government to deliver lower tax rates and consequently have a preference for narrower bases.[10] This type of argument can reconcile a taxpayer preference for refunds and rationality. In this view taxpayers are happy to trade-off a loss of interest in the present against being over-taxed in the future.

4. Australian Evidence

In this section I evaluate the arguments for and against a no return tax system using Australian data and experiences. The arguments put forward by Australian proponents of this type of tax system usually emphasise the convenience factor of not having to lodge a return. The counter-argument to this view is that no return tax systems only operate for taxpayers who have relatively simple tax affairs.

In the 2006-07 financial year only 27.54 percent of Australia's 11.8 million individual taxpayers prepared their own tax return.[11] The vast majority of Australians employed a tax agent or accountant to prepare their return. The average cost for preparing the tax return in that year was $268.21. Figure one shows the average cost of preparing a tax return broken down by income groups. It also shows the average work-related tax refund by income group. The overall average work-related refund was $1,860.96 in that financial year. In other words, if making a trade-off between a no return tax policy and work-related deductions the average Australian (making a claim) would be asked to save $270 and give up over $1,800.

Figure One: Average Costs and Average Work Claims



Source: ATO Tax Statistics (2006-07), author calculations

Table one shows the average 'cost of managing tax affairs' – an allowable deduction and reported in aggregate by the ATO - over the period 1996-97 to 2006-07. The second column shows the percentage of taxpayers making this particular claim while the third column reports the percentage of taxpayers the ATO report using a tax agent. The large number of taxpayers employing a tax agent or accountant indicates that the Australian tax system is quite complex.

Table One: Cost of Managing Tax Affairs

	Average Fee	Proportion of taxpayers making claim	Proportion of Taxpayers using a tax agent
1996–97	131.52	42.80	74.07
1997–98	136.34	45.07	75.98
1998–99	144.17	46.36	77.45
1999–20	152.51	46.47	77.53

2000–01	179.34	46.12	76.70
2001–02	196.30	45.81	75.77
2002–03	209.59	45.35	74.83
2003–04	226.42	44.93	74.20
2004–05	242.51	45.16	73.50
2005–06	251.29	45.35	72.79
2006-07	268.21	44.79	72.46

Source: ATO Tax Statistics (2006-07), author calculations

Indeed in a February 2006 speech, the Tax Commissioner Michael D'Ascenzo admitted that understanding tax law was beyond the comprehension of normal people.[12] As John Roskam has summarised, 'If tax professionals were the only people who paid tax, it might be of no consequence that tax law was incomprehensible'.[13] In short, this implies that the tax system itself is complex and would require substantial simplification before reform to the tax administration could be considered. It is an open question as to how many of these individuals would switch to a no-return tax system.

What of the remaining taxpayers who currently prepare their own tax returns? What are the costs associated with their compliance? To calculate this cost I calculated the annual after-tax income for taxpayers in their income groups, and then translated that into an hourly rate (based on 24 hours in the day and 365 days in the year). I then multiplied that figure by 8.5 hours – the generally accepted number of hours taxpayers use to manage their tax affairs. The ATO have reported that the average time taken to complete a tax return is only 5.9 hours. To the extent that the ATO figures are correct rather than the generally accepted figure, the calculations reported below are likely to overstate the costs of completing a tax return. Across the 27.54 percent of taxpayers who lodge their own returns this all adds up to $88.3 million in 2006-07. (The overall average, not taking into account the income distribution is $112.2 million in 2006-07). Even if my calculations are out by a factor of three it would still add up to only $265 million. By comparison taxpayers claimed $1.4 billion in the costs of managing their tax affairs. The cost of preparing a tax return for this proportion of the population is between six and nineteen percent of the cost of the rest of the taxpaying population. That, of course, doesn't indicate that no effort should be made to further reduce this cost, but it does suggest that the benefits of doing so are likely to be low.

I now look specifically at the idea of trading off work-related deductions for a no return tax system. It is likely that eliminating work-related deductions will be regressive. Before making that argument, however, table two shows that the average claim has increased slightly over time, as have the percentage of taxpayers making work-related claims. At the same time, however, it is important to note that the economy grew very dramatically over the period 1996-97 to 2006-07. Increases in work-related expenditure are not unreasonable.

