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Parliament via the medium of statutory interpretation. Sir William Wade, one of the leading exponents of administrative law in the UK expresses this as follows,

> Having no written constitution on which he can fall back, the judge must in every case be able to demonstrate that he is carrying out the will of Parliament as expressed in the statute conferring the power. He is on safe ground only where he can show that the offending act is outside the power, The only way in which he can do this, in the absence of an express provision, is by finding an implied term or condition in the Act, violation of which then entails the condemnation of ultra vires.[7]

The courts have a constitutional mandate only to impose the will of an elected parliament. Thus is the legitimacy of the courts' role estaT 0 10.98 376.521198 376.5734 Tm(le es

derives independently from common law principles.o

Section 1 of the

that acts which are *prima facie* within the scope of a body's lawful powers become unlawful if they are tainted by either procedural or substantive defects: an abuse of power as opposed to a simple excess of power. One is struck when reading the judgments in this area by the frequency of the reference to fairness as the overarching principle. Lord Scarman explained the pr

Wilkinson) v IRC[42], careful judicial consideration of the constitutional basis of such concessions is apparent. One of the issues in this case was whether the Inland Revenue should have granted a concession in order to make a statutory relief (available to

The Inland Revenue had initially argued that, although in general they had the power to enter into forward tax agreements, this particular one was ultra vires. This was on the basis that it provided that the taxpayers were to be treated as domiciled outside the UK, whatever the true position, but coTm( )0 0 7.9410.98 356.37354 7.98 0 0 7.98 455.46 0 10.

another factor in the equation: the balance between some tax and no tax. In a narrow sense, the agreement maximises the return to the Treasury. The deal is as follows: a taxpayer, contemplating a transaction (A), says to the Revenue, "If you tax A in full, it is not worthwhile me carrying it out. I will not engage in the transaction and you get no tax. However, if you agree to take a lower sum, we both win." Expressed like this, one can see why such agreements cannot be permitted: they subvert the tax system by attributing different tax consequence from those which are intended by parliament and they give particular taxpayers preferential treatment.

Legitimate expectation – the reliance cases

There are a number of different situations in which a taxpayer may seek to rely on statements by the tax authorities. The statement may be about the authority's interpretation of a particular rule, as to the amount of tax due, or their intention to take no further proceedings. The statement may be made to a specific taxpayer, either at a preliminary stage in response to a request for a clearance by the taxpayer or much later, in the context of settling a dispute, or may be contained in a published document setting out the tax authorities' interpretation of a particular area of law. Included also under this heading are those situations where the tax authorities may be implied to be bound as to the future by past actions.

The fairness issue usually raised in the reliance cases is that of "legitimate expectation", a relatively recent development in administrative law where it first emerged in the context of procedural fairness and the expectation of being heard.[50] It was indeed in a tax case, *R v IRC ex parte Preston*,[51] that it was firmly established that the principle applied not only to expectations as to procedural fairness but also to the substance: the body could be held to its previous statements. *Preston* involved a taxpayer who, on the point of an investigation by the Inland Revenue, offered to abandon various claims for relief on the basis that this would "facilitate the agreement" of his tax affairs. Various questions were asked of him, which he answered (with, as it turned out, a lack of complete candour), with the result that the investigations were closed. Subsequently further information came to light and the Inland Revenue returned to his tax affairs for those years.

The opinion of Lord Templeman in *Preston* reveals a broad notion of fairness. regarding legitimate expectation as a wg8e

weighed up in the event that the authority was considering whether to change its mind, rather than an independent ground. In other words, his view was that the existence of

> legitimate expectation is, prima facie, that he will be taxed according to statute, not concession or a wrong view of the law. …No doubt a statement formally published by the Inland Revenue to the world might safely be regarded as binding, subject to its terms, in any case falling clearly within them. But where the approach to the Revenue is of a less formal nature a more detailed enquiry is in my view necessary. If it is to be successfully said that as a result of such an approach the Inland Revenue has agreed to forego, or has represented that it will forego, tax which might arguably be payable on a proper construction of the relevant legislation it would in my judgment be ordinarily necessary for the taxpayer to show that certain conditions had been fulfilled. I say 'ordinarily' to allow for the exceptional case where different rules might be appropriate, but the necessity in my view exists here. First, it is necessary that the taxpayer should have put all his cards face upwards on the table. This means that he must giver

The taxpayers failed on two grounds: one, on the basis that although sufficient information to enable inferences to be drawn was di

Limits to legitimate expectation

Notwithstanding the importance that the courts have attached to the principle that statements by public bodies can be relied upon, the limits to this principle have recently been probed in two cases. In *F & I Services* the Court of Appeal recently considered the effect of the withdrawal of a VAT clearance for a voucher scheme which had an effect on a continuing basis on the taxpayer.[67] The withdrawal was consequent upon a change in the view of the tax authorities as to the operation of the legislation and, although it was not sought to operate the change retrospectively, the taxpayer had

However, despite acknowledgment of the existence of the equality principle in court judgments, it has not yet succeeded in practice. It would only be in the m

This was not a view shared by any of the five Lords who heard the appeal. Each was of the view that in the circumstances, the Federation had no locus standi. Curiously, most of the judgments regarded the locus standi decision as being intimately connected with the substantive issues. Lord Wilberforce expressed his views as follows:

> There maybe simple cases in which it can be seen at the earliest stage that the person applying for judicial review has no interest at all ...; then it would be quite correct at the threshold to refuse him leave to apply. The right to do so is an important safeguard against the courts being flooded and public bodies harassed by irresponsible applications. But in other cases this will not be so. In these it will be necessary to consider the powers or the duties in law of those against whom the relief is asked, the position of the applicant in relation to those powers or duties, and to the breach of those said to have been committed. In other words, the question of sufficient interest can not, in such cases, be considered in the abstract, or as an isolated point: it must be taken together with the legal and factual context.[81]

Lord Diplock[82] appears to be of the view that the National Federation would have had locus standi had they established that the Inland Revenue had entered into agreement for improper reasons. Lord Scarman was also apparently of the same view.[83] The difficulty with this approach is that it boils down to accepting that a third party has interest if he can succeed on the merits, but otherwise he does not.

Whilst none of the opinions were prepared entirely to shut the door on the possibility of a third party showing sufficient interest to challenge a decision by the tax authorities, it was clearly regarded as possible only in exceptional circumstances.[84] This balance was expressed by Lord Fraser as follows,

> All are agreed that a direct financial or legal interest is not now required … . There is also general agreement that a mere busybody does not have a sufficient interest. … The correct approach in such a case is, in my opinion, to look at the statute under which the duty arises and to see whether it gives an

evidently hoped, by requiring Customs to apply the strict letter of the law, to put their competitors out of business. More recently, in a case in which Freeserve, a UK internet service provider, was denied locus standi to challenge the tax treatment of an offshore competitor, Evans Lombe J referred to the "rule" that one taxpayer has no right to bring judicial review proceedings in relation to the tax affairs of another.[88]

The one case where standing was granted to a third party in a tax context was unusual in the extreme.[89] ICI plc had sought review of the Inland Revenue's determination of a transfer price of a gas for the purposes of oil producers. ICI, not being an oil producer, was not eligible for this treatment and was disadvantaged by what it (correctly) regarded as an erroneously fixed price. One critical aspect of the decision was that the complaint did not concern a specific assessment but a valuation, the effects of which would have continued for a period of time. Another aspect mentioned was that the act was complained of by ICI not as taxpayer, but as competitor, an argument which, as already noted, subsequently failed in *Freeserve*.

