

eJournal of Tax Research

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eJournal of Tax Research

EDITORS' NOTE

The *eJournal of Tax Research* is a refereed journal that publishes original, scholarly works on all aspects of taxation. It aims to promote timely dissemination of research and public discussion of tax-related issues, from both theoretical and practical perspectives. It provides a channel for academics, researchers, practitioners, administrators, judges and policy makers to enhance their understanding and knowledge of taxation. The journal emphasises the interdisciplinary nature of taxation. To ensure the topicality of the journal, submissions will be refereed quickly.

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Editorial Announcements

I wish to announce with pleasure that Dr Nolan Sharkey, a Senior Lecturer at Atax, has been appointed to the position of co-editor of the *eJournal of Tax Research*, effective immediately. Nolan is a well published tax academic with research interests in international tax and double tax agreements, particularly in the Asia-Pacific region. He has also played a key role on several international initiatives involving China. Congratulations to Nolan and I look forward to having a productive collaboration with him.

Our production editor, Kathrin Bain, has resigned from her position to take up a full time lectureship in taxation law, commencing 1 January 2011. I wish to take this opportunity to thank Kathrin for her contributions to the *eJournal*.

Binh Tran-Nam
Joint editor of the *eJournal of Tax Research*
December 2010

Combating the Phoenix Phenomenon: An Analysis of International Approaches

Murray Roach*

Abstract

The phoenix syndrome involves company directors misusing the protection afforded by the corporate form to evade debt and fraudulently pocket taxes that should benefit the community. The literature suggests that despite the concerted efforts of tax and corporate authorities, the incidence of phoenixing is growing in the international community. The impacts are far reaching in the industries in which phoenix practices tend to pervade. Enforcement strategies are complicated by the difficulty in distinguishing between harmful and beneficial business reconstructions. Government policy setting must strike a delicate balance between encouraging entrepreneurial risk taking and stopping outright fraud. Despite the attendant difficulties, various international jurisdictions have attempted to combat phoenixing with an interesting array of legislative and compliance approaches. This paper attempts to reconcile a definition of harmful phoenixing and examines the reasoning behind the rise of the corporate form. It questions the efficacy of the doctrines of separate legal entity and limited liability in the context of the closely-held company scenario, so prevalent with phoenixing. Next, it reviews a selective sample of international jurisdictions to compare how contextual factors affect the strategies adopted to address the phoenix phenomenon. Finally, the paper presents a series of recommendations that may provide an effective response to the worst aspects of phoenixing whilst preserving the corporate form as an attractive mechanism for honest business ventures.

1. INTRODUCTION

Much of the economic growth experienced in the developed world over the past two hundred years can be attributed to the rise of the concept of incorporation.¹ The unique legal structure and the protections afforded investors and management under the corporate form have permitted the efficient accumulation of vast amounts of capital and the sophisticated management necessary to the success of high-risk, large-scale projects. World governments have fostered the rise of corporations in the knowledge that they have a predominantly positive effect in the community. Corporations provide mass employment, support and encourage entrepreneurial risk taking, create economic growth and increase national revenue.

However, in recent years there has been growing concern in the international community about the misuse of companies to avoid debts through the strategic exploitation of cyclical liquidations; a phenomenon commonly referred to as 'phoenixing'. It is no accident that the increasing prevalence of the phoenixing phenomenon in the latter stages of the twentieth century correlates closely with the

* Murray Roach is a Masters graduate of the Australian School of Taxation (ATAX), Faculty of Law, University of New South Wales. This paper began its life as an ATAX research paper. The author expresses his gratitude to Professor Chris Evans (UNSW) for his comments and encouragement on the development of this paper and for the benefit of his international contacts. The author also wishes to thank Eugene Walsh (HMRC - UK), Adrian Brennan (ODCE - Ireland), Katherine Jones (IR - NZ), John Kowalski (CRA – Canada), Grant Darmanin, Mark Barron and Marianne Rogers (ATO) for their valuable regional insights into the phoenixing problem.

¹ Orhnlial, T. (1982), p.81

emergence of the small single-director, single-shareholder company. In 2003, the Cole Royal Commission² highlighted the existence of a serious problem with phoenixing in the Australian building and construction industry. However, the literature confirms that the phoenixing syndrome is not unique to Australia.

Individual international jurisdictions have tended to tackle the issues in isolation as they have surfaced, careful not to over prescribe in the legislation for fear of stifling entrepreneurship. The result has been diverse legislative and compliance approaches across the international spectrum which operate with varying degrees of success. Some commonalities are emerging however, which hint at the possibility of a best practice approach to the problem. Cross jurisdictional conversations are beginning to take place in an effort to compare approaches and arrive at a comprehensive solution.³

2. A DEFINITION FOR PHOENIXING

The term 'phoenixing' was coined to describe the arising of a new business out of the 'ashes' of an expired former business – an analogy with the phoenix bird of Egyptian mythology.⁴ However, arriving at an exact definition for phoenixing is problematic.⁵ Although the term 'phoenixing' is increasingly being used in the pejorative sense, its definition is nebulous and difficult to pin down. A study conducted by the International Association of Insolvency Regulators (IAIR) revealed that no jurisdiction within the association was able to provide a categorical definition for phoenixing, although all acknowledged the phoenixing phenomenon as a problem to a greater or lesser extent.⁶

The difficulty in nailing down the term resides partly in the fact that phoenixing, of itself, is not inherently unlawful. To illustrate, it is not an offence for a business to fail once, or even on multiple occasions. If a company becomes insolvent and enters into liquidation, it is not improper for the directors of the insolvent company to form a new company involved in similar business activities. In the course of that new enterprise, it is not illegal for the management of the new company, to purchase assets out of the liquidation proceedings of the previous company for use in the new company.⁷ There are good reasons for this.

History is replete with stories of innovators who have suffered bankruptcy somewhere along the path to success. The list includes such notables as: Henry Ford - who perfected the production line concept and the full application of specialisation; Walt Disney - entertainment entrepreneur; Charles Goodyear - inventor of the vulcanised rubber tyre; and Henry Heinz – founder of the eponymous American food conglomerate.⁸ Experience shows that, on the whole, society benefits when entrepreneurs are not hindered from pursuing new entrepreneurial visions merely because of a previous failed business venture. The acquisition of business nous is, after all, an iterative process, with each business failure informing future business endeavours.

² See Final Report of the Cole Royal Commission into the Building and Construction Industry tabled to Parliament 20 August 2002

³ Appleby (2004)

⁴ Pinch, G. (2004), p.118

⁵ Parliamentary Joint Committee on Corporations and Financial Services (2004), p.131

⁶ Appleby (2004), p.72

⁷ Parliamentary Joint Committee on Corporations and Financial Services (2004), p.131

⁸ Margulies, L (2009)

Phoenixing however, is ultimately an abuse of the limited liability concept and any analysis of phoenixing must necessarily consider the purpose of the corporate form and the theory underpinning company law. The rise in predominance of the limited liability company emanated from the period of rapid industrialisation in the UK during the 1700s.⁹ It was a time when substantial amounts of venture capital were needed to exploit emergent technologies and embark on large-scale capital projects. Limited liability was originally designed to protect individual investors and encourage investment funding for major ventures that would benefit society. The limited liability concept has been vital to the aggregation of the vast sums of money necessary to implement the many large-scale infrastructure projects which have benefited society and appreciably improved first world living standards over the past two centuries.

The abuse of the corporate form however, is well documented, especially in the last half of the 20th century. The Costigan Royal Commission's revelation of the exploitation of 'bottom of the harbour' schemes to strip company assets, divert profits, and avoid tax was considered sufficiently repugnant as to trigger retrospective laws to prosecute culpable directors.¹⁰ 'Bottom of the harbour' schemes were unethical legalistic constructions involving the fraudulent manipulation of transactions using loopholes in the law. Phoenixing however, is not quite as clear cut. The range of phoenix activities extends, at one end of the continuum, from the conscientious restructuring of a company that has failed due to economic downturn or poor market conditions, to the other end, where recidivist phoenix operators perpetually cycle the productive assets of a business through an endless series of companies in a deliberate effort to avoid tax, trade creditors and other liabilities.

Before a jurisdiction can effectively address harmful phoenixing and its undesirable consequences, it must first gain an appreciation as to what constitutes honest business failure. Paradoxes quickly emerge in analysing the various responsibilities of directors. Most corporate governance systems across the international arena require directors to minimise the impact of insolvency by ceasing to trade as soon as it becomes clear that a business cannot be saved. However, an enterprise can be expected to find itself in a predicament of inadequate cash flow at many times throughout its lifetime. A primary role of management is to accept and balance risk, engage professional advice and develop strategies in an effort to overcome liquidity problems, rather than concede at the first hurdle. Dealing with problems is, after all, a critical function and core responsibility of management. It is only when a business becomes untenable that it is beholden on directors to act swiftly to limit the losses for creditors. But the line between crisis and failure is frequently far from distinct.

Part of the resolution to a liquidity crisis may be to enter into deeds of arrangement with creditors or even to reconstitute the business by purchasing from the insolvency practitioner, at arms-length and at market value, key assets of the failed company for use in a new company. This approach may produce the best long-term result for all stakeholders, including; employees, who benefit from continuous employment, the tax authorities, who reap ongoing revenue from a revitalised enterprise; and creditors, who may achieve an ongoing profitable relationship with the successor company.

⁹ Rickett & Grantham (1998)

¹⁰ Hannan & Hughes (2009)

Whilst such a strategy may fall under various definitions of phoenixing activity, it is not the type of phoenix activity that is of concern to governments around the world.¹¹

The Australian Securities and Investments Commission (ASIC) categorises the phoenixing phenomenon in terms of ‘*innocent phoenixing*’, ‘*occupational hazard*’ and ‘*careerist offenders*’.¹² *Innocent phoenixing* occurs when a business comes under financial stress due to poor (as opposed to deliberately fraudulent) management decisions, inadequate record keeping and poor cash flow and financial management techniques. In some industries, such as building and construction, phoenixing is considered an *occupational hazard* in that once the business has collapsed, the operator’s skill set drives them back into the same industry, where they are at high risk of failing again. They are affectively locked in to the industry by their skill-set. However, it is *careerist offenders* that pose the most serious concern for tax administrators. These operators intentionally structure their businesses to engage in cyclical phoenix activity, exploiting loopholes in insolvency laws and fractures in communication between government agencies and the insolvency profession.¹³

The Cole Royal Commission accepted ASIC’s definition of phoenixing as the situation where an incorporated entity:¹⁴

- fails or is unable to pay its debts; and/or
- acts in a manner which intentionally denies unsecured creditors equal access to the entity’s assets to meet outstanding debts; and
- within 12 months, another business commences which may use some or all of the assets of the former business, and is controlled by parties related to either the management or directors of the previous business

The Australian Tax Office (ATO) qualifies this definition somewhat to include only that behaviour which poses a significant risk to the tax revenue and retirement income systems. For the ATO phoenixing is defined as ‘(t)he evasion of tax and superannuation guarantee liabilities through the deliberate, systematic and sometimes cyclic liquidation of related trading corporate entities’.¹⁵

Some jurisdictions prefer the term ‘*strategic bankruptcy*’ to describe phoenixing.¹⁶ In many ways, this term helps to outline an important distinction between the motivations and intents in the minds of business owners engaged in fraudulent phoenix activity and those who have simply fallen foul of egregious economic conditions or disastrous but innocent business decisions.

It is important to keep in mind that there are many positive policy reasons for a government to foster an environment in which a failing enterprise is able to wipe the slate clean and start again. Innocent phoenix activity can preserve jobs and reduce the burden on the transfer payment system. It can encourage entrepreneurship and

¹¹ Appleby (2004)

¹² ASIC (2002)

¹³ Ibid, p.4-5

¹⁴ Cole (2003), pp.113-114

¹⁵ ATO internal brief, “Strategically managing the risk posed by phoenix practices”, p.4; Darmanin (2010), p.4

¹⁶ Delaney (1992), Ch.6

rational risk taking and provide innovation, economic growth and new commodities for the community. Legitimate businesses do not always succeed on the first attempt. One UK source estimates that one in three businesses fails within their first three years of operation.¹⁷ An innocent phoenix arrangement allows the profitable elements of a business to survive and start again, which provides some continuity for employees and suppliers. The critical factor is in deciding how to frame laws and policies to distinguish between harmful and beneficial phoenixing. For the purpose of this paper the use of the term “phoenixing”, unless otherwise specifically stated, can be taken to refer to those business practices, which have a predominately undesirable effect on society.

3. PHOENIXING AND THE RATIONALE FOR LIMITED LIABILITY

The corporate form has two key facets; separate legal identity for the business and limited liability of the owners. Phoenixing allows the directors of closely held companies to take unfair advantage of these facets in tandem; firstly by isolating the directors’ responsibility for their management decisions under the corporate veil and, secondly, by limiting their liability as investors to recompense the unpaid creditors of the business. The phoenix phenomenon is therefore fundamentally an abuse of the corporate form.

Nevertheless, it is important to qualify from the outset that limited liability is not intrinsically inequitable in itself. The UK Insolvency Service highlights that a misconception exists amongst the general population in understanding company reconstructions. People intuitively feel that directors have a moral, if not legal, duty to discharge the debts of a failed company before undertaking a new venture.¹⁸ However, this perception belies the underpinning rationale for the corporate form, which emanated in the industrial age during a period of rapid economic expansion.

Corporations under royal charter were a feature in English commerce from as early as the late sixteenth century. Although the concept of limited liability existed in theory at this early time, in reality it was illusory, with companies frequently calling on their members to meet outstanding debts.¹⁹ Chartered corporations eventually began to wane principally due to the difficulties of obtaining a charter from the Crown and joint stock companies began to dominate the commercial world from about 1840.²⁰ Joint stock companies were in effect nothing more than vast partnerships with freely transferable shares, where members retained personal liability for company debts.

