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1. Australian Income Tax System

- Goals in designing tax system: (Hard to maximize all 3 things)
    - Equity (Fairness):
        - Horizontal Equity→ Taxpayers in like situations should be treated alike
        - Vertical Equity→ Taxpayers in different positions should pay appropriately different amounts of taxes
    - Efficiency:
        - Elasticity
        - Deadweight loss
        - Taxes should not influence individual choices (neutrality)
    - Simplicity: Taxes should be collected with minimum of costs whether of administration by government or of compliance by taxpayers

1. Traditional Approach to Tax Policy

a) Alternative tax bases

- Tax base=What is the basis upon which the government determines how much each taxpayer must pay? Options…
    1. **Income**
    2. **Consumption** (e.g. excises on alcohol/GST)
    3. **Wealth** (e.g. land tax/total wealth)
    4. Head tax
- Usually a mix
- Australian Government tax mix. 3 main ones…
    - Individuals' income taxation 47.1%
    - Company and resource rent taxation 22.6%
    - Sales taxes 14.6%
- Australia have focused on the balance between income and consumption taxes, though some argue that compared with Australia's trading partners, it is relaying too greatly on income tax as its major tax base.

i) Difficulties of comparing tax statistics in different countries

1. Different federal systems.
    a. In Australia, a single income tax is levied at the Cth level. In other federal jurisdictions, there are often separate federal and State taxes.
    b. E.g. in some US jurisdictions, taxpayers may receive a third income tax assessment from their city or municipality
2. Use of different instruments with the same economic effect where one instrument is classified as a tax while the other is not.
    a. E.g. It appears that income taxes account for a fairly high % of total tax revenues in Australia (60% total tax revenue-3rd place among OECD countries). However, our income tax are also used to fund programs paid for by social security levies overseas.
    b. Also, Australia funds an increasingly large amount of retirement income out of superannuation and similar funds, which in other countries, is mainly funded out of social security. Although superannuation is compulsory in Australia, as are social security taxes overseas, contributions to superannuation funds are not treated as taxes

3. Tax Expenditures
    a. Tax concessions which are functional equivalent of collecting the tax and paying out amounts by way of grants to the activityor taxpayer that benefits from the commission

a) Income

1) Haig-Simons Income:

- Income= Consumption+ Change in wealth (accumulation)
- Difficulties:
    - How to define 'income'? What is and what is not economic activity? E.g. housewives work at home, leisure activities etc.
    - Receipts in the form of compensation in kind
        - E.g. relative income of ordinary officer v. military officer. Both receive the same nominal pay, but the latter receives quarters in the palace, food, servants and horses.
    - It ignores the patent instability of the monetary numeraire (the currency).
        - In period of changing price levels, comparisons of incomes would be partially vitiated as between persons who distributed consumption outlays differently over the year.
    - Valuation problems
        - The objective measurement of income implies the existence of perfect markets from which one, after ascertaining quantities, may obtain the prices necessary for routine valuation of all possible inventories of commodities, services and property rights. In actuality there are few perfect markets and goods which can be valued accurately by recourse to market price.
- This has been influential in Australia so far as legislative changes to income tax are concerned, but had not had any significant impact on the judicial concept of income.

2) Schedular System

- Often contrasted ton Simon's comprehensive income concept
- Under this system, income is divided into categories and each category is taxed separately. (not comprehensive)
- The UK system is schedular in origin, whereas Australia's system is apparently comprehensive in its drafting but not necessarily in operation.
- Reasoning in UK: preventing tax officials knowing the full extent of any taxpayer's income

ii) Consumption

- Consumption taxes are generally thought of as indirect taxes levied on businesses which are passed on to consumers (indirect taxes)
- Arguments in favour of indirect taxes:
    - Relieve pressures in terms of complexity, avoidance, evasion and political acceptance which afflict the personal tax system
    - Horizontal equity and efficiency

iii) Wealth

- Most countries have that as a tax base, but not in Australia and Canada. Political events led to the demise of gift and estate taxes in 1982.
- Not considered in the course

2. Welfare economics and tax policy

a) 2 theorems of welfare economics and taxes

- Welfare economics start with the question of why we need taxes, or why we need government?
- 2 theorems to explain that:
    - Under certain conditions, competitive markets lead to an allocation of resources with very special property→ there is no change in the allocation that can make someone better off without making someone else worse off (Pareto efficiency)
    - Such possibility can be attained by a competitive economy, provided we begin with a particular distribution of resources among individuals. Hence, by taking resources from an individual and giving them to another, it is till possible to have a Pareto efficient outcome
- Hence, the role of the government can be limited to that of setting lump sum taxes on individuals, to achieve the socially desired distribution of income (first best solution to the tax problem)
    - Lump sum tax: Tax that does not distort competitive prices by making one kind of goods relatively more or less expensive than another. Individuals whose income fall reduce some purchases, and those whose income rises, increase them→ outcome still pareto efficient.
        - Changes behaviour, but only has income effect
- Contrast with differential tax which distort prices
    - E.g. tax on one kind of goods but not other goods.
        - Produces both income and substitution effect(behavioral response to fall in relative price of untaxed goods). I.e. the individual buys less taxed goods and more of untaxed goods (cf. lump sum tax→ individual buys less goods in total but does not change the mix of goods purchased)
    - Result: efficiency loss referred to as deadweight loss (difference between the amount of tax that an equivalent lump sum tax would produce and the lesser amount that the differential tax produces)

b) Optimal Taxation

- Ramsey Taxes
    - Ramsey's basic insight was to observe that commodities with a low elasticity of demand have a lower deadweight loss and thus should face higher ta rates
    - Problem: poor will bear a larger burden than the rich. Hence, this approach was dismissed
    - However, it was later accepted in the 1970s because the new models extended Ramsey's original analysis to include redistributive goals.
- Solution to the tax problem involves trade offs: Optimal policy on one hand minimizes the efficiency cost of achieving a particular distributional outcome and on the other attains the outcome which appropriately balances the social gain from redistributing income against the social cost of using distortionary taxes
- Optimal point is where the marginal social gain from the government giving an extra dollar to an individual is just equal to the marginal social loss caused by raising an additional dollar of tax revenue.

3. Sources of Australian Income Tax Law

<u>Income Tax Legislation</u>

- Income Tax Act 1986
- Income Tax Assessment Act 1936
- Income Tac Assessment Act 1997
- Income Tax Rates Act 1986
- FBT Act 1986