CONCLUSION

The cases reveal the existence of tensions between a number of competing interests. Most obviously there are the parties who are most immediately concerned in the resolution of the case: the individual taxpayer seeking fair treatment from a powerful state body and the tax authorities who, it might be argued, would prefer to exercise their statutory powers without interference from the judiciary. Less obviously, other individuals or groups have a stake in the outcome of these decisions. Each member of the taxpaying community is entitled to expect that he or she is being afforded equal treatment with their neighbours and is not being unduly burdened by the failure of others to pay their fair share. There are also the collective interests of the wider community to consider. For example, is the power wielded by the tax authorities consistent with their statutory powers because, if not, the executive may be acting without legitimacy? To this extent, the tax system may not reflect wider policy decisions such as distribution of the tax burden, taxation based on ability to pay, or the achievement of vertical and horizontal equity.

Looking

Denning, in the Court of Appeal, used the rating cases in support of his argument in favour of granting standing to the National Federation. He made the following observations,

> The most instructive cases on this topic are those in which a ratepayer qualifies as a 'person aggrieved.' He has a sufficient standing to complain of an error in the valuation list whereby some other person has been rated too little. The complainant may be only one ratepayer out of the 21 million people in the area of Greater London. He may complain that a valuation is too little on the other side of London 20 miles away. He is a 'person aggrieved' even though he is not affected in his pocket in the slightest. Lord Wilberforce put it well when he said in *Arsenal Football Club Ltd. v. Ende* [1979] A.C. 1, 17:
>
> 'Uniformity and fairness have always been proclaimed, and judicially approved, as standards by which to judge the validity of rates. Indeed I

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Tax Knowledge for Undergraduate Accounting Majors: Conceptual v. Technical

Lin Mei Tan and John Veal*

Abstract

With the call in recent years for a change in accounting education to redirect the focus from being too technically oriented to more conceptually oriented and more skills based, this study examined the content coverage of first tax courses in New Zealand.

The survey results show that both educators and practitioners considered a higher level of conceptual understanding than technical proficiency is required in most taxation topics canvassed. A wide range of topics was covered but not to the extent that tax educators would like or the practitioners expected them to.

INTRODUCTION

Since the mid-1980s, numerous reports and articles concerning the inadequacies of the traditional accounting curriculum have been published. A recurring theme in these publications is that a curriculum which is too technically focused does not adequately prepare students to cope with the changing business environment and the evolving needs of the accounting profession. In addition, accounting graduates need to be familiar with and skilled in using modern technologies, and to be excellent t t

believe that taxation is a distinct, non

an entry level accounting graduate who intends to join a public accounting firm will need to possess. A random sample of 200 practitioners in public practice was therefore obtained from ICANZ. The sample was selected from practitioners in senior positions because they would have more years of experience in working with accounting

awareness to creative thinking or evaluation.' *Technical ability* was referred as the 'skill in applying knowledge of tax law to specific taxation problems.'

Background information such as academic qualifications, professional affiliations, employment, and years of experience, was also obtained from respondents.

Two additional questions were included in the questionnaire for tax educators. Respondents who were course controllers or course co-ordinators of the compulsory tax courses were asked to indicate the level of conceptual knowledge and technical ability that was actually required in the tax course they taught. The purpose of this question was to find out whether there were any gaps between what practitioners perceived should be the required level of knowledge and what was actually covered in the tax curriculum.

The questionnaire was initially pilot tested and was shortened in response to comments that the length of the original questionnaire may deter some respondents from completing it. The final questionnaires, with a cover letter explaining the purpose of the survey, were then mailed out, followed by a reminder three weeks later.

Out of 200 questionnaires sent to practitioners, 93 were completed and 7 were returned undelivered, giving a usable response rate of 48%. For educators, 38 questionnaires were completed and returned, and 8 returned undelivered, giving a usable response rate of 32%. Out of the total number of educators' responses, 11 were from tax educators and 27 were from non tax educators.

RESULTS

Background

Table 1 shows that the practitioners' primary areas of expertise were not mainly concentrated in one particular area, such as taxation. A large number also specialised in other areas like financial accounting, auditing, business planning and management accounting. Since respondents' expertise is not 0.5 g and

TABLE 1: BACKGROUND INFORMATION – PRACTITIONERS

	No.	%
Areas of expertise*		
Financial accounting		
Taxation		
Auditing		
Business planning		
Managerial accounting		
No of years in practice**		
5 or less		
6-10		
>10		
No of owners**		
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Out of the 11 tax educators, 10 (91%) indicated that only one tax course was compulsory in their tertiary institutions. These findings indicate that it is important that accounting students are exposed to the many issues in taxation that impact on businesses as this may be the only tax course they encounter in their undergraduate years.

Conceptual knowledge and technical ability

Table 3 shows the mean scores for the level of conceptual knowledge respondents think an accounting graduate would need before entering an accounting career in public practice. The mean scores for both practitioners and educators indicate that a higher level of conceptual knowledge on deductions, income, GST, depreciation, principles of taxation, tax losses and tax bases is required as compared to other topics. This is not surprising, considering that these topics cover the most fundamental or basic areas of taxation and that an understanding of GST is essential to many aspects of accounting practice. Farm taxation, gift duty and history of taxation had 559.1039.t530 18 0430 n3

accounting graduate as compared to practitioners. However, the views were not significantly different (p<0.01). Statistical tests also showed that there were no significant differences in views between non-tax and tax educators.[5]

TABLE 3: CONCEPTUAL KNOWLEDGE AND TECHNICAL ABILITY REQUIRED - MEAN SCORES

Topics	**Conceptual Knowledge** *Mean Scores*		**Technical Ability** *Mean Scores*	
	All Educators	**Practitioners**	**All Educators**	**Practitioners**
Deductions	4.11	4.08	4.03	3.90
Income	4.13	4.05	4.00	3.86
Goods and services tax	3.95	3.95	4.03	3.86
Depreciation	4.03	3.81	3.82	3.75
Principles of taxation	4.05	3.65	n/a	n/a
Tax losses	3.82			

Conceptual v Technical

By comparing the mean scores of the level of conceptual knowledge required and the level of technical ability

topics were mainly relevant to individual taxpayers only (O' Neil, Weber and Harris, 1999). In the UK, Craner and Lymer (1999) found that many tax courses were highly focused on student's ability to carry out detailed computations.