Limited liability as we know it today was formalised in 1855 with the enactment of the UK Limited Liability Act.²¹ From a theoretical perspective, the case for limited liability was premised on the notion that, within a widely-held company, there was a separation of the ownership from the control of a business and this limited control justified a limited liability to accumulated debts.²² Liberal economists countered this argument with the contention that limited liability was incompatible with free market behaviour and cautious investment and so limited liability resulted in economic

¹⁷ See Insolvency Network at: <http://www.insolvencynetwork.co.uk/page.php?id=56>

¹⁸ Appleby (2004), p31; Quainton (2008)

¹⁹ Davies & Gower (2003), p.22

²⁰ Rickett & Grantham (1998); Sealy, cited in Feldman & Meisel (1996), p.22

²¹ Mayson, S. French, D. & Ryan, C. (2007), p.55

²² Orhnial, T. (1982), p.45

inefficiency.²³ An inherent tension exists between fostering the expedient gathering of large amounts of capital and assuring a well behaved marketplace. Too little regulation fosters volatility and corruption, while too much restrains innovation and flexibility.²⁴

Early literature on the theoretical justification of the limited liability concept focused on the widely-held corporation and rarely considered the single-director, single-shareholder company. However, it has more recently been suggested that the extension of limited liability to the sole trader is justified on the grounds that the fixed 'special' assets of the business are said to represent the 'special capital' of the enterprise undertaken, rather than that of the individual.²⁵ Certainly, the 'separation of ownership and control' argument seems weak in the context of closely held companies, the predominant entity structure in phoenix operations.

Phoenixing represents a clear breach of a director's legal and ethical duty to act in the interests of all the investors (which includes the creditors) of the company. The resultant agency cost of the phoenixing director's breach of duty is ultimately borne by the creditors of the business. Nevertheless, it bears emphasising that the true nucleus of the phoenix problem is not so much located in theoretical flaws in the doctrines of limited liability and separate legal identity which underpin incorporation; rather, it resides in the transfer of assets from the failed company at undervalue.

4. COMMON PHOENIXING TECHNIQUES

Phoenixing essentially involves a director hiding behind the corporate veil which separates their actions and responsibilities. The basic premise of using a company to avoid responsibility for debt is common to all phoenixing, but the exact manner in which that outcome is achieved can vary from industry to industry and from jurisdiction to jurisdiction. Even so, the following common characteristics of harmful phoenixing tend to be observable across the international experience:²⁶

- the failed entity is formed with only a nominal share capital
- the failed entity is under capitalised
- the directors/managers/controllers of the failed and successor company are the same
- the failed entity is trading whilst insolvent
- assets of the failed company are depleted shortly before the cessation of business
- the failed company makes preferential payments to key creditors to assure supply to the successor company
- the failed entity was operated to evade prior liabilities
- the successor company operates in the same industry

²³ Ibid, p.46

²⁴ Appleby (2004), p.70

²⁵ Orhnial, T. (1982), p.44

²⁶ Appleby (2004), p.6

- the successor company trades with the same or similar name
- the successor company commences trading immediately prior to, or within 12 months of, the cessation of the failed entity
- assets of the failed company are transferred at below market value to the successor company
- many of the employees of the failed company are re-employed by the successor company

The technique of phoenixing may vary somewhat between jurisdictions to accommodate legislative or other contextual differences. Within the Australian context, the following principle phoenixing scenarios predominate.²⁷

4.1 One after the Other Method

In this scenario a closely held company is formed. The company trades for a short period, typically between six months and two years. During that time, the company accumulates large debts, most commonly in relation to unremitted tax, workers compensation and superannuation contributions. The management stalls creditors for as long as possible. Liquid assets that in a normal trading situation would be applied to payment of creditors are syphoned off the business for the personal use of the directors and their associates. When the pressure from creditors becomes intolerable, the company goes into liquidation and another company, frequently with a very similar name, purchases the productive assets and takes over the operations of the failing company. Often the new company operates out of the same premises, with the same suppliers, employees and customers. To all outward appearances, it is difficult to detect that there has been any change in the business at all. The directors of both companies may be identical or they may be related persons or associates who act as a puppet management for the phoenixing directors. The new company is usually able to continue to cash cheques from the former company because of the similarity in trading names. Liquidators generally conduct very limited investigations into the conduct of the directors, because there are insufficient funds left in the company to fund such activity.²⁸

4.2 Management Company Method

Another strategy of phoenix operators is to quarantine the productive assets of the business in a management company. This primary company is kept solvent. A second labour supply company employs the workers and conducts the principal business operations. The management company hires the equipment to the labour supply company at exorbitant rates, thus stripping any profits out of the labour supply company. The labour hire company does not remit PAYG or GST withholding, these provisional amounts additionally being stripped by the management company. Eventually, the labour hire company will be liquidated, with little to no capital reserves, and a new one will rise in its stead. The real assets of the business are isolated and protected under the corporate veil of the management company for use in

²⁷ Cole (2003), pp.116-117

²⁸ Ibid, p.115-118

successive labour hire companies. The workforce is simply re-employed by the new labour hire company.²⁹

4.3 Labour Hire Method

This strategy utilises a management company, a sales company and a labour hire company. The sales company receives all the income from the activities of the overarching business. The management company owns all the productive assets of the enterprise and hires them to the sales company. The sales company also hires employees from the labour hire company, but only to the extent of the net wages paid to the employees and other worker entitlements. Little, if any, provision is made for PAYG withholdings and workers compensation premiums. Often the labour hire company is a façade, merely issuing payment summaries, while the sales company pays the workers directly. The labour hire company is eventually forced into liquidation by the ATO or the workers compensation authority. The core assets of the overall enterprise are preserved in the management company.³⁰

4.4 Shadow Directors Method

The control of phoenix activity is further complicated because of the ease with which former directors can control a company through spouses, relatives and associates.³¹ There is little to prevent a disqualified director from giving advice as an employee of a successor company. An effective strategy to address the phoenix phenomenon must acknowledge the use of shadow directorships to circumvent disqualifications and find a way to counter them.

5. THE SOCIO-ECONOMIC IMPLICATIONS

In developing a compliance strategy, it is important to understand the powerful socioeconomic drivers that underpin the phoenix phenomenon. Phoenixing helps to fund a lifestyle for directors that they otherwise could not afford. It provides the director a status of wealth that is extremely tempting. There appears to be varying degrees of acceptance of phoenixing amongst different ethnic, industry and socioeconomic cultures.³² This may be due in part to a perception that the tax system is oppressive or unfair, or that phoenixing is essential to compete in an industry. Analyses of certain industries where phoenixing is prevalent indicates a general belief that phoenixing is ethical, or at least normal behaviour³³. Generally, phoenix operators tend to be uncooperative with tax authorities and not particularly concerned with the consequences of being caught.³⁴ These data provide a reasonable heuristic of the relative ineffectiveness of present sanctions.

The insolvency process is designed to achieve a number of economic efficiency and equity policy objectives. Economic efficiency is achieved by promoting confidence in a credit system, where risks can be objectively quantified and high levels of trust exist that the insolvency process operates fairly and consistently.³⁵ Two efficiency aims

²⁹ Cole (2003), p.115-118

³⁰ Ibid

³¹ Parliamentary Joint Committee on Corporations and Financial Services (2004), p.132

³² ATO BISEP Analysis of Phoenix Practices

³³ Ibid

³⁴ Ibid

³⁵ Swain (2003), p.3

influence the development of policy on phoenixing. Firstly, there is pressure to deal with liquidations quickly and fairly to keep the transaction cost of bankruptcy and the cost of debt capital as low as possible. Importantly, the cost and availability of capital for all companies are directly influenced by what happens in the insolvency setting. Secondly, there is a social interest in expediting the transfer of the productive assets of the failed company to their new owners to mitigate the economic losses that come with the prolonged inactivity of these key assets.

Equity is achieved in the insolvency process by distributing the net assets of the failed business fairly, punishing fraudulent offenders and by reforming honest debtors by relieving them of financial liabilities and rehabilitating them. Inevitably, equity outcomes also help to support economic efficiency, because they provide a structure under which the corollary of business failure can be administered in a methodical and less wasteful manner.³⁶

A business that is fundamentally sound is a significant piece of social capital. If its core structure of customers, suppliers, employees, assets, and tax contributions are broken up in insolvency, no doubt the individual elements will eventually be re-employed within the economy, but not without large transaction costs. So long as the going concern value of a business is greater than its liquidation value, it is more efficient to maintain an entity intact. In practical terms, this efficiency outcome is best effected by putting energetic new managers in place with a sound strategy for revitalising the business and consigning the mistakes of the past to those directors who made them.³⁷ These efficiency principles are evident in the insolvency legislation of a number of countries, including Canada and the United States, which promote business reorganisations where they are practicable. These reorganisations usually involve creditors trading debt for equity in order to keep an enterprise in tact.³⁸

Quantifying the socio-economic costs of phoenixing is problematic, partly because of the vagueness of its definition and partly because of the subjective judgment required in distinguishing between innocent business reconstruction and fraudulent phoenixing. Not surprisingly, very few countries are able to provide any definitive metrics on the incidence of phoenixing or the costs associated with phoenix insolvencies.³⁹ A limited number of countries have attempted to extrapolate the cost of phoenix activities based on insolvency and tax authority statistics however, these estimates are vague to say the least.⁴⁰ Most large-scale phoenix activity in Australia occurs with closely held companies with turnovers of between \$2 million and \$10 million per annum.⁴¹ Phoenixing by its nature is the almost exclusive domain of closely held companies. The ATO has estimated that each year approximately 12,500 companies in Australia are subject to a phoenix process, resulting in an annual loss of revenue amounting to somewhere between \$500 million and \$1 billion. Limited public resources mean that only a small percentage of these are targeted for compliance activity. The Parliamentary Joint Committee on Corporations and Financial Services advised in its 2004 annual report to Parliament that the risk to the Australian economy posed by

³⁶ Ibid

³⁷ Ibid, p.4

³⁸ Bankruptcy and Insolvency Act (Canada) Part III; Bankruptcy Code (US) Chapter 11.

³⁹ Appleby (2004), pp.8, 25, 29, 31, 35, 37, 45, 49, 55, 66.

⁴⁰ Ibid, p.72

⁴¹ ATO (2002)

Phoenix and insolvency related practices was estimated at between \$1 billion and \$2.4 billion per annum.⁴²

In 1996, ASIC conducted research into the incidence of phoenixing in Australia.⁴³ Although now somewhat dated, the report provides an indication of the impact of phoenixing within this region. ASIC's research suggested that the overall loss to the Australian economy as a result of phoenix activities amounted to \$1.3 billion, or just over a quarter of 1% of Australia's GDP. Almost one in five small to medium sized firms were affected by phoenix activities, yet only 20% of those affected had attempted to report it to authorities. Almost half of all phoenix activities in Australia occurred in the building and construction industry. This phenomenon was mirrored in the international experience.⁴⁴ Internationally, phoenixing is recognised as a growing problem that threatens to substantially erode revenue and undermine community and business confidence.

Although phoenixing can potentially affect all creditors, generally it is the tax authorities that bear the greatest financial cost of the phoenixing phenomenon. Tax authorities are involuntary creditors in that they cannot choose to disengage with high-risk companies like other creditors can.⁴⁵ The non-payment of group tax, payroll tax and consumption tax can be significant. In Australia, the loss of revenue due to phoenixing has been conservatively estimated to be \$500 million to \$1 billion per annum.⁴⁶ Other jurisdictions report similar significant revenue losses.⁴⁷ This tax gap is at least in part borne by the population of individual taxpayers, whose proportionate tax burden is increased due to the shortfall from the corporate tax regime.⁴⁸

Compounding the revenue shortfall problem, directors of Australian phoenix companies often ascribe to themselves large amounts of nominal withholding tax from the failing company. As with all the other outstanding tax liabilities, the withholding amount is never remitted to the tax administration. However, the phoenix operator is aware that the administration historically honours the tax credit that this withholding represents to preserve the integrity of the tax-transfer system. As a result, the director is permitted an additional benefit of the tax credit as a result of the phoenixing activity. This process is known as "double dipping".⁴⁹

Insolvent trading inevitably results in a financial loss for the unsecured trade creditors of the failed companies that have been unethically stripped of assets.⁵⁰ These losses can have follow-on or 'downstream' effects on the cash-flows of creditors, who may in turn become insolvent as a result of the primary event. Often, phoenix operators will pay their key suppliers to keep them on side and maintain supply.⁵¹ This is especially true where there are few reliable suppliers in the industry.

⁴² The Parliamentary Joint Committee on Corporations and Financial Services (2004)

⁴³ ASIC Research Paper, Phoenix Companies and insolvent trading cited in Martin (2007), p.3

⁴⁴ Appleby (2004), Ch 15

⁴⁵ Jones ((2010), p.10

⁴⁶ ATO (2006), p.6

⁴⁷ See various agency responses in Appleby (2004)

⁴⁸ Office of the Revenue Commissioners (2002), p.1

⁴⁹ ATO BISEP Analysis of Phoenix Practices

⁵⁰ Cole (2003), p.131

⁵¹ Appleby (2004), p.62

Trade creditors possess the ability to diversify bad debt risk across a large number of client companies.⁵² It has been argued that creditors are in no position to complain that insolvency has caused them loss because they have contracted to bear that risk and should have built compensation into the cost of credit.⁵³ Creditors charge a fee for the goods and services they provide. Factored into that fee is an element that represents the risk that they bear in extending trade credit. The greater the risk, the greater is the premium to compensate for that risk. However, this contention is specious in that it fails to acknowledge that these unnecessary costs are ultimately absorbed by down-stream customers in the supply chain, not just the phoenix operator.