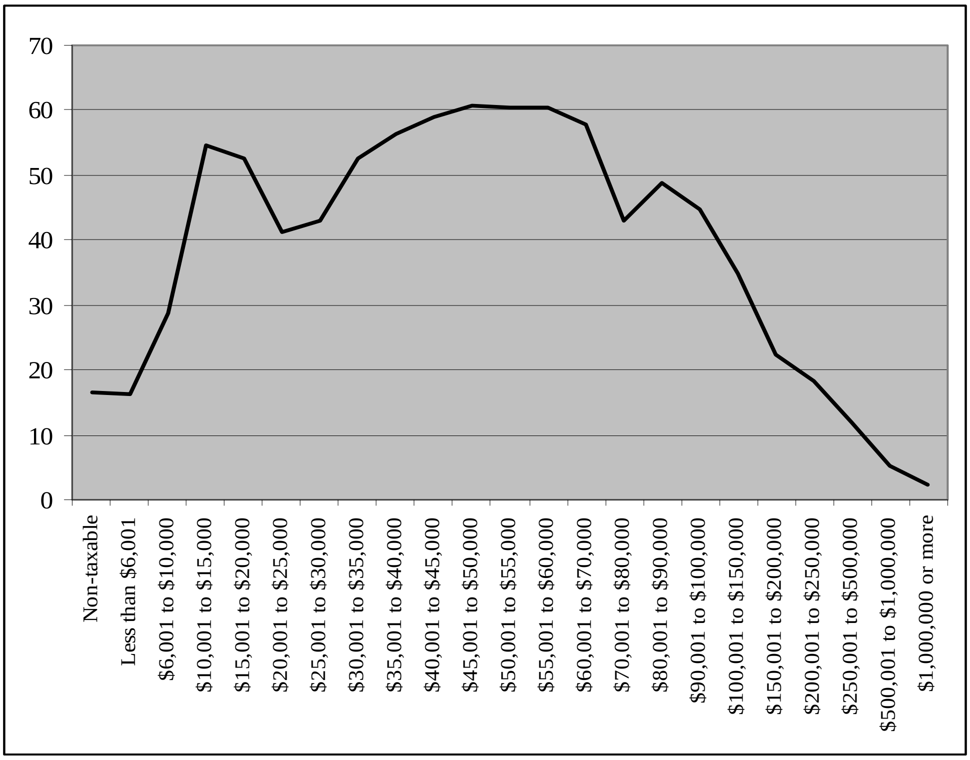
Table Two: Work Related Expenditure

	Total work related expenses as % of Total taxable income	Percentage of taxpayers making Work related claims
1996–97	2.43	60.66
1997–98	2.38	61.64
1998–99	2.37	62.96
1999–20	2.48	63.69
2000–01	2.63	64.22
2001–02	2.81	62.68
2002–03	2.80	62.33
2003–04	2.82	62.71
2004–05	2.81	63.32
2005–06	2.86	63.95
2006-07	2.83	64.51

Source: ATO Tax Statistics (2005-06), author calculations

In 2006-07 work related deductions comprised 41.54 percent of all deductions in dollar terms, down from a high of 58.70 percent in 1999-00. Similarly, they comprise about 80 percent of all deductions that are claimed. In other words, work-related deductions comprise a large component of the ATOs workload. Yet it is quite clear when looking at the income distribution of claimants that many lower income individuals benefit from having these deductions.