TABLE 4: CONCEPTUAL KNOWLEDGE AND TECHNICAL SKILLS: TAX EDUCATORS' COVERAGE AND PRACTITIONERS' EXPECTATIONS - MEAN SCORES

	Conceptual Knowledge *Mean Scores*		**Technical Ability** *Mean Scores*	
	Tax Educators	**Practitioners**	**Tax Educators**	**Practitioners**
Goods and services tax	4.17			

Tax courses and pedagogy

The teaching methods used to impart tax knowledge are as important as the course content. In particular, because skills enable graduates to learn to critique and use knowledge, skills development should be part of the process of imparting knowledge. To ascertain the instructional methods used, tax educators were asked further questions relating to teaching and assessment methods, and course revision.

TABLE 5: TAX COURSE AND T

technology or computer based learning here. Overall it appeared that technology is hardly relied on as a teaching aid in the compulsory tax course. This result is consistent with the findings of Craner and Lymer (1999) in the UK but is very different from a survey conducted by

Lastly, those tax educators who placed great emphasis on students' development of

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Competency of Malaysian Salaried Individuals

Bhupalan, 2001). Thus compliance under the SAS would place an onerous burden on taxpayers, particularly the burden of having to learn the tax laws (Natrah et al, 2003).

One of the factors that may influence the level of compliance by salaried individuals is functional literacy or illiteracy (Madi & Amrizah, 2003). Functional tax literacy is defined as the ability of a taxpayer to file tax returns and calculate his or her own tax liability independently and it encompasses the comprehension of some tax jargons and having basic tax knowledge on what constitute taxable income, allowable deductions, relief and rebates (Madi & Amrizah, 2003). Meanwhile functional tax illiteracy is defined as a situation where a person, who, with some basic knowledge in taxation, but as time goes by, becomes out of date and hence not able to determine his or her income tax liability independently (Barjoyai 1992).

In the early 1990's, under the then OAS, although most individual taxpayers in Malaysia considered themselves to be tax literate, however it was found that more than 50% of them were "functionally illiterate" (Barjoyai, 1992). About a decade later, in Sarawak[1], Madi and Amrizah (2003) found that very few salaried taxpayers were able to demonstrate high tax literacy, and that the majority of them were not aware of the implementation of the SAS and still would prefer the IRB to assess their tax liabilities.

Kasipillai et al (1999) also found that although more than half of the individuals surveyed indicated that they were able to compute their own taxes, but nearly all of them were in favour of receiving more tax instructions from the IRB as the majority indicated that the income tax law was ambiguous and subjected to frequent changes.

Academic Qualification and Tax Knowledge

A study by Madi (1999) on sole proprietors and partners in Sarawak revealed that the level of taxpayers' academic qualification was linearly and significantly associated with the level of tax knowledge, which is consistent with the contention that a low level of tax knowledge among taxpayers would not contribute to higher level of compliance (Natrah, et al, 2003). However, tax knowledge among secondary school teachers in Sarawak was found to be quite low (James, 1998). Even lecturers at a tertiary education institution in the Klang Valley[2] were found to be unaware of their obligations to file tax returns (Fazida, 1996) in spite of the fact that teachers and lecturers possess higher educational qualification. Observations by Siti (1996) indicated that individuals who were self-employed and who traditionally possess very low educational standards were ignorant of the tax law. On the contrary, factory workers in the Klang Valley, who generally possess lower educational qualification were found to have a relatively high level of tax knowledge in relation to allowable tax relief (Nor, 1996). Thus, it may be construed that those possessing higher academic qualification need not necessarily possess higher level of tax knowledge.

Prepared for Self Assessment?

Under the SAS, one of the objectives of the IRB is, as far as possible, to achieve voluntary compliance by the majority of the taxpayers (Kasipillai, 2002). In fact, it was found that taxpayers agreed on the need to voluntarily comply and disclose their

[1] Sarawak is one of the states in the Federation of Malaysia.

[2] Klang Valley is the geographical area consisting of the Federal Capital of Kuala Lumpur, and the area approximately within a radius of 40 kilometer of Kuala Lumpur.

income (Kasipillai et al, 2003). Although it was found that there was a strong positive co-relationship between tax knowledge and the level of tax compliance (Kasipillai et al, 1999), however a study by Mottiakavandar et al (2003) covering taxpayers in the northern states of Peninsular Malaysia revealed that the level of tax knowledge had no effect on their non-compliance behaviour. Instead, Mottiakavandar et al (2003) found positive co-relationships between attitude towards one's own compliance with attitudes towards other taxpayers' compliance, effectiv

commercial center of Melaka Raya[4]

(2) the chargeability to tax on income remitted to Malaysia and (3) the correct year for which income from bonus should be chargeable to tax.

Scenario One: “An individual has a chargeable income of RM70,000. Using the Tax Table provided, are you able to compute his or her tax chargeable?”

Scenario Two: “An individual derived in

compliance (LHDN, 2004)[15], the impact of tax literacy on the rate of appropriate comp

TABLE 1: PROFILE OF RESPONDENTS*

Gender; Marital Status and Language Proficiency (Written and Spoken)

Male	62.26 %	Not Married	29.25 %	Malay and English +	85.85%
Female	37.74 %	Married	70.75 %	English only	14.15%

TABLE 3: HUSBAND AND WIFE: JOINT OR SEPARATE ASSESSMENT

The Respondents	All Respondents (n = 106)				Married Respondents (n = 75)			
Husband and Wife: Joint or Separate Assessment and Spouse Relief	Yes * %	No %	Not Sure %	Total %	Yes * %	No %	Not Sure %	Total %
If both husband & wife have taxable income, can the wife request that her income be jointly assessed together with that of her husband?	25.47	36.79	37.74					

TABLE 4: PERSONAL AND SOME OTHER RELIEF

If an individual has income, in computing his or her chargeable income, can he or she deduct the following and the stated amount from his or her income?	Yes * %	No %	Not Sure %	Total %
A perso3pers				

TABLE 6: RELIEF IN RELATION TO CHILDREN

The Respondents	All Respondents (n = 106)	Respondents Having Children (n = 60)
When an individual has taxable income, in computing his or her chargeable income, can he or she		

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Quarantining Interest Deductions for Negatively Geared Rental Property Investments

Jim O'Donnell

When the timing of losses and gains is considered, the benefits of negative gearing are even greater. In addition to the immediate tax benefit available from offsetting the

- Negative gearing encourages investment in assets such as property and shares that appreciate in value, rather than capital used in other areas of production that add value to the economy.
- Negative gearing increases demand for loan finances and, in turn, leads to overheating of the economy and puts upward pressure on Australian interest rates.
- Negative gearing exacerbates the effects of economip downturns as investors are forced to unwind their debts by cutting back spending.
- Negative gearing has contributed to declining birth rates.
- A number of important questions can also be asked of the macroeconomic effects of negative gearing. Looking beyond this paper, for example:
- What is the impact of negative gearing on the level of investment in Australia?
- Does negative gearing affect Australia's international competitiveness?