Employees are also exposed to greater risk than trade creditors because they tend to invest all of their human capital in a single business. While some highly skilled employees may be able to bargain for increased remuneration to offset the risk of financial instability, in reality few employees enjoy such a favourable position and the employees who are most likely to need protection are also the ones least likely to be able to negotiate additional compensation.⁵⁴ Employees face losing basic entitlements including remuneration and leave accumulations as a result of phoenixing, however because they enjoy the status of a preferred creditor they often receive unpaid wages in the liquidation process.⁵⁵ Superannuation payments, on the other hand, frequently remain unpaid.⁵⁶ Surveys conducted in Australia during the late 1990s found that nearly 28% of employers were non-compliant with their Superannuation Guarantee obligations with 1% of employers wholly failing to pay any superannuation contributions for their eligible employees. Between 2002 and 2008, the average shortfall increased six fold, from \$300 to over \$1800 per employee.⁵⁷

Because the transition between the failed and successor companies is often seamless, it is possible for an employee to work in the same factory, with the same machinery, for the same management, in ostensibly the same business, over the course of the employee's working life, with no immediate realisation that the business has been perpetually phoenixed. Each time the company may have been wound up, the assets sold to a new shell company and unpaid superannuation contribution liability wiped clean. The business doors close one day and open the next under the veil of the new company. Essentially, the employee appears to be in continuous employment. However, the employee's superannuation benefit will be significantly reduced as a result.⁵⁸ This adversely affects standards of living of retirees and places added pressure on an already straining publicly funded pension system.⁵⁹ Where the phoenix transition is not seamless, employees suffer discontinuity of employment. This is especially detrimental in industries where phoenixing is prevalent, as employees are continuously forced to move from one employer to another.

One significant implication of phoenixing that has received much discussion in the literature is the unethical competitive advantage afforded to phoenix operators. Since

⁵² Anderson, (2008), p.476

⁵³ Wishart (1991), p.336

⁵⁴ Anderson, (2008), p.476

⁵⁵ Corporations Act 2001, s.556

⁵⁶ ACTU et al (2009)

⁵⁷ Ibid, p.2

⁵⁸ ACTU et al (2009), p.3 extrapolation of ATO data found that more than \$900 million in superannuation entitlements was outstanding as at 2008

⁵⁹ Australia's Future Tax System: Retirement Income Consultation Paper, p. 11

they strategically avoid paying taxes, a phoenix operator can factor the non-payment of tax into their pricing decisions. A phoenix company enjoys considerably lower labour costs than its honest competitors do because they under-remitt PAYG withholding tax. They also benefit from reduced labour on-costs from underpaying superannuation contributions and workers compensation insurance. Similarly, a phoenix operator who plans to under-remitt consumption tax does not have to factor it into their price to the client. GST/VAT may appear on the bill; however, the phoenix operator is conscious that this tax will not be paid and so, in reality, to the extent that it is collected and under-remitted, it represents contribution margin rather than actual tax. Thus, phoenix companies enjoy an unfair competitive advantage resulting from this artificial cost leadership.

A phoenix operator can opt to price their output at the going market rate and pocket the unremitted tax element as economic profit, or alternatively they can pass part or all of these savings on to their customers and exercise their competitive advantage. If they choose the latter option, this is likely to have a compounding effect on revenue. All other things being equal, the unfair competitive advantage will result in phoenix operators attracting a larger market share than they otherwise deserve. The tax base is increasingly eroded as a greater share of the market is effectively conducted outside the tax system. Further to this, as phoenixing becomes more and more prolific in an industry, companies that would otherwise act honestly may be effectively forced into adopting phoenixing, simply to compete on a level playing field. Unchecked, the phoenixing phenomenon can eventually become entrenched in an industry.⁶⁰

Goodwill is a business asset that can represent a significant economic value. Phoenix operators are particularly adept at holding on to the goodwill that is stored in the failing company. This can be accomplished by holding valuable contracts in a separate contracting entity, but it is often achieved by simply ensuring that the name of the new company is only subtly different from that of the failed company. The new company often retains the contracts and custom of the previous business because customers are convinced that they are still dealing with the original company from which the successor company emerged.

In actuality, this situation represents a sub-par value transfer of the goodwill in the liquidation process. By rights, the full value of the goodwill should be harnessed by the liquidator for the benefit of the creditors. In jurisdictions where a company is free to appoint its own liquidator, there is a risk of collusion between the director and the insolvency professional.⁶¹ Although at law the liquidator has a fiduciary duty to the creditors, the power of the director to appoint the liquidator creates a potential risk of conflict of interest. This issue is widely acknowledged and various jurisdictions have implemented legislative measures to prevent it.⁶²

6. A COMPARISON OF INTERNATIONAL APPROACHES

6.1 Australia

Phoenixing is not defined in Australian law, despite it being a major focus of various enforcement agencies since the late 1990s. The Corporations Act details the general

⁶⁰ Cole (2003), p.161

⁶¹ Taylor (2006)

⁶² Insolvency Act (UK) 1986, s.216; Companies Act (NZ) 1993, s.386

duties of directors and other officers of a corporation and includes both criminal and civil penalty provisions for breaches of these duties. Authorities rely on these provisions to counter phoenix practices.⁶³ The level of community concern over phoenixing has been building in recent years. The ATO is experiencing increasing levels of phoenix activity which is adversely affecting revenue collections across the full ambit of tax regimes it administers.⁶⁴ A number of government and industry enquiries have outlined the serious detrimental impact that phoenixing poses to the community.⁶⁵ The ATO estimates that phoenixing results in an annual loss to Australia's revenue in the region of \$600 million.⁶⁶

The Labor federal government outlined a number of commitments during its recent election campaign to crack down on the rising incidence of fraudulent phoenixing. These measures included restricting the re-use of business names under legislation similar to that of the UK and New Zealand, extending the promoter penalty regime to include phoenixing schemes, extending the director penalty regime to include unpaid superannuation, income tax and indirect tax withholdings and strengthening ASIC's powers to place companies into liquidation.⁶⁷

The ATO has audited over 1600 businesses suspected of engaging in phoenixing since 1998, when it began to specifically target the problem.⁶⁸ Audits focus on labour intensive industries and on compliance with income tax withholding, GST and Superannuation Guarantee obligations.⁶⁹ The return on investment, at first glance, appears substantial. Every dollar spent on phoenix compliance during 2001-2002, uncovered eight dollars in additional assessed revenue.⁷⁰ However, the collectability of much of this tax is questionable.⁷¹ The ATO favours an early intervention approach which seeks to identify and track existing phoenix operators. Phoenix behaviour is identified by analysing data to identify tax agents who are hubs of phoenix behaviour. Early contact discourages directors from becoming serial offenders.⁷²

As phoenix activity often involves non-compliance issues beyond the jurisdiction of tax authorities (such as non-lodgment of company returns and licences), the ATO exchanges intelligence and works in partnership with other government agencies, particularly ASIC. Phoenixing tends to thrive in a climate of fractured legislation and disconnection between the government agencies responsible for identifying and prosecuting phoenixing related offences. In 2007, ASIC and the ATO signed a memorandum of understanding designed to consolidate and strengthen the working relationship between the two agencies to promote public confidence in the financial system.⁷³

More recently the ATO has concluded that a general failure across the international spectrum to define the real phoenix mischief has delayed broader resolution of the

⁶³ Martin, A (2007), *Directors' Duties and Phoenix Companies*, 3 April 2007, p.4

⁶⁴ Discussion with G. Darmanin, Phoenix Risk Manager, ATO, 22 July 2008

⁶⁵ See Cole Royal Commission Report

⁶⁶ Darmanin (2010), p.5; Australian Government (2009), p.5

⁶⁷ Gillard et al (2010)

⁶⁸ Darmanin (2010), p.3

⁶⁹ ATO (2007)

⁷⁰ Cole(2003), p.140

⁷¹ Darmanin (2010), p.3

⁷² ATO (2007)

⁷³ ASIC/ATO Combined Media Release, (2007)

phoenixing problem. Accordingly, the ATO has attempted to distinguish and characterise *fraudulent* phoenix behaviour. Qualifying the types of behaviour that are considered fraudulent, illegal and abusive immediately excludes other less harmful, even positive, forms of business reconstruction. Moreover, it enables authorities to respond promptly to the worst aspects of phoenixing rather than causing them to remain distracted and bogged down in philosophical and legalistic debate.⁷⁴

The ATO uses a variety of strategies to identify phoenix activity. Data matching examines the tax payment and insolvency patterns of directors and their entities. Intelligence from internal business lines is fed into the phoenix compliance area as is information provided by the community, including insolvency practitioners and trade creditors. Public reports of corporate insolvencies are also monitored within the ATO. Industry profiling permits the targeting of limited compliance resources on areas of highest risk, particularly labour-intensive trades in the building and construction industry.⁷⁵

Since 2002, ASIC has required insolvency practitioners to indicate if they suspect phoenix activity by the directors of any failed company. In the late 1990s, ASIC implemented Operation Westgate to directly combat phoenixing. Westgate was a strategic intelligence-based approach, which involved using lead-time indicators of insolvency from sources including credit reference agencies and exercising ASIC's powers of inspection to target phoenix operations. Companies of dubious solvency were monitored closely and those that were clearly insolvent were given a very short time to appoint an administrator.⁷⁶ Despite some clear successes Westgate was short lived, lasting only 12 months. During the last decade, ASIC's focus on small business has been distracted by a number of large corporate collapses, including HIH, One.Tel and Ansett. ASIC's current strategy favours maintaining a flexible and responsive enforcement team over the division of its resources by category of misconduct.⁷⁷ ASIC acknowledges that it is untenable to investigate all reported cases of phoenixing, due to resource constraints and other factors.⁷⁸

An ASIC administered Assetless Administration Fund (AAF) finances liquidator investigations where offences are suspected in companies that have insufficient residual assets to fund a proper investigation. The AAF addresses the phoenixing tactic of stripping funds to prevent investigations that might result in prosecution of phoenix directors for breach of the Corporations Law.

Under Australian corporate law, a person is automatically disqualified from taking part in the management of a corporation if they are convicted of certain offences including breaches of directors' duties.⁷⁹ A person who is automatically disqualified may seek leave from the court to manage a corporation. The court may disqualify a person from managing corporations if the person has contravened a civil penalty provision, including those in relation to breaches of directors' duties;⁸⁰ if the person

⁷⁴ Discussion with Grant Darmanin, Phoenix Risk Manager, ATO, 22 October 2010

⁷⁵ Ibid

⁷⁶ Cole (2003), p.144

⁷⁷ Ibid, p.145

⁷⁸ Ibid, p.146

⁷⁹ Corporations Act 2001, s.206B

⁸⁰ Ibid, s.206C

has been at least partly responsible for the failure of two or more corporations within seven years⁸¹ or has repeatedly contravened the Act.⁸²

ASIC is empowered (although not required) by the law to disqualify a person from managing corporations if the person has managed two or more failed corporations within a seven year period and providing the liquidator has reported to ASIC on those failed companies.⁸³ The director must be given an opportunity to show cause why a disqualification should not be imposed. The Cole Royal Commission recommended this power be amended to apply after just one company failure.

Australia's Corporations Law imposes a duty on directors to prevent insolvent trading and provide for both civil and criminal penalties if the director breaches this provision.⁸⁴ In conjunction with civil penalty provisions, the director can be held personally liable for the debt incurred whilst trading in insolvency and ordered to pay compensation to the company. The court may order a director to be personally responsible for the debts of a company if they managed a company while disqualified.⁸⁵ These provisions, if applied, lift the corporate veil on phoenix companies by holding directors personally accountable for the debts left in the failed entity.

Despite its apparent far reaching powers, the Corporations Law has proved ineffectual in its application against phoenix activities. Prosecutions have proven time consuming and resource intensive, relative to their outcomes. The Commissioner of Taxation has recently called for a tougher penalty regime for phoenixing in the light of evidence that the phenomenon is growing.⁸⁶ A lack of prosecutions in relation to phoenix activity and lenient sentences from Australian courts was contributing to the problem.⁸⁷ Since 2000, only 12 directors have been prosecuted under the phoenix-related provisions.⁸⁸ The ATO has lately ramped up its efforts in pursuing phoenix activity with at least six new cases in the hands of the Commonwealth Director of Public Prosecutions (DPP).⁸⁹ One recent case against a phoenix promoter held a solicitor culpable for advice and assistance given to a number of clients in relation to facilitating phoenixing.⁹⁰ Despite a refocusing of efforts, the Commissioner commented that phoenix cases struggled to gain priority amongst the high case loads of serious crimes already before the DPP.⁹¹ Given the ATO and ASIC's continued pursuit of legislative change it can be inferred that the existing legislative and administrative regimes do not provide adequate disincentive to deter directors from phoenixing.

⁸¹ Ibid, s.206D

⁸² Ibid, s.206E

⁸³ Ibid, s.206F

⁸⁴ Ibid, s.588G

⁸⁵ Corporations Act 2001, s.588Z

⁸⁶ Salna (2009)

⁸⁷ See DCT Mark Konza's comments at Biannual Hearing with Commissioner of Taxation before the Joint Committee of Public Accounts and Audit, Parliament of Australia, Canberra, 23 October 2009

⁸⁸ Darmanin (2010), p.7

⁸⁹ Ibid

⁹⁰ See ASIC v Sommerville and Ors [2009] NSWSC 934

⁹¹ Ibid

6.2 Canada

Phoenixing is a recognised concern for Canadian authorities, chiefly in relation to small company bankruptcies.⁹² Again, there is no formal definition of phoenix activity in Canadian law.