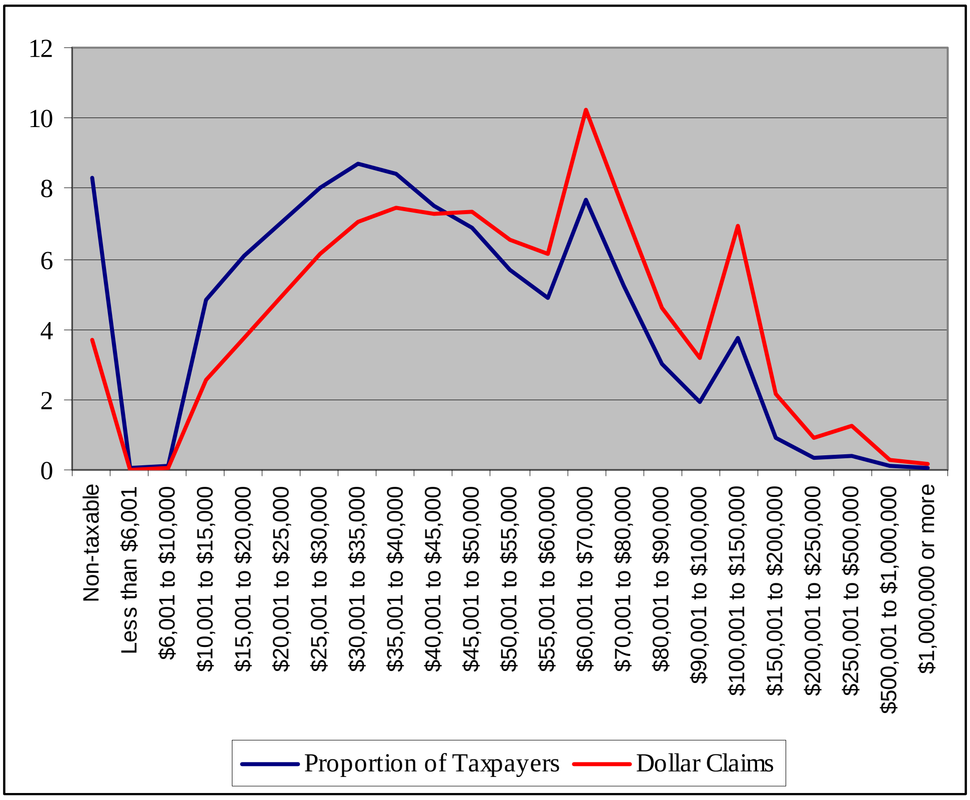
Figure Two: Work Related Deductions as % of Total Deductions



Source: ATO Tax Statistics (2006-07), Author calculations

Figure two shows that individuals earning between $23,000 and $70,000 make the most use of work related deductions with this type of deduction making up more than 50 percent of all deductions in this income group. As a rule of thumb this income group can be described as earning between half and one and a half times the average income for a full time employee. Figure three examines who actually makes these claims by income group. The single largest group of taxpayers making work-related claims earn between $30,000 and $35,000 while the largest monetary value of claim is for individuals earning between $60,000 and $70,000. Looking at information such as this indicates that work-related claims substantially lower the effective tax rates for lower-income and average-income Australian workers.

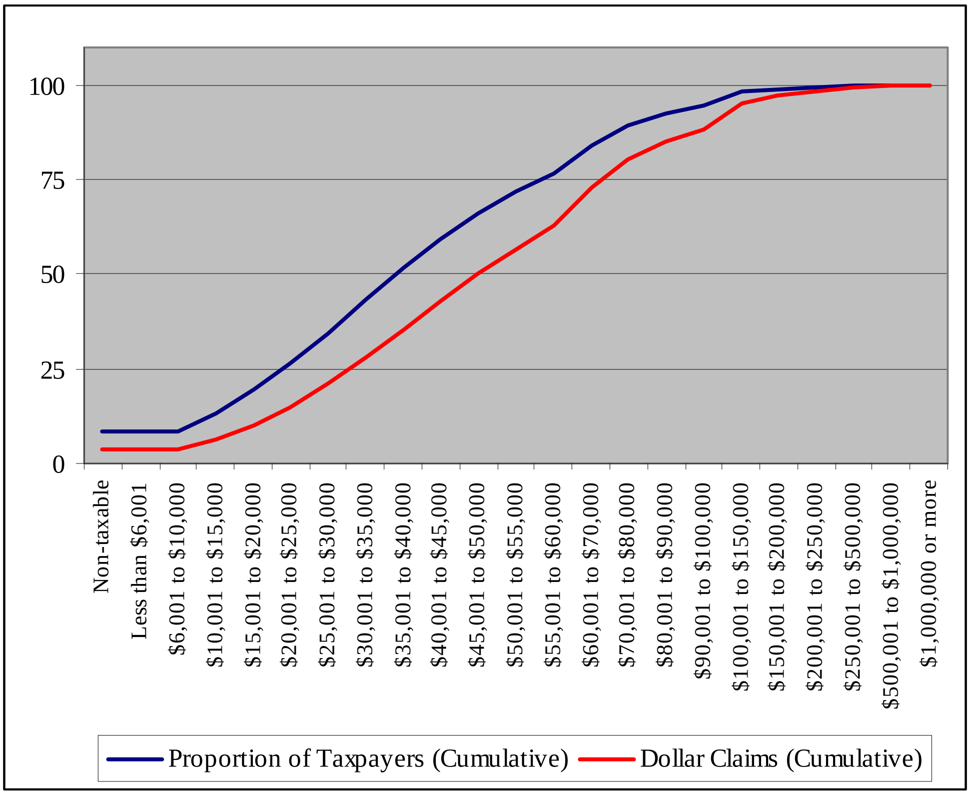
Figure Three: Who Makes Work Related Claims?