A tax measure that is generally seen as unfair or arbitrary in its incidence can generate reluctance among taxpayers to comply.[15] Applying this to quarantining, it is debatable whether the removal of negative gearing would give rise to improved attitudes of compliance (through a greater degree of respect for the tax system), or if it would encourage more extreme forms of tax planning (as it is so popularly entrenched in our tax system).

There is little doubt that successive federal governments in Australia have had the same clear expectations on how taxpayers would react if told they can no longer claim full interest deductions on their investments. For many taxpayers, rental property investments (made attractive by negative gearing) represent a substantial part of their retirement savings (their 'superannuation') – which would be made unattractive and put at economic risk if negative gearing is abolished. Perhaps negative gearing is now too entrenched to make its removal a possibility.

Is there a more serious danger that negative gearing conveys the wrong message to taxpayers – that it is acceptable to minimise tax, to lower your taxable income and access a lower marginal tax rate? Some might query whether this message is necessarily unhealthy, particularly if the result on the other side of the ledger is a healthy boost for investment.[16]

Simplicity

Under this criterion, consider for example whether the Australian tax system would be a more complex system, with higher compliance costs, if we introduced quarantining measures. It is also important to ask whether such measures would necessarily stop the revenue leakage. Looking to overseas experience, which method of quarantining would work best in Australia? Should Australia consider going back to the measures we had in the 1980s?

International

Does overseas experience present a clear solution? Would Australia become internationally more competitive if we took a path taken by one of the other OECD nations to restrict or deny the tax shelter? What would be the effect of introducing quarantining measures on international capital flows into and outside Australia? 220.62247 414.68124

In Australia, interest is ordinarily deductible under the general deduction provisions of sec.8-1 of the 1997 Act, and previously sec.51(1),[18] prov

The Australian government has generally supported the tax shelter of negative gearing, despite its growing burden on the tax revenue.[25]

In December 1967, the Commissioner of Taxation issued an income tax ruling giving tacit approval to negative gearing.[26]

On 30 June 1983 the Treasurer announced that the Commissioner would not be changing the long standing practice of allowing deductions in full for interest on moneys borrowed to invest in rent-producing properties where the interest and other outgoings exceeded the rental income in any year.27 This came after a brief period when the Victorian Deputy Commissioner took matters into his own hands by denying real estate investors in Victoria a deduction for interest expenses to the extent they exceeded rental income.[28]

However by 1985 the government came to realise that negative gearing ofn

investors. The restrictions affected only real estate purchased after 17 July 1985. The reform quarantined any losses made from owning rental properties, so that any excess of deductions over rental income could not be used to reduce tax on other sources of assessable income.[30] However, losses could be carried forward to offset against future rental profits and reduce taxable gains made from other rental properties purchased after that date.[31]

This quarantine measure was justified on three main grounds: (i) taxpayers should not have to subsidise rental property investors; (ii) negative gearing resulted in increased home prices to the detriment of ordinary home buyers; and (iii) an estimated revenue gain of $55m in 1986-87, $100m in 1987-88, rising to $195m in 1990-91 and subsequent years.[32]

Due to various pressures, in one of the more remarkable backflips in Australian tax policy history, the government removed the measure, effective from 1 July 1987.[33] According to official records, repeal of the measure was justified on two main grounds: (i) uniformity of tax treatment of interest costs for all types of investment; and (ii) the belief that the excessive tax benefits offered to high income earners by negative gearing were adequately countered by other tax reform measures, notably introduction of the capital gains tax regime.[34] There were also unofficial reasons for the quick repeal of the measure, including an impending federal election and complaints from NSW facing a State election.[35]

Since July 1987, negative gearing has been allowed on all forms of investments in Australia.[36]

JUDICIAL APPROVAL OF NEGATIVE GEARING

Australian courts have made it quite clear that if there is to be any change to the law on negative gearing, it will require specific legislative amendment, rather than any change in judicial attitude or interpretation.[37]

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[30] The qu

Janmor Nominees[38] is the landmark case on negatively gearing rental properties. The decision in that case was handed down after the quarantine measures were repealed but was based on the law in place before those measures were introduced. The Court held that high gearing alone does not deprive interest payments of the character of

On the second assumption, supporters claim that increased housing stock has led to lower rents and more affordable housing, which has also been good for construction, jobs and the economy. Critics assert that it has distorted investment away from production, and also argue this has led to

TESTING THE ASSUMPTIONS

Increased house prices

Housing prices have risen dramatically in the past few years,[44] but have fallen in recent times.[45] From a ratio of housing prices to average incomes, Australia has amongst the most expensive housing in the developed world.[46]

On the other hand, the recent housing price boom in Australia is not unique. Since the mid-1990s, several other countries have recorded larger house price rises than Australia.[47]

When it quarantined interest deductions on real estate investments in 1985, the government made an admission that negative gearing increased real estate prices.[48] In theory, by making property ownership more attractive to investors than it otherwise would be, it is contended that negative gearing leads to an increased demand for residential property and, in turn, real estate prices rise. It is argued that house prices continue to rise from negative gearing until the tax savings has been 'capitalised' into the price.[49] Economic modelling and research has been relied on to substantiate this price effect.[50]

As Figure 1 shows, explosive growth in house prices really began in 1988. Some explain this byy

contributing to house price pressures, although in principle negative gearing does not favour private investment in rental housing over other passive investments. While it recommended broader review of a range of features of the income tax system, the Productivity Commission indicated that the focus should be on the capital gains tax regime.[57]

Increased housing stock

It has been argued that negative gearing increases the availability of rental properties in the long run by increasing new housing construction.[58] Support is given for this view in a 1989 Reserve Bank study that found a lowering of tax incentives available to real estate investors leads to a decrease in the construction of real estate.[59] Those who run this argument also refer to the slowdown of new residential construction for the period when negative gearing was abolished.[60]

Statistics do not support the argument that negative gearing leads to an increase in the number of dwellings, as there is no firm correlation between the two variables.[61] There is also no observable relationship between negative gearing and construction activity or rental property loans. Curiously, the inverse relationship suggested by the statistics between negative gearing and the number of rental property investors supports a contrary conclusion.[62] This may give weight to the hypothesis that as negative gearing is capitalised into rental housing prices, the return on the capital invested is diminished.

It is fallacious to assume interchangeability in negative gearing and the construction of new dwellings. Rental property investors do not

CONTRADICTED ARGUMENTS

Having formed a view that several critical assumptions about negative gearing are false, it is important to isolate the arguments that rely on them. The major arguments contradicted by the statistics are summarised in Table 2 and are discussed in turn below.