In the 1990s, strong consideration was given to addressing the phoenix problem by prohibiting the sale of the assets of a bankrupt company to its directors; a strategy known as ‘asset rollovers’. Although this proposal aroused some interest amongst stakeholder groups, the prohibition was never implemented. Public consultations on various insolvency reform issues confirmed a consensus view that asset rollovers should not be prohibited, the rationale being that they often generate the best returns for creditors and produce the most efficient reallocation of assets.⁹³

Phoenix activity in Canada is challenged through the use of civil and criminal remedies in the court system. Canada’s approach to phoenixing closely parallels that of the US. If there is a formal insolvency, the trustee may pursue assets through fraudulent conveyance actions against the directors. Trustees are also empowered at a federal level to challenge arrangements which result in certain creditors receiving preferential treatment, including payment of outstanding liabilities in exchange for a promise to continue to supply the new company. Such remedies are also available outside of a formal insolvency through the use of provincial fraudulent conveyance and preferences legislation.⁹⁴

Canadian law provides criminal sanctions for the fraudulent activities of directors, however it is difficult to determine the extent to which such sanctions are imposed in the context of phoenixing. In the normal course, if the Office of the Superintendent of Bankruptcy receives a complaint in relation to phoenix activity, a referral is made to the Royal Canadian Mounted Police for investigation. However, no reliable data is available regarding the frequency or effectiveness of such investigations.⁹⁵

The liability of directors and officers of the company is not necessarily extinguished when a company ceases trading. Canadian law specifically assigns personal liability to directors for source deductions and GST, although directors may avoid personal liability if they can establish that they exercised a reasonable degree of care.⁹⁶

Canadian company law does very little to protect creditors from repeated reckless behaviour and wrongful conduct of phoenix directors. There is currently no disqualification scheme in place and no public register of directors of failed companies exists. Although the concept of a register has been discussed, the idea is not widely supported.⁹⁷ Girgis (2009) urges incorporation of a disqualification scheme into the federal insolvency provisions, commenting that the director disqualification scheme in the UK has had more success in protecting creditors than any existing Canadian measures.⁹⁸

⁹² Appleby (2004)

⁹³ Appleby (2004), p.29

⁹⁴ Girgis (2009)

⁹⁵ Appleby (2004), p.30

⁹⁶ Bomhof (2009), p.5

⁹⁷ Ibid, p.30

⁹⁸ Girgis (2009)

6.3 Ireland

The Office of the Director of Corporate Enforcement (ODCE) is responsible for developing legislative measures to counter phoenixing activity in Ireland. The Irish tax authority, Revenue, is generally the primary creditor of phoenix companies. Revenue manages this growing tax risk by monitoring a list of some 400 companies that exhibit certain common characteristics of the phoenix syndrome. However, the monitored segment is believed to represent only a small fraction of the annual incidences of phoenixing in Ireland.⁹⁹

For two decades Ireland has been vigorously pursuing economic growth through corporate investment. A liberal corporate regime is designed to attract foreign direct investment and encourage individuals to take advantage of corporate entities to engage in business ventures.¹⁰⁰ At 12.5%, Ireland's corporate tax rate is amongst the lowest in the world. Company formation costs are low at around €500. In the ten year period up until 2005, Ireland's strategy enabled it to attract five times as much foreign direct investment as Australia.¹⁰¹ This substantial influx of capital has enabled Ireland to achieve economic growth way in excess of the rest of the EU. Unfortunately, the policies that promoted growth in corporate investment have also realised an increase in the abuse of the privilege of limited liability. One report from Revenue estimated a tax gap of €140 million due to phoenixing.¹⁰²

The ODCE believes that a rise in phoenixing is partly attributed to a recent decline in the stigma associated with insolvency.¹⁰³ Ireland employs a bond provision to help prevent offshore abuse of corporations. Under section 43(3) of the Companies (Amendment) (No.2) Act 1999, companies that have no Irish resident directors are required to lodge a bond of around €25,000. Serial phoenix offenders tend to be residents however, so this response arguably has limited effect on the phoenixing syndrome. A person is eligible to be appointed a director providing they are not an undischarged bankrupt or otherwise prohibited or restricted by the Companies Act.¹⁰⁴ Like other jurisdictions, the lack of any specific qualifications or standards to become a director has been highlighted as a possible contributing factor in the growth of phoenixing.¹⁰⁵

While theoretically there is no automatic inhibition of a person acting as a director as a result of insolvency, Ireland's insolvency law prescribes that a liquidator must report to ODCE on the conduct of the director within six months of being appointed. The liquidator is subsequently required to instigate High Court proceedings for the restriction of all company directors *unless* the ODCE grants relief from making this application.¹⁰⁶ The director must satisfy the court that they acted responsibly and honestly in their conduct of the company or face restriction under section 150 of the Companies Act.¹⁰⁷ A restricted director cannot be a director of a company unless that

⁹⁹ Appleby (2004), p.37

¹⁰⁰ Ibid, p.38

¹⁰¹ Gruen (2006), p.12

¹⁰² Appleby (2004), p.38

¹⁰³ Ibid, p.38

¹⁰⁴ Companies Act (1990), s.150

¹⁰⁵ Appleby (2004)

¹⁰⁶ Company Law Enforcement Act (Ireland) 2001, s.56

¹⁰⁷ Companies Act 1990 (Ireland), s.150

company is capitalised to approximately €63,500 for a private company and €317,500 for a public company.

Authorities around the world are frequently frustrated by the resources expended, and the difficulties involved, in building cases against phoenix operators in order to have courts impose restrictions and interrupt the cycle of phoenixing. Ireland's unique approach reverses the burden of proof and frees up compliance resources. Honest directors who wish to pursue future ventures under a corporate structure are entitled to prove their case before a judge. Serial phoenix operators are thwarted because of the capitalisation rules that ensure substantial equity that creditors can access in a future liquidation.

The Companies Act provides an automatic five-year director disqualification where a person (director or otherwise) is convicted on an indictable offence in relation to a company or involving fraud or dishonesty.¹⁰⁸

Phoenix activity in Ireland is primarily detected and reported by creditors.¹⁰⁹ However, as with other jurisdictions, phoenix companies tend to arrange to discharge their key trade creditors prior to falling under administration. Trade creditors in Ireland seem prepared to continue to deal with phoenix companies if their losses have not been substantial. Legal action against fraudulent preferential payments is available, however ODCE believes the prevailing feeling amongst creditors to be that there is little point in pursuing such action.

There is no mandatory requirement for insolvent companies to undergo liquidation in Irish company law. Until the introduction of the ODCE, there was a distinct lack of resources available to investigate corporate failures and the risk of phoenixing being detected and prosecuted was insignificant. The ODCE is entitled under the Companies Act, to conduct its own investigations and seek sanctions against phoenix activity by applying insolvency and winding up provisions relating to:

- criminal and civil liability for fraudulent trading (s297)
- civil liability for fraudulent preference (s286)
- civil liability for director malfeasance (s298)
- criminal liability for transfer of assets with intent to defraud creditors (s295)

However, obtaining proof of fraud is extremely difficult and as a result, there have been few instances of personal liability being imposed on directors of phoenix companies in Ireland. Revenue has instigated a number of initiatives to counter phoenixing in problem industries. For instance, public bar licence renewals require a tax clearance certificate, which will not issue if there is an outstanding tax obligation.¹¹⁰

Revenue's approach to the phoenix problem is proactive. Strategy is integrated across organisational departments and utilises cross functional and external intelligence.

¹⁰⁸ Ibid, s.160

¹⁰⁹ Appleby (2004), p.40

¹¹⁰ Taxes Consolidation Act (Ireland) 1997, s.1064

Phoenix activity is identified at the earliest possible stage. Rapid follow-up action is instigated to prevent the build up of tax arrears, fraudulent and reckless trading is aggressively pursued in the courts, and a rigorous monitoring program of identified high-risk directors is implemented.¹¹¹ A 'commonality check' uses data matching techniques to compare companies with current tax arrears with companies that have been liquidated to detect the presence of common directors.¹¹²

6.4 New Zealand

New Zealand's corporate regulatory system recognises the national need to encourage entrepreneurship. The incorporation processes is inexpensive and simple, which enables the swift establishment of new companies in the event of the failure of an antecedent company.¹¹³ New Zealand poses few restrictions on the incorporation of new companies. There is no minimum capital requirement and few limitations on who may become a director.¹¹⁴ There are no mandatory qualifications or training requirements for a company director.¹¹⁵ A company can be established over the Internet, across borders, for a fee of \$NZ160. The comparative ease of incorporating in New Zealand¹¹⁶ is beginning to cause concern for other jurisdictions, who are detecting an increase in use of New Zealand registered labour supply companies¹¹⁷ to facilitate phoenixing in Australia.¹¹⁸

The Official Assignee acknowledges a lack of definitive data on the extent of the phoenixing phenomenon in New Zealand.¹¹⁹ Anecdotal evidence suggests that suppliers and Inland Revenue (IR) are the parties most significantly affected.¹²⁰ While there is still some stigma associated with business failure, creditors tend to be pragmatic about dealing with new entities despite previous mismanagement or bad faith interactions.¹²¹

Detection of phoenixing in New Zealand up until the late 1990s largely depended on referrals from disaffected creditors. This approach proved ineffectual as creditors were generally apathetic, believing that reporting phoenixing would not result in any benefit to them. The prominent corporate failure of New Zealand Stevedoring Ltd in the late 1990s helped to garner the attention of law makers on the phoenixing phenomenon. In 1999, the Ministry of Economic Development announced that the issue of phoenix companies would be targeted in a review of the insolvency law. The Minister of Commerce released a Cabinet Paper in late 2003 which acknowledged that phoenix arrangements were not always counter to stakeholder interests.¹²² The paper recommended the introduction of restrictions on directors re-using the trading names

¹¹¹ Extract from the Office of the Chief Inspector of Taxes, Tax Briefing, Issue 24, revised January 2002.

¹¹² Irwin (2004)

¹¹³ Appleby (2004), p.56

¹¹⁴ See Companies Amendment Act (NZ) 2006, s. 368

¹¹⁵ Appleby (2004), p.56

¹¹⁶ compared with the Australian registration process, which requires submission of certified copies of relevant validating documentation and costs at least \$AU4,000

¹¹⁷ See discussion under heading *Labour hire method* on p.8

¹¹⁸ ATO (2010), p.3

¹¹⁹ Appleby (2004), p.57

¹²⁰ Ibid

¹²¹ Ibid

¹²² Office of the Minister of Commerce (2003), para 3

of insolvent companies, along the lines of the United Kingdom *Insolvency Act 1986*.¹²³ A contemporary report on the effectiveness of UK Company Law had concluded that incidence of phoenixing had been reduced by the changes introduced in 1986.¹²⁴ The Cabinet Paper accepted that the proposed provisions could not create a widespread restriction on the re-use of the name of insolvent companies; neither would they eliminate the abuse of phoenix companies.¹²⁵ Regardless, the decision was taken to implement the provisions in New Zealand corporate law.

New Zealand law prohibits a person from being a director of a phoenix company within a certain period of being a director of a failed company, unless that director has been granted leave of the court.¹²⁶ The prohibition is not calculated to prevent the re-use of a company or business name as such, simply the recycling of a company name by a director of the failed company. It does not attempt to restrict transactions by delinquent directors with new companies which have no relationship with the failed company. However, the sale of any asset, including goodwill, by a director at undervalue to another company, with which that director is associated, if done in bad faith will contravene the Act.¹²⁷ The offence is not circumvented by adopting a non-corporate form for the new business. The prohibition extends to involvement in any business that has an identical or similar name to a failed company.¹²⁸ This prevents the exploitation of any goodwill of the failed company that is attached to its name.

If a director has been involved in one or more failed companies, the Act empowers the Registrar of Companies to disqualify that person from acting as a director, if the Registrar is satisfied that there has been mismanagement on the part of the director.¹²⁹ Where there have been two or more failures in a five year period, the onus of proof is on the director to demonstrate that there has been no mismanagement.¹³⁰ Failed directors are not only prohibited from being an active director but also from being directly or indirectly involved in the formation, promotion or management of a subsequent phoenix company.¹³¹ This legislative approach attempts to stymie the often used tactic of shadow directorships.

The legislation provides a mechanism for directors to capitalise on any goodwill in the failed company name, if the new company qualifies as a *successor company* and is named in a successor company notice.¹³² A *successor company* is a company that acquires the whole or a substantial proportion of the business of the failed company, provided that the acquisition is arranged by a liquidator or receiver or under a deed of company arrangement.

It is an offence for any director to do anything that causes material loss with intent to defraud any creditor.¹³³ This targets intentional acts by directors to defraud creditors and so should not capture directors engaging in legitimate company reconstructions.