Source: ATO Tax Statistics (2006-07), Author calculations

Figure four confirms this view by calculating the cumulative proportion of taxpayers making a claim and cumulative dollar value of the work-related claims. As can be seen over 50 percent of all work-related claims are made by individuals earning less than $40,000 while 50 percent of the dollar value of claims is made by individuals earning less than $50,000.

Figure Four: Cumulative Work Related Deductions



Source: ATO Tax Statistics (2006-07), Author calculations

An argument that is often made is that itemised deductions could be replaced with a standardised deduction. It is quite likely that this would be very expensive; the deduction would have to reasonably compensate current claimants but also be accessible to those individuals who do not currently make work-related deductions. At the same time a standardised deduction could be eroded by inflation (like the tax-free threshold has been eroded) or even eliminated in total by a future government. By having a specific set of ear-marked deductions taxpayers can maintain a tighter control over the tax base.

5. Conclusion

The argument this paper alludes to is that simplification of the tax system itself must preceded simplification of tax administration. The direct costs of maintaining tax returns do not appear to be greater than the benefits of such a system. Certainly the idea of trading off work-related deductions for a simplified tax return system would not be in the financial interests of the taxpayers and buying them out would be very expensive for the authorities. Andrew Leigh has argued in favour of a no return tax system as follows:[14]

> Plenty of taxpayers may choose to forfeit deductions to which they are entitled in exchange for avoiding the hassle of filing a tax return. Indeed, the rise in tax revenue from these forfeited deductions is likely to outweigh any increase in administrative costs for the ATO in moving towards a system of pre-population.

The analysis presented in this paper, however, suggests that his argument is wishful thinking at best. Few taxpayers would want to give up their work-related deductions to save the cost of an accountant or tax agent.

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[1] Australia's Future Tax System Consultation paper, December 2008, Commonwealth of Australia, available at www.taxreview.treasury.gov.au.

[2] Henry Review, pg. 176.

[3] Henry Review, pg 176 – 177.

[4] See Chris Evans, 2004, Diminishing Returns, The case for reduced annual filing for personal income taxpayers in Australia, *Australian Tax Review*, 33: 168 – 181, and Andrew Leigh, 2007, Taxpaying made easy, *Agenda*, 14: 81 – 86.

[5] William Gale and Janet Holtzblatt, 1997, On the possibility of a no-return tax system, *National Tax Journal*, 50: 475 – 485.

[6] Leigh, pg. 85.

[7] Binh Tran-Nam, Chris Evans, Michael Walpole and Katherine Ritchie, 2000, Tax compliance cost: Research methodology and empirical evidence from Australia, *National Tax Journal*, 53: 229 – 252.

[8] See Sinclair Davidson, 2007, Fiscal illusion: How big government makes tax look small, Perspectives on Tax Reform (15). CIS Policy Monograph 81. Available at www.cis.org.au.

[9] See for example Evans, pg. 179.

[10] Geoffrey Brennan and James M. Buchanan, 1980, *The Power to Tax: Analytical Foundations of a Fiscal Constitution*, Cambridge University Press, see especially chapter three.

[11] Australian Tax Office, 2009, Taxation Statistics 2006-07, available from http://www.ato.gov.au/corporate/content.asp?doc=/content/00177078.htm&mnu=47213&mfp=001. All ATO statistics are from this source.

[12] John Roskam, Tangled web of federal law, *Australian Financial Review*, 10 February 2006, pg. 82.

[13] Roskam, as above.

[14] Leigh, pg. 84.