TABLE 2: SUMMARY OF ARGUMENTS BASED ON THE FALSE ASSUMPTIONS

Tax Policy Criteria	Summary of Contradicted Arguments
Equity	Negative gearing rewards home ownership due to rising house prices
Equity	Negative gearing discriminates against non-home owners (the young and poorer sections of the community) by locking them out of the real estate market with increased house prices
Equity	Negative gearing makes rental accommodation more affordable by lowering rents as a result of an increased supply of rental properties and lower costs for landlords
Efficiency	Negative gearing is good for the economy because it has led to increased jobs and activity in the residential construction sector
Efficiency	Negative gearing leads to a substitution of investment from productive capital formation into real estate and other appreciating assets

Negative gearing rewards home ownership

Australia has a high rate of home ownership. If negative gearing has raised house prices, the one group clearly benefited by it is homeowners, who represent approximately two-thirds of the population.[64]

This argument is contradicted by the statistics, which indicate there is no relationship between negative gearing and house prices.

Wealth inequality

> "Home ownership is falling. It is harder than ever for younger or poorer Australians to become homeowners." [65]

Statistics show that home ownership for first homebuyers is becoming increasingly difficult to attain, even after direct measures such as the first home owners grants have been implemented.

For example, in March 2004 the percentage of first homebuyers fell to a record low of 12.5%, a continuation of the general decline since the record high of 25.8% set in July 2001.[66]

[64] Hanegbi, R. "Negative Gearing: Future Directions" (2002) 7 *Deakin Law Review* 349, 365; Australian Bureau of Statistics, *Catalogue No. 4130.0* "Housing Occupancy and Costs, Australia", 15 October 1999.
[65] Senator Andrew Murray, Australian Democrats, *Press Release Number 03/485*, 3 July 2003.
[66] Australian Bureau of Statistics, *Catalogue No. 5609.0* "Housing Finance, Australia", 12 May 2004.

> If negative gearing has led to increased real estate prices, it has advantaged people who own real estate at the expense of those who do not. [67]

properties in 1993 and 1997 respectively, but who represented 18.2% and 17.1% of the adult population.[73]

It is also important to understand the demographics of home ownership when considering political implications. While negative gearing and home ownership are generally more associated with the baby boomer generation, Figure 3 illustrates that as a percentage of the voting population, baby boomers are a significant but declining force.

FIGURE 3: ADULT BABY BOOMERS AND 18-35 YEAR OLDS AS A PERCENTAGE OF VOTING AGE AUSTRALIANS [74]

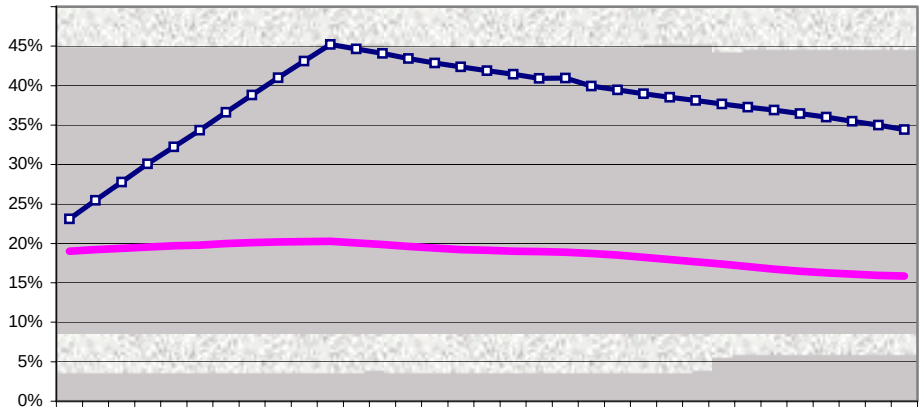
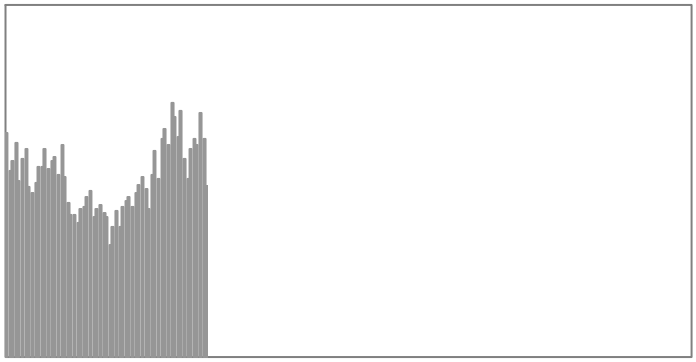


FIGURE 4: GROWTH AND DECLINE IN CONSTRUCTION JOBS AND DWELLING APPROVALS [88]



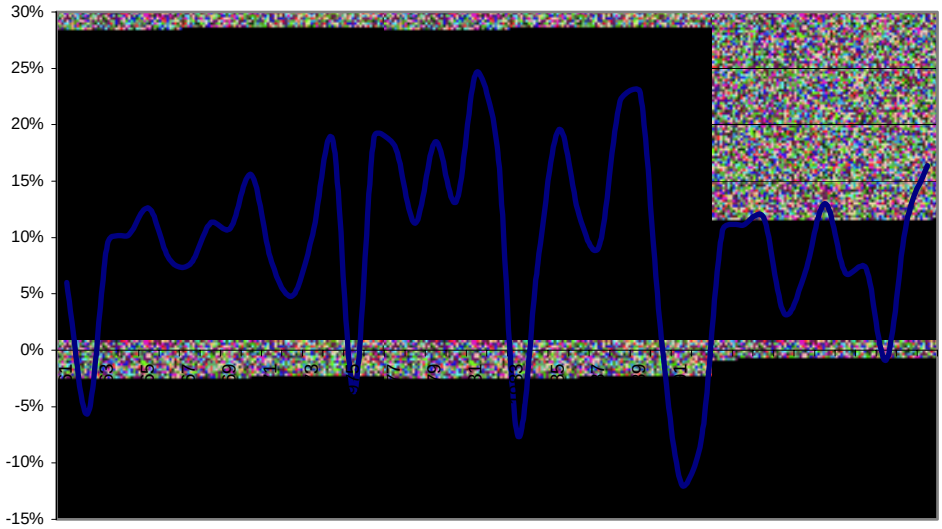
look to buy established houses rather than build new ones, and therefore the level of housing stock is not affected.[90]

Even if it can be proven

This does not mean there is a causal relationship. It does not necessarily follow that negative gearing causes investment dollars to be pulled out of fixed capital formation. Observations below suggest four possible alternatives: (i) the relationship could work

rental properties.[104] Note that negative gearing rental losses that year are small in comparison ($2.78 billion).[105]

FIGURE 6: GROWTH AND DECLINE IN PRIVATE FIXED CAPITAL FORMATION, 1961-2003 [106]



The economic data suggests but does not compel the conclusion that the tax shelter of negative gearing leads to a substitution of investment from productive capital into rental properties.