¹²³ Ibid, para 44

¹²⁴ Ibid, para 49

¹²⁵ Ibid, paras 48-52

¹²⁶ Laughton (2007); Companies Act (NZ) 1993 s. 386A

¹²⁷ Companies Act (NZ) 1993 s.380(2)

¹²⁸ Ibid, s.386(1)(c)

¹²⁹ Ibid, s.385

¹³⁰ Appleby (2004), p.58

¹³¹ Companies Amendment Act (NZ) 2006, s.386A(1)

¹³² Companies Amendment Act (NZ) 2006, s.386D(2)

¹³³ Companies Amendment Act (NZ) 2006, s.380

While the proposal to create a new criminal provision was widely supported in submissions to the Insolvency Law Review, concerns have been raised about the potential for prosecution successes given the required standard of proof of intent on the part of the director. The provision of a criminal penalty of up to five years imprisonment and a fine of up to \$200,000 serves as a significant deterrent.¹³⁴

In 1999 the Official Assignee and the Registrar of Companies established a joint National Enforcement Unit which carries out prosecutions under the Companies Act and prepares reports on candidates for director disqualifications.¹³⁵ To date there has been only one successful prosecution directly related to managing a phoenix company, which resulted in a 5 year disqualification and a \$500 fine.¹³⁶ Enforcement has been hampered by the high cost of running legal proceedings, low levels of action from enforcement bodies and uncertainty amongst creditors that legal action will succeed.¹³⁷

6.5 United Kingdom

The compliance approach in the UK recognises that not all business regeneration is unhealthy. Phoenixing is viewed as an abuse of the privilege of limited liability and sanctions focus only on those who abuse the corporate form, leaving innocent failed directors free to learn from their mistakes and persevere.¹³⁸ Responsibility for administering UK insolvency laws and carrying out investigations rests with regional Insolvency Services.¹³⁹ Much of the recent change in UK insolvency legislation has centred on rescuing viable companies and encouraging victims of honest failure to try again. Although acknowledged as a problem in England and Wales, the Insolvency Service of Northern Ireland has downplayed the impact of phoenixing within their jurisdiction.¹⁴⁰

The focus of UK compliance enforcement action has been on detecting director misconduct in the transferring of assets, including goodwill, of the failed company. Like many regions, the UK places a heavy reliance on insolvency practitioners to identify director malfeasance during the investigation phase of the liquidation.¹⁴¹ Liquidators have a statutory duty to report any apparent criminal offences by the directors of companies in liquidation.¹⁴²

Under UK law, the courts can disqualify unfit directors for periods of between two and fifteen years, however precedent shows that substantial evidence is required to achieve disqualifications.¹⁴³ Companies House maintains a *Register of Disqualified Persons*. Anyone who acts as a director while disqualified is held personally liable for all company's debts and is additionally liable to a penalty of up to two years

¹³⁴ Keeper (2008)

¹³⁵ Appleby (2004), p.59

¹³⁶ See Donovan case discussed at <http://www.business.govt.nz/companies/about-us/enforcement/conviction-results/1-july-2009-30-june-2010>

¹³⁷ Appleby (2004), p.57

¹³⁸ Ibid, p.31

¹³⁹ The UK has three insolvency regions – combined England and Wales, Northern Ireland and Scotland

¹⁴⁰ Appleby (2004), p.61, 65

¹⁴¹ Ibid, p.32

¹⁴² Insolvency Act (UK) 1986, s.218(4); Insolvency Act (UK) 2000, s.10

¹⁴³ Company Director Disqualification Act (UK) 1986, s.18

imprisonment.¹⁴⁴ Approximately one quarter of all director disqualifications in the UK is related to phoenix activity.¹⁴⁵

While the insolvency legislation contains claw-back provisions to recover misappropriated assets, all too frequently there are insufficient residual company funds to enable the liquidator to undertake the necessary legal action. The UK government makes no specific provision of public funds to permit investigations of phoenixing in assetless companies.¹⁴⁶ However, the Financial Services Authority, which has a wide range of rule-making, investigatory and enforcement powers to promote fair markets and business capability and effectiveness, has indicated its preparedness to intervene and invest resources to deal with complaints against phoenix activity where a company has left insufficient provisions to enable a thorough investigation.¹⁴⁷

Another key feature of the UK's compliance strategy is to prevent the undervalue transfer of goodwill to the new company. UK legislation makes it a criminal offence for any director of an insolvent company to reuse the company's name, or a similar name, within five years of the insolvency unless the director first obtains the leave of the court.¹⁴⁸ The ban extends to anyone who has been a director of the insolvent company in the twelve month period before the date of liquidation. A director in breach of this legislation becomes personally liable for the debts of the former company and risks imprisonment and/or a fine.¹⁴⁹

This legislation was specifically introduced to address the rising incidence of phoenixing in the UK. Its purpose is to prevent the undervalue transfer of goodwill to the new company. However, the "anti-phoenix" provisions of the Insolvency Act are widely drafted, leaving broad scope for judicial interpretation. Recent case law has revealed that the effect of the legislation goes beyond the phoenixing situation and creates a strict liability regime where non-compliance occurs. The courts confirmed that there is no requirement for creditors to have been disadvantaged in relation to the act of using the name. It is sufficient for the act to have occurred.¹⁵⁰ In *Ricketts v Ad Valorem Factors Ltd* [2003] a successor company was trading under a similar name to that of the failed company. The central issue under consideration was whether the successor company's name was a prohibited name for the purposes of the act. In this case there was no under-value transfer of assets between the failed company and the successor company. There was no evidence that the companies were used to incur debts and avoid liabilities, nor was there any evidence that creditors of the failed company had been misled by the similarity of the two names. Notwithstanding this, the court found that the director was in breach and, accordingly, was personally liable for all the debts of the successor company.¹⁵¹

¹⁴⁴ Quainton (2008); The Insolvency Service (2004), p.3

¹⁴⁵ Appleby (2004), p.61

¹⁴⁶ Ibid, p.65

¹⁴⁷ Lord (2005)

¹⁴⁸ Insolvency Act (UK) 1986, ss.216-217 'Restriction on Re-use of Company Names'; also Insolvency Order (Northern Ireland) 1989 – Article 18

¹⁴⁹ Appleby (2004), p.32

¹⁵⁰ Kean, F. & McLauchlan, R. (2009)

¹⁵¹ *Ricketts v Ad Valorem Factors Ltd* [2003] EWCA Civ 1706; [2004] 1 All E.R. 894

At an administrative level, HMRC readily acknowledges that phoenix companies pose a higher than normal risk to revenue. To mitigate this risk procedures are employed to flag 'successor' (phoenix) companies, in circumstances where the liquidated company has avoided a revenue debt of £10,000 or more and the successor company is engaged in the same industry.¹⁵² The flag promotes the full use of available intelligence to highlight issues at a very early stage and manage compliance of the phoenix company. The flag ensures a PAYE scheme is initiated for the new company. It also ensures an escalated tax debt recovery process is implemented. The PAYE regulations provide for HMRC on the basis of previous payment history to insist on payment of an unremitted PAYE withholding within seven days.¹⁵³ These measures proactively monitor the activity of high-risk 'successor' companies and prevent a subsequent excessive buildup of unremitted tax before HMRC initiates insolvency proceedings.

The Higgs Review in 2003 examined the role and effectiveness of non-executive directors in the UK. One of its key recommendations was the development of a code of conduct for non-executive directors to outline their responsibilities and increase their effectiveness.¹⁵⁴ The establishment of a code of conduct for directors of closely held companies might go some way towards combating phoenixing by articulating the behaviours expected of directors of insolvent companies.

6.6 United States

The Global Financial Crisis had a marked impact on the level of insolvency in the US. Business Reorganisations under Chapter 11 of the insolvency code more than doubled during the first half of 2009.¹⁵⁵ Chapter 7 Business Liquidations increased by more than 50% in the same period with some 20,375 filings.¹⁵⁶

The US does not define phoenixing in its statutes.¹⁵⁷ However, the United States Trustee Manual provides a description of 'parallel entities' that closely aligns with phoenixing.¹⁵⁸ The activities that facilitate phoenixing are prosecuted under a variety of civil and criminal legal actions. The law imposes a fiduciary duty on the officers of an insolvent company to act in the interests of the company's creditors. Under the federal bankruptcy system, the officers of a company are obliged to disclose under oath any transactions that may expose phoenix activity.¹⁵⁹ The trustees of the liquidation are empowered to conduct enquiries and examinations to detect and rectify phoenix transactions.¹⁶⁰

The US criminal code contains wide-ranging provisions to deal with the criminal conduct of directors under a bankruptcy process.¹⁶¹ Notwithstanding this, referrals to

¹⁵² HMRC, Insolvency Manual, INS1121 – Insolvency and Insolvency Practitioners

¹⁵³ Income Tax (Pay as You Earn) Regulations (UK) 2003, s.78

¹⁵⁴ Financial Reporting Council, Good practice suggestions from the Higgs Report, June 2006

¹⁵⁵ Chapter 11 filings for first two quarters of 2009 numbered 7,396 compared to just 3,470 during the same period of 2008

¹⁵⁶ See American Bankruptcy Institute website at:

<http://www.abiworld.org/AM/Template.cfm?Section=Home&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=58407>

¹⁵⁷ Appleby (2004), p.68

¹⁵⁸ US Trustee Manual, s5-10.3.1.3 *Parallel Entities*

¹⁵⁹ See <http://www.uscourts.gov/bankform/form7.pdf>

¹⁶⁰ Federal Rule of Bankruptcy Procedure 2004

¹⁶¹ US Code - Title 18, Part 1, Chapter 9, *Bankruptcy*, ss.150-158

the US Attorney by the US Trustee program are rare and prosecutions rarer still.¹⁶² The Administrative Department of the US Court suggests that this may be due to the availability of other criminal and civil legal avenues to redress phoenixing activity in the US legal system, but it also acknowledges that resource constraints on regulators hamper compliance action against phoenix operators. For this reason, most remedies are instituted by the liquidator and are therefore ultimately financed by the creditors. No public funding exists in the US to carry out investigations on assetless liquidations, which permits an unknown number of phoenix operators to slip through the compliance net.¹⁶³

The collapse of major corporates such as Enron and WorldCom during the first decade of 2000 created uproar in the US and resulted in sweeping reforms to corporate governance in the form of the Sarbanes-Oxley Act. Although the Act was not specifically targeted at phoenixing, it is inevitable that a tightening of corporate practices is likely to have a positive impact on the phenomenon.¹⁶⁴

The US Bankruptcy Code permits the reorganisation of businesses in financial trouble, as an option to resorting to liquidation. Under a Chapter 11 reorganisation, the existing management remains in control of the business as a debtor in possession, although they are subject to the oversight of the court. The court is able to grant partial or full relief from many of the company's liabilities. If the business has negative equity, the owners' rights and interests in the business are ended and the creditors assume ownership of the reorganised company. Chapter 11 intrinsically recognises that often the value of a business is greater if sold in tact as a going concern rather than broken down into its composite assets. The reorganised company can be retained, in which case creditors swap their debt for equity in the reorganisation. Alternatively, the revamped company can be sold as a going concern with the net proceeds of the sale distributed pro rata to the creditors.¹⁶⁵

Critics assert that Chapter 11 fails on economic efficiency grounds. The leniency it affords promotes incompetent management. Companies operating under Chapter 11 trade under the protection of the court, which distorts the market and disadvantages competitive businesses. Yet another criticism focuses on the potential increase in the cost of capital resultant from the forestalling of creditors' rights.¹⁶⁶ Notwithstanding these criticisms, providing an avenue for creditors to take control and reorganise a failing business for their own advantage has enormous potential to preserve value for creditors and prevent phoenix operators from syphoning off key assets to their own advantage, particularly the goodwill of the business, which often evaporates in the insolvency process.

7. EVALUATING THE SOLUTIONS

No single solution is likely to bring about an end of the phoenixing syndrome. The problem is extremely complex and requires careful consideration of competing agenda. It is of profound importance that the solution should not undermine genuine entrepreneurial spirit and commitment to the principles of incorporation. A holistic

¹⁶² Appleby (2004), p.69

¹⁶³ Ibid, p.69

¹⁶⁴ Sarbanes-Oxley Act (2002)

¹⁶⁵ Swanson et al (2008), Ch.3

¹⁶⁶ Haidar (2009)

approach is required which clearly enunciates the issues, coordinates compliance efforts, reduces opportunity, eradicates phoenixing benefits, enhances lead-time detection and mitigates any residual negative effects of phoenixing.

7.1 Legal definition, legislative change and agency responsibilities

It is clear from the international experience that the development of anti-phoenixing measures is heavily influenced and constrained by concerns about stifling entrepreneurship. The term “phoenixing” is seldom mentioned across the spectrum of international taxation and corporations’ legislation. Definitions are rarer still.¹⁶⁷ The legislation dealing with the phoenixing phenomenon tends to be disjoint, split between tax authorities and corporation watchdogs, which makes detection and enforcement problematic.

Defining phoenixing at law is an essential precursor to combating the syndrome. A legal definition might reasonably include indicia of both acceptable and unacceptable business reconstructions to reaffirm the validity of genuine reorganisations. However, legislative design needs to follow a coherent principles approach rather than a black letter drafting style. Clear articulation of the legislative intent in the drafting of the law will reduce complexity and prevent the development and exploitation of technical loopholes by enabling judicial decisions to adapt to changing circumstances.¹⁶⁸ Equally, legislation must provide certainty for those directors of failed companies who wish to engage in legitimate business reconstructions. In particular, the legislation should recognise illicit phoenixing as a criminal offence of fraud on the creditors of a company and provide a penalty regime on par with fraud offences of comparable magnitude.

It is important that individual government agency responsibilities in relation to the monitoring and prosecution of phoenixing be clearly articulated in the legislation and the interfaces between agencies outlined in memoranda of understanding. Where appropriate, jurisdictions should look at implementing an inter-agency/cross-functional phoenix task force to synergise agency technical capabilities, intelligence resources and enforcement powers. This is likely to result in more efficient and effective application of resources.

7.2 Protecting legitimate reconstructions

The literature demonstrates a universal recognition that the legitimate reconstruction of ailing businesses often maximizes stakeholder outcomes. The difficulty lies in determining when a reconstruction is in the public interest and when it is a mere sham to facilitate fraud.¹⁶⁹ Legitimate reconstructions should be supported. Bogus reconstructions should be quashed. The government should consider the benefits that would result from a formal legal process for reviewing and sanctioning bona fide company reconstructions. Such a mechanism could be expected to include legislation, policy and guidelines and a formal independent review panel to examine and approve corporate reconstructions. The mechanism would assure the probity of insolvency transactions and provide certainty to directors wishing to engage in honest business rehabilitation. Ideally, the process should be administered by appropriately skilled

¹⁶⁷ Appleby (2004)

¹⁶⁸ Pinder (2005), p. 77

¹⁶⁹ See Jones (2010) for a full discussion on the reconciliation of commercial and public interests

management specialists, rather than judges, who may not have the business expertise necessary to distinguish between a legitimate and fraudulent reconstruction.

7.3 Detection and response

The compliance approach adopted to combat phoenixing must be comprehensive - strategic and tactical, proactive and reactive. From a top-down perspective the strategy must target known high-risk industries, regions and individuals. Processes must support early detection and rapid reaction. Where possible, compliance responses, such as the early issue of director penalty notices, should be automated to tighten the compliance net and reduce the burden on limited resources. At the same time, from the bottom-up, lead-time data needs to be collected and synthesised into intelligence, which in turn will inform the strategy as to emerging risks.