SUPPORTED ARGUMENTS

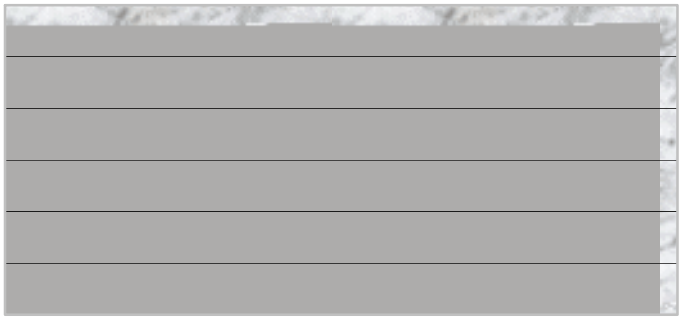
The major arguments that are supported by the statistics are summarised in Table 3 and are discussed below.

In the ATO's *2004-05 Compliance Program*, the Commissioner observed a growing imbalance between rental property income and deductions. In 2002-03 there was an 8% increase in rental property income but a 13% increase in rental deductions. This imbalance led the ATO to believe there may be significant non-compliance. The ATO response is to carry out around 4,600 reviews and audits of rental income and expenses in 2004-05.[112] However, so long as negative gearing is allowed, it is hard to believe that increased audit activity alone will have any major impact in reversing the revenue loss.

Equity Argument

Figure 8 illustrates that negative gearing rewards taxpayers on higher marginal rates more than lower income taxpayers.

FIGURE 8: 2000-01 NEGATIVE GEARING OF RENTAL PROPERTIES ACCORDING TO INCOME LEVEL



Declining birth rates

Statistics reveal a declining birth rate in Australia, as indicated in Figure 10.[124]

The declining birth rate has an impact on government policy and reform of the tax system.[125] Some also consider the relationship works in the other direction, in that birth rates can be affected by government policy and by the design

INTERNATIONAL COMPARISONS

Australia is one of few countries that allow negative gearing on real estate and other investments. Few of the major OECD nations allow a tax shelter for negatively geared rental properties, as many

deduction to the amount of net rental income.[133] This administrative quarantine no longer applies.

The U.S. has an extensive system of limitations on deductibility, including 'passive activity loss' rules.[134] While interest is generally deductible[135] there are notable limitations.[136]

Rental income is treated as passive income. Unless the individual actively participates in the rental activity, losses from rental property may be limited. Individuals who actively participate in the rental activity may be able to deduct up to $US25,000 of loss against other income. No additional loss is available for individuals whose modified adjusted gross income exceeds $US150,000.[137]

Interest is only deductible on rental properties to the extent it does not exceed the taxpayer's net investment income,[138] however the excess may be carried forward up to 20 years and offset against future net investment income. Alternatively it can be offset against capital gains realised on the sale of U.S. real estate.[139]

The U.K. adopts a schedular system to quarantine deductions for investments. Losses from one activity source can only be offset against future income from the same source. Rental property losses are quarantined to income from real property under Schedule A.[140]

Whereas each Schedule and Case has its own detailed expense rules, generally expenditure thes i52854 519.50031 Tm(nse.359.28012 459.9280.25729 Tw 10.31 Tm(rantine m

categories. For losses in excess of $15,000 the credit rate is 21% and is restricted to current year losses where the gain on the investment is deferred.[149]

In Germany rental income is one of seven income categories.[150] Losses can be carried forward against future income or offset against previous income, but a limit applies to the amount of losses that can be carried back.[151] Losses in particular income categories can generally be applied against income in other categories.[152]

In France there are separate categories of income. Restrictions apply to certain categories of losses. For real estate losses, the first €10,700 can be set off against other income, but to the extent it arises from interest outgoings, it must be amortised over a 10 year period against future rental income. The excess losses over €10,700 not due to interest paid may only be carried forward against future rental income for a maximum period of 5 years.[153]

Rental income in France is not subject to withholding tax and is assessable with other income as declared in the annual tax return, although it must be returned in a special schedule attached to the tax return. A restrictive list of expenses can be deducted against rental income, which incluc.1498 0 08 0 17694 528.50043 Tm(n be de)Til0w 7t

Similar arguments apply to the quarantining of interest deductions on investment assets and the concessional CGT treatment in Australia. For a quarantining model, consideration may also be given to the way our CGT regime restricts the offset of capital losses only against capital gains.[156]

One of the reasons the government gave to justify repeal of our quarantine provisions in 1987 was that negative gearing was adequately countered by measures such as the CGT regime. With the effluxion of time this justification appears doubtful. The fact that capital gains are subject to taxation in Australia at best provides only a part answer, since capital gains are taxed concessionally in Australia compared with most other sources of income. This arises because capital gains are taxed on a deferred, realisation basis, and is also due to the availability of exemptions and concessions such as the general CGT discount.

A case can be made for tying our approach to quarantining with our CGT regime. Few people choose to invest with the purpose of making a loss, although that is always a risk of most investments. Investment assets are acquired for the purpose of producing income, whether as a stream of revenue from year to year, such as rent or dividends from shares, or as a capital gain on disposal of the investment, or a combination of the two. The taxing provisions should take into account the fact a taxpayer's return on an investment can take a combination of revenue stream and capital gain and adjust the deduction of losses accordingly.[157] At the same time the provisions should not penalise an investor who makes a lo

A less severe approach would be to allow such

the U.K., France or Germany) or in a similar way to the quarantining "passive investment" rules in the U.S.

Again, an issue may arise as to how to deal with accumulated net losses when assets within the category are sold. Again, the easiest option would be to do nothing. Thus the accumulated losses would not have to be offset against capital proceeds. Another option would be to require the taxpayer to offset any accumulated investment losses in that category against capital gains on investments in that same category as they arise in any year. This would only apply to the extent of eliminating the capital gains and not give rise to any capital losses. A more complex option would be to require the taxpayer to keep a record of the net losses accumulated from ea

On the other hand, some may consider this distortionary effect to be desirable from the point of view of counterbalancing the di

from that asset in a later income year. This approach implies a stricter level of tracing

This promises the strongest solution for closing the tax shelter. At the same time, it is expected that this approach would probably be the most practically enforceable, requiring the least legislative amendment and giving rise to the least complexity and compliance burden on taxpayers. Whether it would be politically acceptable is another matter entirely.

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GST and the changing incidence of Australian Taxes: 1994-95 to 2001-02

Neil Warren, Ann Harding and Rachel Lloyd*

Abstract

The past decade has seen major reforms to the design of Australia's tax system. This paper outlines these reforms and examines their distributional impact across the household income spectrum.

Wina

Ultimately, in order to obtain a complete picture of the impact of government on its citizenry over a period of time, the impact of all aspects of government on the community would need to be considered.

It is to this end, that the authors are unde

TABLE 2 TAX REVENUE: 1994-95 AND 2001-

Changes were also made to the method of calculati

retail value of luxury cars above a threshold (which was $57,009 in the 2002-03 financial year[292]).