Importantly, compliance strategies should adhere to regional compliance models and support the political objectives of encouraging legitimate entrepreneurial risk taking under the protection of corporate limited liability. Processes and systems must support and encourage those directors generally willing to comply and strong enforcement action taken against the worst serial phoenix offenders.¹⁷⁰

Phoenix compliance teams need to make the best use of the full ambit of available intelligence. To the end government agencies need to foster partnerships with other government and non-government organisations, such as credit reference associations and industry associations. This approach offers the opportunity of real-time intelligence and the development of prospective indicia of emergent phoenixing risks. Information from these sources will prove invaluable for data matching and profiling of phoenix operators. Several jurisdictions have shown benefits from monitoring acknowledged indicators of phoenix preparation.¹⁷¹ The strategic sharing of data related to non-lodgment and unpaid tax liabilities between tax and corporate enforcement authorities would help trigger compliance activity across both spheres. The adoption of a tax clearance certificate, such as that employed in Ireland, could be made a condition of continued annual company registration. However, this policy may be less effective than a simple program of expeditious debt enforcement action from within the tax authority. Currently, a raft of Australian legislative restrictions thwarts interagency communication, hindering the detection and prosecution of phoenixing offences. There is a need to revisit secrecy and exchange of information laws with a view to removing this blocker to effective enforcement against phoenixing.¹⁷²

Tax and corporate authorities need to cooperate to ensure that robust automated data matching occurs against the restricted/disqualification register to ensure that disqualified directors cannot register a company. Suspected phoenix operators must be identified at an early stage and flagged on tax administration systems.¹⁷³ The flag should trigger a high-risk response to non-lodgment and/or unpaid tax liabilities by way of high-level monitoring, early intervention and escalated debt recovery. The production of directors' penalty notices, holding the director personally liable if tax

¹⁷⁰ See ATO Compliance Model at <http://www.ato.gov.au/corporate/content.asp?doc=/content/5704.htm>

¹⁷¹ the UK's flags identified successor companies

¹⁷² Cole (2003), p.165

¹⁷³ HMRC, Insolvency Manual, INS1121 – Insolvency and Insolvency Practitioners

debt is not cleared within a prescribed period, should be automated and issued at an early stage where phoenixing is suspected and/or flagged.

7.4 Directors' liability for non-remission of collected tax

At a legislative level, there is a credible argument that directors' should be held personally liable for non-remission of taxes as per the Canadian approach.¹⁷⁴ The basis of this view is that GST collections and tax withholdings are not liabilities in the same manner as trade creditors are. These moneys are collected in good faith from customers and employees who have the expectation that they will be remitted to the government as tax. The non-remission of these funds, either because they have been allocated for business or for personal use, is effectively a misappropriation of funds for which the director arguably should be held personally accountable.

The international experience reveals that tax administrations are overwhelmingly the foremost victim of phoenixing. Holding directors personally accountable for the taxes that they collect would eliminate a substantial benefit of phoenixing and thus should significantly reduce the extent of the phenomenon. It must be acknowledged however, that this measure would also no doubt act as a significant disincentive to entrepreneurs who currently enjoy the option of utilising tax withholdings to overcome periodic cash flow problems or as initial capital funding of the business. Further analysis is required before the efficacy of such a policy can be accurately assessed.

7.5 Double-dipping of withholding taxes

Legislation should include a provision to ensure that PAYG withholding credits are denied to directors to the extent that they are not remitted. This prevents 'double dipping' of phoenixing directors who misuse the PAYG withholding system to dishonestly allot themselves large income tax credits. Similarly, GST credits should be denied between companies in business groups where a former company has phoenixed to prevent abuse of the GST system. Grouping provisions should look through the corporate veil into the successor company for misappropriated assets where phoenixing is proven.

7.6 Investigation of assetless companies

Publicly funded investigations have proved effective in overcoming the issue of phoenix directors stripping company funds to prevent detection of their malfeasance. Conceptually, a liquidator is expected not to engage in a course of action if it is unlikely to produce a worthwhile benefit for the creditors.¹⁷⁵ Moreover, liquidators, being commercial operators, are reluctant to conduct any activity, such as an investigation or legal action, for which they are unlikely to be paid. The Assetless Administration Fund, implemented in Australia, has permitted director misconduct to be identified where it might otherwise have remained undetected. The overarching strategy to combat phoenixing must provide funding to permit investigations into suspected director misconduct especially when asset stripping has occurred. In many jurisdictions this means public funding of liquidator investigations.

¹⁷⁴ Bomhof (2009), p.5

¹⁷⁵ Economic References Committee (2010), p.100

Alternatively, the responsibility for investigating director misconduct could be allocated to a specialist government agency with appropriate investigative and forensic accounting capabilities and the power to prosecute misconduct. Interestingly, the UK has established the Companies Investigation Branch (CIB), which has wide investigatory powers and the statutory authority to request the court to wind-up rogue companies in the public interest without having to establish insolvency or breach of the law.¹⁷⁶ Having a dedicated corporate investigative department to look into director misconduct enables the robust and vigorous pursuit of phoenixing operators and also mitigates the risk of collusion between liquidator and director that exists under the current investigation scheme.

The self-sufficiency and longevity of any investigations program, whether performed by liquidators through the Assetless Administration Fund or by a new government agency, could be underwritten by imposition of a levy on corporate registration fees and by channelling the proceeds of directors' fines back into investigations.

7.7 Strengthening the penalty regime

Overall, it is readily apparent that the current penalty regime needs strengthening. The penalties administered by the courts in recent phoenixing cases seem incongruous with the nature of the offence, which is in reality a fraud. The absence of a strong deterrent effect is undoubtedly contributing to the growth of the phenomenon.¹⁷⁷ Low conviction rates and light penalties reinforce the belief amongst directors that phoenixing is a low-risk activity with big rewards.¹⁷⁸ The clear articulation in the legislation that phoenixing is a fraud, with penalty provisions that correspond with the seriousness of the offence, is therefore essential to provide a disincentive for directors considering participating in phoenixing.

7.8 Improving the qualifications of directors

Low qualification requirements for directors are a common feature of the phoenix problem across jurisdictions. Some countries have gone some way towards tackling this problem. The UK has issued a set of guidelines that outline the full ambit of director responsibilities, especially in relation to duties to act in good faith and with due diligence. The establishment of guidelines which outline what is permissible and what is fraudulent in corporate reconstructions would be a further step in the right direction.

An International Association of Insolvency Regulators survey shows that few countries mandate any formal training for directors¹⁷⁹. Phoenixing is usually characterised by a deficiency in the formal processes, records and systems that are typically found in a successful company administered by competent management. Most professional bodies, including medicine, law and accountancy, readily accept the necessity of ongoing professional development to maintain competencies and protect the integrity and legitimacy of the profession. The implementation of compulsory short courses would help to outline the responsibilities and duties of directors and explain the consequences for breaches of the Corporations Law. The development

¹⁷⁶ See CIB website at: <http://www.insolvency.gov.uk/cib/>

¹⁷⁷ Salna, K. 'ATO anger over rising phoenix', *The Age*, 24 October 2009

¹⁷⁸ Ibid

¹⁷⁹ Appleby (2004)

and implementation of a mandatory qualification for people wanting to use the corporate form to run their businesses could also help to lift the skill levels and competence of directorship, promote an ethical approach to management and institute more robust corporate governance.

7.9 Arms-length asset transfers

A recurring theme in this paper is that the crux of the phoenixing problem is the undervalue transfer of assets from the failed company to the successor company. Because of the economic imperatives of insolvency, which include achieving the fastest possible reallocation of economic resources, given the highly specialised nature of assets under liquidation and the fact that the break-up of the assets during sale usually diminishes their overall value, liquidators will often have little alternative but to dispose of the business assets to the successor company.¹⁸⁰ An absolute prohibition on transfer of tangible assets to the original directors is almost universally seen as undesirable policy because it restricts the opportunity of achieving the highest price. However, stalking horse bids have been successfully employed in some jurisdictions to help ensure an arms length transfer price is achieved for creditors.¹⁸¹

The restriction of the re-use of business names of insolvent companies is a common feature in the insolvency regimes of some jurisdictions. Although various critics point to the fact that such legislation does not effectively prevent phoenixing,¹⁸² it has been a valuable legal device to prevent the undervalue transfer of goodwill to directors of phoenix companies. The implementation of similar legislation to that adopted in the UK and New Zealand must be considered as a measure to ensure that creditors receive the full residual value of the insolvent company.¹⁸³ Restricting the re-use of business names has the added benefit of making the liquidation of phoenix companies more transparent to customers, creditors and employees and alerts stakeholders to heightened risk. A change in business name hints at discontinuity and draws the attention of stakeholders. The retention of the phoenix operator's customer bases and supply chains becomes more problematic. As a result, phoenixing becomes much less attractive as a first option for debt avoidance.

Pre-packing is becoming a common feature in insolvency, particularly in the UK.¹⁸⁴ Pre-packing is a business reconstruction process not dissimilar to phoenixing but with the repugnant features removed. The viable core of a failing business is saved, priced at market value, and transferred to a successor company. The proceeds of the sale of the business, which represent fair value of all valuable assets including goodwill, are transferred to the creditors. The new business is legislatively bound to take on the employee entitlement liabilities for the failed company, thus preserving employment. The pre-pack does not circumvent director investigations and disqualification

¹⁸⁰ Ibid, p.63

¹⁸¹ Groklaw website, 'SCO Has a Bid; Would Like More' at: <http://www.groklaw.net/article.php?story=20071023172159177>

¹⁸² Office of the Minister of Commerce (2003), paras 48-52

¹⁸³ Insolvency Act (UK), s.216;

¹⁸⁴ Cooper Mathews Website, *Phoenixing or Pre-packing*, at <http://coopermathews.com/phoenixing.html>

reporting to authorities. Pre-packing preserves the value of the goodwill of the failed company that would otherwise be eroded in a formal liquidation process.¹⁸⁵

Whatever disposition strategy is adopted it must ensure the integrity of transactions involving both tangible and intangible assets. The liquidation process must balance the desire for fast redeployment of economic assets (and the swift remedy of liabilities) with obtaining the highest possible value return for creditors.

7.10 Automated restriction and disqualification regime

It is generally acknowledged that an effective restriction and disqualification regime plays an important role in reducing the incidence of phoenixing.¹⁸⁶ Under current Australian law, ASIC and the courts have specific powers to prevent inappropriate people from acting as directors. However, the process is slow and costly with the onus of proof resting on the enforcement agency. Few directors are disqualified and, when they are, the periods of disqualification are inconsequential. Recalcitrant directors can readily operate with low risk of detection through shadow directorships, with family and associates ostensibly at the helm of their businesses.

The implementation of a two-tiered regime providing for restrictions as well as disqualifications of directors helps to balance the competing policies of tackling phoenixing whilst encouraging enterprise using the corporate form. The restricted category permits a high-risk person to act as a director of a successor company under certain strict conditions that help mitigate the risk of future phoenix activity, such as the lodgment of a substantial bond.

The Irish system automates the restriction/disqualification process and shifts the onus of proof from the enforcement agency onto the failed directors, who are required to show cause why they should not be restricted or disqualified and proving that they acted with due diligence and in good faith. This approach frees up significant enforcement agency resources and provides a guaranteed review of the actions of directors who wish to continue their entrepreneurial endeavours using the corporate form. Automating the disqualification process is a sound strategic approach and furthermore reduces the risk of passive or even complicit liquidators failing to report on rogue directors.

7.11 Minimum capitalisation

The establishment of a minimum capitalisation requirement for restricted directors reduces the likelihood of that director phoenixing a successor company. The Irish system requires a closely-held private company with a restricted director to have minimum liquid assets of around \$100,000 AUD. This provides a healthy buffer for creditors to call on should a company begin to commit acts of insolvency, such as failing to pay liabilities as and when they fall due. Australia's present bond provisions are inadequate and not sufficiently targeted to address phoenixing; however they could be expanded to expedite payment of phoenix related tax liabilities.¹⁸⁷

¹⁸⁵ See Carter Clark website, Pre-pack Administration, at <http://www.carterclark.co.uk/index.php?section=39&page=2237>

¹⁸⁶ Appleby (2004), p.62; Girgis (2009)

¹⁸⁷ See Bond Provision, Income Tax Assessment Act 1936 s.213

7.12 Reliance on creditors to initiate action

Most enforcement systems around the world place an unrealistic expectation on creditors to identify and report incidences of phoenix. While creditors are certainly in an ideal position to recognise a phoenixing situation, there are serious doubts as to whether this strategy is effective in detecting phoenixing. Directors often diffuse this risk by conferring preferential payments to placate angry creditors. Many creditors simply accept phoenixing as a business risk, building the cost into their pricing. Generally, creditors perceive little benefit in reporting a phoenix activity.¹⁸⁸ Pursuing an insolvent company independently and driving it into administration incurs significant legal costs for the creditor whilst leaving them on an even footing with all other creditors. Creditors who fund actions against phoenix companies should be granted priority at law. Inevitably the policy of relying on creditors to report phoenixing is flawed and detection by enforcement agencies must become more proactive and intelligence based.