Excise Duties and State Business Franchise Taxes

Excise duties have been subject to a number of changes over the period of study. Other than rate increases due to indexation and one off increases, there have been four main changes:

1. State Business Franchise Taxes (BFT) were declared unconstitutional in August 1997 and those BFTs on petrol, tobacco and beer were then incorporated into excise duties (and that on wine reflected in a change in the WST on wine);
2. Excise duties changed in July 2000 to reflect the introduction of the GST and to ensure that prices did not change as a result (as noted above);
3. In November 1999, the previous system of imposing excise duty on cigarettes by weight was replaced by a per stick system which, when combined with the 10% GST, resulted in a substantial increase in the taxation of tobacco;
4. Indexation of petroleum products was repealed, effective August 2001.

were originally proposed for repeal were postponed for later review as a result of food being removed from the GST base[294]. It was expected that if all States received above the expected level of GST revenue, that by 1 July 2005 they would favourably consider repealing these taxes.

SOCIO-ECONOMIC AND DEMOGRAPHIC CHANGES

Understanding and interpreting intertemporal tax incidence results requires an appreciation of not just the nature of tax changes, but how the composition and circumstances of the household groups changed over the period studied. It is quite possible that the changes in tax revenue evident in Table 2 for example, might be due as much to changes in the circumstance and preference of the taxpayers as to changes in the base and rates of the taxes (as might be the case with alcohol and tobacco).

For this and other reasons, it is important to outline socio-economic and demographic changes over the period studied and this is the objective of this section.

Table 5 shows just how markae(a)Tj10.98 0 0 10.971 1 socio-economc

TABLE 5 SELECTED INDICATORS OF THE CHANGING ECONOMIC, SOCIAL AND DEMOGRAPHIC SITUATION IN AUSTRALIA

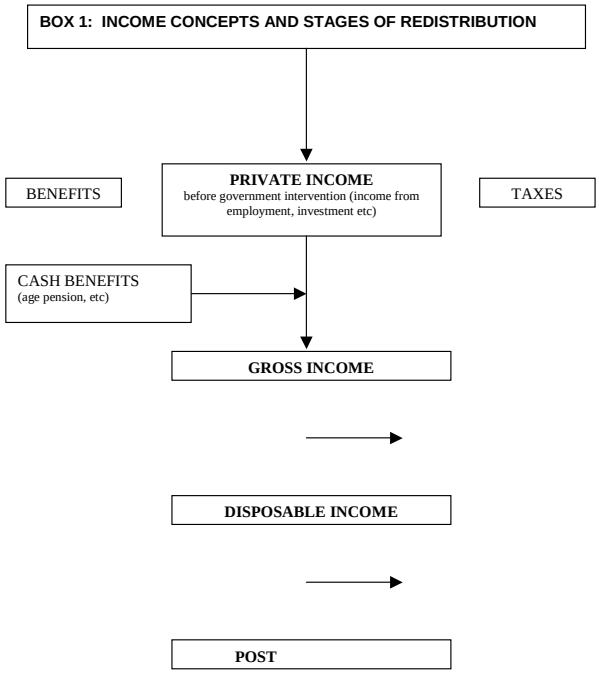
	1994-95	2001-02	Change
Percent of population:			
0-14 years	21.5%	20.4%	-5.1%
65 years and above	11.8%	12.6%	6.8%
Mean duration of Unemployment (weeks)	57.5	51.9	
Percent of labour force:a			
Unemp			

in the sources of household income over the period 1994-95 and 2001-02. The contribution to household income from compensation of employees has increased, as would be expected with increased employment.

Similarly, with falling interest rates, we would also expect a falling contribution from interest income. The big changes have been in the contribution from dividends and from government social assistance programs. The latter has occurred despite falling unemployment and appears due to increased welfare payments to families with children and to the aged, as well as to the general increase in transfer payments that occurred as compensation for the introduction of the GST for low income households.

The other important trend is that associated with household expenditure as shown in Table 7. Here there was a marked change in the consumption patterns of households over the period. Some of this has been due to the arrival of new products (computers and mobile phones) and others to improved standards of living which result in less expenditure on durables (furniture, clothing)proved

(Harding, Lloyd and Greenwell, 2001, and Saunders, 2001). The ABS has also used this income concept for ranking Australians in its latest Income Distribution Survey (ABS 2003).



Equivalent incomes

When attempting to compare the economic well-being of households of differing size and composition, it is important to use equivalence scales. For example, it would be expected that a household comprising four people would need more income than a single person household if the two households were to enjoy the same standard of living.

There is not, however, agreement internationally or nationally about exactly how much more income the four person household requires than the single person household to achieve the same standard of living. Like the recent ABS income distribution study (2003), our study uses the modified OECD equivalence scale. In our study, this means that we have given the first adult in each household a weight of 1.0, second and subsequent adults a weight of 0.5 points, and

TAX INCIDENCE: 1994-95 AND 2001-02

The taxes imposed in Australia can be borne by both residents and non-residents depending on how the taxes are shifted. The shifting assumptions adopted in this study are detailed in Appendix B.

The resulting distribution of Australian taxes between residents and non-residents in the two periods of study is shown in Table 9. These incidence estimates are far from uncontroversial. There is a substantial debate that taxes which ultimately impact on exports such as the Payroll Tax or the petroleum excise, will in the case of a small open economy, impact not directly on non-residents but cause a devaluation in the Australian currency (the so-called purchasing power parity theory). This would force the tax back onto Australians through higher priced imports in general.

Similar debates exist about the incidence of company taxes imposed on non-resident investors. However, to the extent that comparable company income taxes are imposed in other jurisdictions, it is probably less controversial to assume that company income taxes are borne in part by non-residents than it is to assume taxes on inputs into exports are borne by non-residents.

TABLE 9 CHANGING TAX BURDEN ON AUSTRALIAN RESIDENTS AND NON-RESIDENTS: 1994-94, 2001-02

	Resident's Tax Burden	Non-Resident's Burden	% on Non

However, the impact of the GST and

The impact of the substantial reforms to the method of imposing and collecting indirect taxes has seen the incidence of this tax fall slightly more on those in the lower

PROGRESSIVITY AND INCOME REDISTRIBUTIVE EFFECT OF TAXATION

Another informative approach to understanding what has happened to the post-tax distribution of income over our period of study is to examine changes in vertical equity in the tax system using single number indicators rather than a tabular approach. The most commonly used approaches here are through the use of concentration indexes (such as when estimating the Gini Indices), the Theil Index and the Atkinson Inequality Index[295]. Warren (1989) and Smith (2001) discuss the estimation and use of various of these measures including the:

- impact of tax changes on Gini index based income inequality measures (as when estimating concentration indexes of pre and post tax income); and
- tax progressivity measures based on concentration curves.