7.13 Probity of the Insolvency Profession

The efficacy of the insolvency regime is fundamentally reliant on the skills and ethical standards of the insolvency profession. The Insolvency Practitioners' Association of Australia (IPAA) sets out core values and ethical standards in an effort to maintain the legitimacy of the profession and preserve its autonomy.¹⁸⁹ However, the IPA has no formal powers to investigate complaints against practitioners and membership is voluntary.¹⁹⁰ The recent Australian Senate Inquiry into Liquidators and Administrators concluded that self regulation of the profession is failing.¹⁹¹

There is a widespread belief that the insolvency profession in Australia is riddled with problems.¹⁹² Surprisingly, Australia has virtually no publicly available data on insolvency. In contrast, other regimes around the world collect a variety of data to measure the effectiveness of their insolvency processes. For instance several countries monitor liquidator fees as a ratio of value returned to creditors, as a metric of the efficacy of the insolvency profession.¹⁹³ Australia's abject failure to collect similar data needs to be addressed to enable comparisons of our insolvency industry against international benchmarks.¹⁹⁴

The supervision of Australia's insolvency profession has been roundly criticised in a recent Senate Inquiry into the profession. Disciplinary proceedings in relation to liquidator misconduct in Australia are rare especially in relation to the number of complaints made.¹⁹⁵ Between July 2006 and December 2009, ASIC received 1647 complaints against insolvency practitioners. With less than 600 insolvency practitioners registered in Australia, this represents an average of nearly three

¹⁸⁸ Appleby (2004)

¹⁸⁹ See Code of Professional Practice at:

<http://www.ipaa.com.au/user/docs/codes/Code%20of%20Professional%20Practice%20%20-%20FINAL.pdf>

¹⁹⁰ Approximately 15% of insolvency professionals are not affiliated with IPAA

¹⁹¹ See Senate Enquiry into Liquidators and Administrators, chapters 5 & 6

¹⁹² See submissions to the Senate Enquiry into Liquidators and Administrators at:

http://www.aph.gov.au/Senate/committee/economics_ctte/liquidators_09/submissions.htm

¹⁹³ Economic References Committee (2010), pp.121-122

¹⁹⁴ Ibid

¹⁹⁵ Ibid, p.50

complaints for every practitioner.¹⁹⁶ The Cole Royal Commission raised concerns regarding the complicity of liquidators in advancing and promoting phoenixing schemes.¹⁹⁷ In recent years, the Companies Auditors and Liquidator's Disciplinary Board (CALDB) has reported a limited number of instances where liquidators were proved to have ignored conflict of interest rules.¹⁹⁸ Of thirteen disciplinary cases proven against liquidators since the inception of CALDB, only two have resulted in suspensions of more than two years.¹⁹⁹

Insolvency firms have been accused of 'touting' for business²⁰⁰ and promoting phoenixing as a legitimate business practice; a common-place tactic to disencumber debt, rather than a process of the last resort.²⁰¹ Insolvency is a lucrative profession. The larger Australian insolvency firms each take more than \$4 million per year in fees, providing partner earnings which are significantly greater than those of comparable leading corporate law firms.²⁰² The remuneration system for insolvencies has been subject to abuse from unscrupulous practitioners unduly prolonging liquidation proceedings to the detriment of creditors.²⁰³ In theory, questionable insolvency fees may be subject to the review of a court or a professional body. In practice however, there is a considerable financial burden on any creditor initiating such a review, especially in situations where other creditors are unwilling to share the cost of the review. The implementation of a prescribed insolvency fee schedule and a robust practice note will help prevent abuses of the fee system. The remuneration scheme should prescribe an automatic independent review of liquidators' fees outside of practice note parameters with the costs of such a review to be borne by the liquidator if they are found to be excessive.²⁰⁴

The integrity of the insolvency profession has been called into question with instances of liquidator complicity in phoenix activity across the international scene.²⁰⁵ In Ireland, evidence has been tendered of liquidators deliberately depressing the value of company assets prior to their sale to phoenix companies.²⁰⁶ Incidences of liquidator misconduct, including fraudulent billing and collusion in permitting false creditor claims to be lodged against companies under liquidation, have emerged in the Australian context in recent years.²⁰⁷ A UK television documentary highlighted questionable practices and regulatory inaction in the insolvency industry in that jurisdiction.²⁰⁸ The programme used covert filming to reveal that insolvency practitioners were readily offering questionable services and collaborating with

¹⁹⁶ Ferguson (2010)

¹⁹⁷ Cole (2003), p.117

¹⁹⁸ See ASIC v Walker (06/VIC07) and ASIC v McVeigh (10/VIC08) on the CALDB website at: <http://www.caldb.gov.au/CALDB/CALDBWeb.nsf/byheadline/Decisions?opendocument>

¹⁹⁹ Economic References Committee (2010), p.50

²⁰⁰ Parliamentary Joint Committee On Corporations And Financial Services, Improving Australia's Corporate Insolvency Laws, Issues Paper, May 2003, p.9

²⁰¹ UK TV Channel 4 'Dispatches' programme, broadcast 19th June 1996

²⁰² Economic References Committee (2010), p.100

²⁰³ Gromec-Broc & Perry (2004), p.74; Economics References Committee (2010), pp.52, 100

²⁰⁴ See Legal Fees Review Panel website at:

http://www.lawlink.nsw.gov.au/lawlink/olsc/ll_olsc.nsf/pages/OLSC_lfrp

²⁰⁵ Appleby (2004), p.41

²⁰⁶ Ibid

²⁰⁷ ASIC, *Liquidator (Stuart Ariff) Banned for Life*, Media Release 09-150AD, 18 August 2009

²⁰⁸ UK TV Channel 4 'Dispatches' programme, broadcast 19th June 1996

directors to cover up fraud and facilitate phoenixing activity.²⁰⁹ The UK Insolvency Service recently highlighted a lack of disclosure and transparency by the insolvency profession in the administration of pre-packs, with more than one-third of liquidators failing to meet basic guidelines protecting creditor interests.²¹⁰ A New Zealand Insolvency Law Reform discussion paper highlighted concerns about the supervision of the insolvency profession, and concluded up to 40% of New Zealand's insolvency practitioners might not meet adequate standards.²¹¹

The Corporations Law seeks to assure the independence of insolvency practitioners by a system which includes mandatory registration, qualification and skilling requirements, detailed legal responsibilities and established criteria for independence.²¹² Insolvency professionals are prohibited from issuing inducements to members or creditors to obtain appointments.²¹³ However, because the vast majority of directors entering into voluntary administration elect to exercise their entitlement to appoint administrators of their own choosing, the independence of these relationships is called into question.

The ATO expressed concern that public confidence in the voluntary administration process may be undermined by a perceived absence of impartiality and advocated the implementation of a roster system for the appointment of administrators on a random basis.²¹⁴ The employment of a roster greatly mitigates the risk of conflicts of interest and the appointment of 'tame' liquidators by phoenixing directors and negates any direct benefit to any individual insolvency firm from promoting phoenixing. Such an approach however, requires overcoming a number of significant difficulties, including matching work allocations to insolvency firm capacities and competencies.

The failure of the insolvency regulatory system is reflected in the fact that the profession, the bulwark against phoenixing in most insolvency regimes, has comprehensively failed to arrest the phoenixing phenomenon. Moreover, there is strong evidence that liquidator misconduct is actually contributing to the problem.²¹⁵ There is strong stakeholder consensus that greater scrutiny of the insolvency profession is necessary.²¹⁶ Regulatory approaches driven by creditor complaints such as the one currently employed in Australia are ineffectual and lead to a weakening of community confidence, not just in the insolvency profession but the insolvency process also.²¹⁷ Creditors are generally not well-positioned to identify when misconduct is occurring due to a limited understanding of legislation, professional guidelines and the inner workings of individual insolvency processes.²¹⁸ When complaints are forthcoming, they are frequently poorly managed by regulatory bodies.²¹⁹ A proactive regulatory approach involving profiling the industry, such as

²⁰⁹ Cousins et al (2009), p.58

²¹⁰ McCulloch (2009)

²¹¹ Business New Zealand (2004), p.3; Vance (2010)

²¹² Corporations Act 2001, ss.448C, 532

²¹³ Corporations Act 2001, s.595

²¹⁴ Parliamentary Joint Committee On Corporations And Financial Services, *Improving Australia's Corporate Insolvency Laws*, Issues Paper, May 2003, Submission 14, p 3.

²¹⁵ Appleby (2004); Cousins et al (2009), p.58; UK TV Channel 4 'Dispatches' programme, broadcast 19th June 1996

²¹⁶ Economic References Committee (2010), pp.130-133, 147-149

²¹⁷ See Senate Enquiry into Liquidators and Administrators, chapters 5 & 6

²¹⁸ Ibid, p.66-68

²¹⁹ Ibid, p.70

that adopted in the UK, greatly improves the likelihood of identifying incompetence, misbehavior and complicity amongst liquidators in respect of phoenixing.²²⁰ Regardless of the approach adopted, comprehensive monitoring of the insolvency industry is required to ensure liquidators are fulfilling their responsibilities in preventing the under-value transfer of assets which characterises and underpins all phoenixing activity.

The establishment of specialised insolvency regulatory authorities, distinct from the corporate regulatory authorities, which are frequently overstretched,²²¹ will enhance supervision of the insolvency profession and reduce the risks of under-value transfer of assets, excessive liquidator fees and liquidator collusion in phoenixing. The insolvency regulatory authority should have statutory powers to manage industry licensing, set ethical standards, policy and guidelines and monitor compliance across the profession. It would investigate complaints of misconduct, fix remuneration scales and review liquidators' fees. It could also review and sanction reconstructions to assure their integrity and provide certainty for successor businesses.

In Australia, the Institute of Chartered Accountants has recommended ASIC implement an inspection program similar to that which it operates over the auditing profession to assure the independence and probity of the insolvency profession.²²² Insolvency and Trustee Service Australia (ITSA) has proffered its own annual inspection program, used to monitor bankruptcy trustees, as a benchmark to be adopted by ASIC to monitor liquidators.²²³

The creation of an independent ombudsman with wide powers to investigate complaints is necessary to provide a high-level mechanism for the prompt, independent review of any contentious actions by insolvency practitioners during a liquidation process. An Insolvency Ombudsman's scope should, of course, extend to any activities by liquidators that facilitate phoenixing.

In many of the regions studied, tax authorities have the ability at law to install their own liquidators if they are the majority creditor. This is significant in that it opens up the possibility of establishing competitive partnering arrangements with panels of insolvency firms who would be more likely to act in the genuine interest of the creditors under a predetermined, cost-effective fee agreement. Tax administrations might also consider taking steps to develop an internal competency in liquidating suspected phoenix companies, to control the probity of the administration process, prevent the erosion of tax revenue from exorbitant insolvency fees, investigate breaches of directors' duties and enforce phoenix related legislation, policies and penalties. Where the insolvency process permits creditors to form 'committees of inspection', as it does in the Australian context, tax administrations should consider exercising this prerogative to take a leading hand in monitoring and advising the liquidator in the administration of insolvencies.²²⁴ The cost of engaging more closely in the insolvency process will be offset by increases in tax revenue which would otherwise be absorbed by insolvency fees.

²²⁰ Ibid, p.67

²²¹ Ibid, p.147

²²² ICAA (2010), p.4

²²³ Ferguson (2010)

²²⁴ Corporations Act 2001, s.548

8. CONCLUSION

Phoenixing remains a significant global problem for taxation authorities and corporate watchdogs. With a few exceptions here and there, jurisdictions have attempted to tackle the phenomenon in isolation, shaping strategies that fit their unique legal frameworks and regional factors. Although there have been some recent attempts to network and share experiences,²²⁵ jurisdictions have not yet grasped the opportunity to synthesise and benchmark approaches across the wider international spectrum in order to develop an international best practice approach to combating phoenixing.

Ultimately, political and institutional dimensions are going to influence the choices taken by policy makers. The recent global financial crisis has heightened community fears that honest businessmen, suffering at the hands of worsening economic conditions, will be unfairly caught up in a tightening compliance net. Consequently, pragmatic governments may well be resigned to tolerating the present level of socio-economic costs associated with phoenixing in order to foster enterprise, encourage growth and prevent alienating the wider business community.

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²²⁵ Appleby (2004)

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Using Refundable Tax Credits to Help Low-income Taxpayers: What Do We Know, and What Can We Learn From Other Countries?

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Abstract

One of the central functions of modern governments is to redistribute income from those who are rewarded by free markets to those who are not. Historically, most of that redistribution was achieved through traditional welfare programs. In recent decades, many developed nations have shifted towards using refundable tax credits in their income tax systems to make welfare transfers to low-income families and individuals. In particular, this article focuses on how the United States, Canada, the United Kingdom, and Australia now use their tax systems to provide benefits to low-income families and individuals.

At the outset, Part 1 of this article provides an overview of income, inequality, and redistribution in various countries. Part 2 then provides a detailed examination of how the U.S. income tax system uses refundable tax credits to help low-income workers and their families. Next, Part 3 shows how redistribution is achieved in the income tax systems of Canada, the United Kingdom, Australia, and some other developed nations. Finally, Part 4 discusses some of the problems with using tax credits for redistribution and the best approaches for dealing with those problems.

1. INCOME, INEQUALITY, AND REDISTRIBUTION IN VARIOUS COUNTRIES

In contemporary welfare states, economic rewards are determined by a combination of market forces and government policies. Markets arise automatically from the economic interactions among people and institutions. Here and there, government policies intervene to influence the operations of those markets and to shape the outcomes that result from market transactions.

Needless to say, policymakers cannot do much about market forces *per se*. But they do influence market outcomes through a combination of regulation, spending, and taxation. Government regulation defines and limits the range of markets, and so influences the shape of the initial distribution of economic resources. Government taxes and spending also have a significant impact on the distribution of economic resources. Most clearly, government taxes and transfers are the primary tools for the redistribution of economic resources and the mitigation of economic inequality.

1.1 An overview of income inequality and redistribution

This section looks at income, inequality, and redistribution in various developed nations. At the outset, Table 1 shows various measures of income inequality and

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redistribution in the Organisation for Economic Co-Operation and Development (OECD) countries.¹ For example, consider the United States. One common way to measure inequality is to compare the income of households at various positions in the income distribution. At the outset, column 2 shows that the ratio of the income of a household in the 90th percentile of household income in the United States is 5.8 times as much as the income of a household in the 10th percentile.