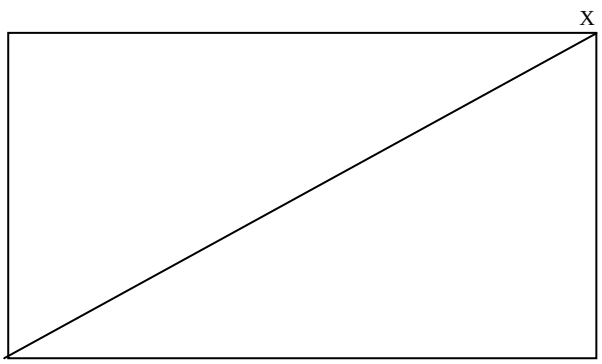
This study will however, focus on the use of Gini indices while, at the same time, acknowledging that such measures do have their limitations. In particular, this measure assumes a particular weighting of groups across the income distribution which is not uncontroversial. Moreover, Lorenz curve based measures such as the Gini index cannot give an unambiguous indication of a trend change when the Lorenz curves cross.

The approach taken in this study will also focus only on the redistribution between households, not within them.

Change in Income Inequality due to Taxation

The Gini index of income inequality is measured as twice the area of A in Figure 2. If we have perfect equality (a concentration curve which is the diagonal line XRS in Figure 2), then the area A would be zero and the Gini index zero. The greater the area of A, the greater the inequality. A concentration curve which maps out perfect inequality (XYS) would have a Gini index (or concentration index) of unity. Between the two extremes is the normal case (XZS) where the Gini index (or concentration index) of income inequality is greater than zero but less than unity.

FIGURE 2 CONCENTRATION CURVES



If the Gini index of pre-tax income is G and the index of post-tax income is G*, we have an indicator of the impact the tax has on income distribution. If G*-G is negative then income inequality is being reduced by the tax - this is defined as an income inequality improving tax. A situation where G*-G is positive is one which worsens income inequality. Results for 1994-95 and 2001-02 are shown in Table 13 for households ranked by equivalent gross income[296].

TABLE 13 TAX PROGRESSIVITY AND INCOME REDISTRIBUTIVE EFFECT OF AUSTRALIAN TAXES ON THE DOMESTIC HOUSEHOLD SECTOR

		Personal Income Tax (PIT)	Reformed Indirect Taxes	Other Taxes	All Taxes excl PIT	All Taxes
ATR	1994-5	18.8	9.3	15.6	24.9	43.6
	2001-2	19.5	9.7	15.9	25.6	45.1
	Change	0.77	0.41	0.32	0.73	1.49
G*	1994-5	0.3027	0.3710	0.3682	0.3901	0.3276
	2001-2	0.3029	0.3763	0.3702	0.3945	0.3274
	Change	0.0002	0.0053	0.002	0.0044	-0.0002
G*-G	1994-5	-0.0516	0.0167	0.0139	0.0358	-0.0267
	2001-2	-0.0547	0.0187	0.0126	0.0369	-0.0302
	Change	-0.0031	0.002	-0.0013	0.0011	-0.0035
%G	1994-5	-21.0	7.6	5.9	13.4	-7.5
	2001-2	-22.5	8.6	5.4	14.0	-8.5
	Change	-1.46	1.01	-0.48	0.54	-0.92
P	1994-5	0.2234	-0.1628	-0.0754	-0.108	0.0345
	2001-2	0.2256	-0.1737	-0.0667	-0.1072	0.0368
	Change	0.0022	-0.0109	0.0087	0.0008	0.0023
%P	1994-5	278.5	-100.4	-78.1	-178.4	100.0
	2001-2	265.4	-101.4	-63.9	-165.2	100.0
	Change	-13.12	-0.99	14.2	13.2	0

Notes

G*	Gini index of post (selected) tax Income
G	Gini index of Gross Income (pre-tax)
G 1994-95	0.3543
G 2001-02	0.3576
G*-G	Gini Index of post-tax income less Gini Index of pre-tax income
%G	Contribution to % change in post-tax Gini index
P	Progressivity index (Concentration index of taxes)
%P	Percentage contribution to tax progressivity

Over the period of study, the distribution of gross income apparently worsened as measured by the Gini Index of gross income (G) (but, as noted below, as the Lorenz curves cross this effect is not robust (Atkinson, 1970). However, the impact of the changes to taxation had the effect of offsetting this change, resulting in the post-tax distribution of income being almost exactly the same in both years, as measured by the Gini index.

[296] The equivalence scale adopted when estimating the values in Table 13 involves giving a weight on 1.0 to the first adult, 0.5 to the

This lack of any significant aggregate change in overall post-tax income inequality (as shown by G*-G in Table 13) masks a change in the impact of different taxes on income distribution. The reformed indirect taxes

Table 13 details the impact of the tax changes over the period 1994-95 to 2001-02 on the progressivity of the different tax groups.

As noted above, the changing impact of tax on the distribution of income arises from two sources, the height of the tax (as reflected in a_i) and the distribution of the tax (as shown in P). Changes in either will cause changes in G*. Table 13 provides estimates of changes in the progressivity of Australian taxes over the period of study. In the case of the personal income tax, its progressivity has increased, as has its average tax rate, which has resulted the income tax being more redistributive.

In the case of the reformed indirect taxes, they are both more regressive and more important, which has resulted in them worsening the post-income distribution. In the case of the "other taxes", while they are more important, because they are less regressive and this falling regressivity offsets the growing importance of these taxes, their overall effect is to improve the post-tax distribution of income relative to their impact in 1994-95.

Complications

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APPENDIX A: METHODOLOGY

Core data sources

2001-02

The core data source used in the simulation of the 2001-02 world was the 1998-99 Household Expenditure Survey (HES) u

APPENDIX B: TAX SHIFTING ASSUMPTIONS

Table A.1 details the basic tax shifting assumptions adopted in the results reported in the body of this paper. The allocation of taxes to domestic households is a three stage process.

1 The allocation to 7 final consumers, of those taxes whose statutory incidence (who initially (or legally) pay the tax) is producers. These final consumers comprise domestic households, the government, industry and foreigners (Section A in Table B.1)
2 The allocation of the tax estimated to be incurred by these final consumers to domestic households (Section B in Table B.1)
3 The allocation of those taxes whose statutory incidence is on the domestic household sector to the domestic household sector (Section C in Table B.1)

Of those taxes incident on dividends paid by corporation operating in Australia, a proportion equal to the level of foreign ownership of incorporated enterprises in Australia are allocated to foreign households.

It has also assumed that while only persons in private dwellings were included in the households expenditure surveys, the composition of the included groups was not dramatically different from that of the population as a whole.

- PCEDIS allocated to households on the basis of their expenditure on a range of specific commodities
- TOTPCE allocated to households on the basis of their total consumption expenditure
- TOTINC allocated to households on the basis of their share in the burden of all taxes
- PCEINV allocated to households on the basis of their consum

B. Treatment of Taxes by Final Consumers when Shifted to Forward

FINAL DEMAND SECTOR SHIFTING OF TAXES

	PCEDIS	FOREIGN	DIVIDENDS	BUS INC	WAGES	TOTAL
1 Household Final Consumption Expenditure						