Another popular measure of income inequality is the Gini index. Basically, the Gini index is a mathematical measure of income inequality that can range from 0, indicating perfect equality (where everyone has the same income), to 1.0, indicating perfect inequality (where one person has all the income and the rest have none). According to column 3 of Table 1, the Gini index for the distribution of household income in the United States before taxes and transfers was a sizeable 0.46 in the mid2000s. Column 4 shows that after taxes and transfers, the Gini index fell to 0.38.²

Along the same lines, column 5 shows that before taxes and transfers, 26.3 percent of American households were poor (defined as having incomes of less than 50 percent of the median household income in the mid2000s). Column 6 shows that after taxes and transfers, 17.1 percent were poor. Finally, column 7 shows that taxes took just 28 percent of gross domestic product (GDP) in the United States (in 2006), and column 8 shows that the United States spent about 15.9 percent of gross domestic product on social spending (in 2006).³

¹ See also B. Cashell, 2009, *Inequality in the Distribution of Income: Trends and International Comparisons*, Congressional Research Service, Report for Congress No. RL32639 (October 19), http://assets.opencrs.com/rpts/RL32639_20091019.pdf.

² See also A. Zacharias, E. Wolff and T. Masterson, 2009, *Levy Institute Measure of Economic Well-Being: New Estimates of Economic Inequality in America, 1959-2004*, Levy Economics Institute of Bard College, Annandale-on-Hudson, New York, April, http://www.levyinstitute.org/pubs/lmw_apr_09.pdf.

³ Readers need to be a little cautious in interpreting comparative tax and spending levels, as these do not take into account the relative size of government deficits and public debts. For example, in 2009, Japan's public debt was estimated to be 189.30 percent of its gross domestic product, compared with 75.40 percent for Canada, 68.10 percent for the United Kingdom, 52.90 for the United States, and just 17.60 percent for Australia. Central Intelligence Agency, 2010, *The World Factbook*, at 'Country Comparisons: Public Debt', <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2186rank.html>. See also Douglas W. Elmendorf, Director, Congressional Budget Office, 2010, 'Fiscal Policy Choices' presentation to the National Association for Business Economics 8 March 2010, Congressional Budget Office, p.13 (showing the debt burden across countries in 2007), http://www.cbo.gov/ftpdocs/112xx/doc11277/CBOPresentation-NABE_3-8-10.pdf.

TABLE 1. INEQUALITY AND REDISTRIBUTION IN OECD NATIONS

<i>Country</i>	<i>90/10 Ratio</i>	<i>Gini Before</i>	<i>Gini After</i>	<i>Poverty Before (50% of median income)</i>	<i>Poverty After (50% of median income)</i>	<i>Tax-to- GDP Ratio</i>	<i>Social Spending- to-GDP Ratio</i>
Australia	4.0	0.46	0.30	28.6	12.4	30.6	17.1
Austria	3.3	0.43	0.27	23.1	6.6	41.7	27.2
Belgium	3.4	0.49	0.27	32.7	8.8	44.5	26.4
Canada	4.1	0.44	0.32	23.1	12	33.3	16.5
Czech Republic	..	0.47	0.27	28.2	5.8	36.9	19.5
Denmark	2.7	0.42	0.23	23.6	5.3	49.1	26.9
Finland	3.2	0.39	0.27	17.6	7.3	43.5	26.1
France	3.4	0.48	0.28	30.7	7.1	44.2	29.2
Germany	4.0	0.51	0.30	33.6	11.0	35.6	26.7
Greece	4.4	..	0.32	32.5	12.6	31.3	20.5
Hungary	3.4	..	0.29	29.9	7.1	37.1	22.5
Iceland	3.1	0.37	0.28	20.1	7.1	41.5	16.9
Ireland	4.4	0.42	0.33	30.9	14.8	31.9	16.7
Italy	4.3	0.56	0.35	33.8	11.4	42.1	25.0
Japan	4.8	0.44	0.32	26.9	14.9	27.9	18.6
Korea	..	0.34	0.31	17.5	14.6	26.8	6.9
Luxembourg	3.2	0.45	0.26	29.1	8.1	35.9	23.2
Mexico	8.5	..	0.47	21.0	18.4	20.6	7.0
Netherlands	3.2	0.42	0.27	24.7	7.7	39.3	20.9
New Zealand	4.3	0.47	0.34	26.6	10.8	36.7	18.5
Norway	2.8	0.43	0.28	24.0	6.8	43.9	21.6
Poland	5.6	0.57	0.37	37.5	14.6	33.5	21.0
Portugal	5.5	0.54	0.38	29.0	12.9	35.7	..
Slovak Republic	3.3	0.46	0.27	27.4	8.1	29.8	16.6
Spain	4.6	..	0.32	17.6	14.1	36.6	21.2
Sweden	2.8	0.43	0.23	26.7	5.3	49.1	29.4
Switzerland	3.4	0.35	0.28	18.0	8.7	29.6	20.3
Turkey	6.5	..	0.43	..	17.5	24.5	13.7
United Kingdom	4.2	0.46	0.34	26.3	8.3	37.1	21.3
United States	5.8	0.46	0.38	26.3	17.1	28.0	15.9
OECD Total	..	0.45	0.31	26.4	10.6	35.9	20.5

Source: Country comparisons in the OECD Stat database related to OECD, 2008, *Growing Unequal? Income Distribution and Poverty in OECD Countries*. Paris, http://www.oecd.org/document/53/0,3343,en_2649_33933_41460917_1_1_1_1,00.html.

1.2 Taxes and transfers

A significant portion of poverty reduction in OECD countries takes the form of family cash benefits—child-related cash transfers to families.⁵ These family benefit schemes can take the form of child allowances for families or refundable tax credits. Many countries provide universal family cash benefits, and some provide additional benefits to low-income families. Pertinent here, Australia, Canada, the United Kingdom, New Zealand, and Germany use refundable tax credits to make cash transfers to families. The United States also uses tax credits to provide benefits to low-income families, but these are conditional on having earned income. Such in-work tax credits are becoming increasingly popular.⁶

Table 2 summarizes the effect of government transfers made to the poorest households in various countries and the taxes collected from those households. Here, the United States only transfers about 2.3 percent of household income to the poorest 20 percent of households. Fortunately, the United States has a fairly progressive tax system—and this initially surprised me.⁷ The United States collects just 0.4 percent of household income from the poorest 20 percent of taxpayers. All in all, however, net transfers to the poor are pretty low in the United States—just 1.9 percent of household income is redistributed to the poorest Americans, compared to a 4.2 percent average for 23 OECD countries.⁸

⁵ See, e.g., OECD, 2010, 'OECD Family Database', Paris, PF3(Family cash benefits [January 7]), <http://www.oecd.org/dataoecd/62/5/41917645.pdf>; OECD, 2008, 'Family benefits 2007', Paris, http://www.oecd.org/document/3/0,3343,en_2649_34637_39617987_1_1_1_1,00.html; Clearinghouse on International Developments in Child, Youth and Family Policies, 2004, 'Section 1.9: Child and Family Tax Benefits', Columbia University, New York, <http://www.childpolicyintl.org/chilntax.html>; M. Corak, C. Lietz and H. Sutherland, 2005, *The Impact of Tax and Transfer Systems on Children in the European Union*, UNICEF Innocenti Research Centre Working Paper 2005-04, Florence, Italy, February, http://www.unicef.org/socialpolicy/files/Impact_of_Tax_and_Transfer_Systems.pdf; J. Kesselman and R. Cheung, 2004, 'Tax Incidence, Progressivity, and Inequality in Canada', *Canadian Tax Journal*, Vol. 52 No.3, pp. 709-789; K. Battle and M. Mendelson (Eds), 2001 *Benefits for Children: A Four Country Study*, Caledon Institute of Social Policy, Ottawa, Canada.

⁶ See, e.g., M. Brewer, M. Francesconi, P. Gregg and J. Grogger, 2009, 'Feature: In-Work Benefit Reform in a Cross-National Perspective- Introduction', *Economic Journal*, Vol. 119 February, pp. F1-F14.

⁷ Based on a different table, the OECD concluded that the tax systems of Italy, Germany, Australia, the United States, Denmark, Ireland, and the Netherlands achieve the largest reductions in income inequality, while the tax systems of Japan, Korea, and Switzerland achieve the smallest reductions. OECD, *Growing Unequal? Income Distribution and Poverty in OECD Countries*, note 4, pp. 113-115 (table 4.6 and accompanying text).

⁸ As more fully explained in Part 2, presumably redistribution to the poor has increased somewhat since the passage of the American Recovery and Reinvestment Act of 2009 (ARRA), Public Law No. 111-5, 123 *Statutes at Large* 115 (February 17, 2009).

TABLE 2. INEQUALITY AND REDISTRIBUTION IN OECD NATIONS

<i>Country</i>	<i>Transfers to lowest quintile</i>	<i>Taxes from lowest quintile</i>	<i>Net transfers to lowest quintile</i>
Australia	5.9	0.2	5.8
Austria	5.1	1.8	3.3
Belgium	7.3	1.5	5.8
Canada	3.5	0.6	2.9
Czech Republic	5.6	0.8	4.8
Denmark	9.2	3.2	6.0
Finland	4.7	1.2	3.5
France	5.3	1.5	3.9
Germany	4.9	0.7	4.2
Ireland	5.4	0.2	5.3
Italy	3.7	0.6	3.1
Japan	3.1	1.2	2.0
Korea	0.9	0.5	0.4
Luxembourg	4.3	1.4	2.8
Netherlands	5.4	0.8	4.5
New Zealand	4.4	0.5	3.9
Norway	6.0	1.5	4.5
Poland	3.2	1.7	1.6
Slovak Republic	4.9	1.0	3.9
Sweden	8.5	2.8	5.7
Switzerland	4.7	4.5	0.2
United Kingdom	4.6	0.4	4.1
United States	2.3	0.4	1.9
OECD 23	5.4	1.2	4.2

Source: OECD, 2008, *Growing Unequal? Income Distribution and Poverty in OECD Countries*. Paris, p. 116 (table 4.7), <http://dx.doi.org/10.1787/422058728151>.

In short, developed countries rely on different methods of redistribution. Countries with low levels of inequality (such as the Nordic countries, Germany, Belgium, and the Netherlands) tend to rely heavily on social welfare programs for redistribution.⁹ On the other hand, countries with high levels of inequality (Australia, Canada, and the United States) rely more heavily on taxes.

Most developed countries operate pretty substantial social welfare systems that are financed largely by three taxes that primarily burden labor income: income taxes,

⁹ N. Prasad, 2008, *Policies for redistribution: The uses of taxes and social transfers*, International Institute for Labour Studies, Discussion Paper No. 194, Geneva, Switzerland, pp. 12-13, <http://www.ilo.org/public/english/bureau/inst/publications/discussion/dp19408.pdf>.

payroll taxes, and consumption taxes.¹⁰ Income taxes typically have large exemptions and progressive tax rates. On the other hand, payroll taxes tend to be regressive as they typically have no exemptions and flat rates up to an earnings cap. Consumption taxes tend to be regressive or, at best, proportional as they typically have flat rates and a broad base (e.g., one that includes elderly retirees as well as workers).

In a recent book, Achim Kemmerling argues that “the real question in contemporary welfare states is not whether, but how welfare is financed.”¹¹ He used longitudinal data from the OECD to develop decades of tax-to-GDP ratios for various countries’ income, payroll, and consumption taxes. Table 3 shows similar tax-to-GDP ratios for 2007.

Not surprisingly, Kemmerling found that the overall tax-to-GDP ratios in OECD countries have risen considerably in the last 40 years.¹² At the same time, payroll taxes and consumption tax revenues have grown much faster than income taxes in most countries.¹³ All in all, there has been “a remarkable shift away from income taxation” in recent years.¹⁴

¹⁰ A. Kemmerling, 2009, *Taxing the Working Poor: The Political Origins and Economic Consequences of Taxing Low Wages*, Edward Elgar Publishing, Cheltenham, UK, p. 3; see also J. Forman, ‘Taxing the Working Poor: The Political Origins and Economic Consequences of Taxing Low Wages (by Achim Kemmerling)’, Vol. 31 No. 1 *Comparative Labor Law and Policy Journal*, Fall, pp. 211-215. Through most of the nineteenth century, labor earned subsistence wages, and, therefore, most of the burden of taxation fell on capital. As real wages have increased since that time, capital was able to shift most of the burden of taxation onto labor. Consequently, most of the revenue needed to finance contemporary welfare states now comes from three taxes that primarily burden labor income: income taxes, payroll taxes, and consumption taxes. See also H. Immervol, 2007, *Minimum Wages, Minimum Labour Costs and the Tax Treatment of Low-Wage Employment*, OECD Social, Employment and Migration Working Paper No. 46, Paris (showing minimum wages and payroll taxes for full-time workers at different wage levels); OECD, 2009, *OECD Factbook 2009: Economic, Environmental and Social Statistics*, OECD, Paris, pp. 238-239 (showing taxes on the average worker); OECD, 2005, *Taxing Working Families: A Distributional Analysis*, OECD Tax Policy Study No. 12, Paris.

¹¹ Kemmerling, note 10, p. 1.

¹² Id. at 16. See also OECD, 2009, ‘OECD Tax Database’, Paris, [Tax revenue statistics](http://www.oecd.org/document/60/0,3343,en_2649_34533_1942460_1_1_1_1.00.html#trs) (table O.1 [Total tax revenue as percentage of GDP]), http://www.oecd.org/document/60/0,3343,en_2649_34533_1942460_1_1_1_1.00.html#trs.

Kemmerling also notes that there has been a broad convergence in the level of social spending among the OECD countries. Kemmerling, note 10, p.13.

¹³ Kemmerling, note 10, p. 16. Payroll taxes nearly doubled from 1965 to 2002, and consumption taxes increased by more than 20 percent from the 1980s to the 1990s. Id. at 18-19.

¹⁴ Id. at 23. It would seem that the sheer magnitude of the revenues needed for modern welfare states have pushed them towards payroll and consumption taxation. International competition may also be responsible for some of the recent trend away from progressive income taxation and towards consumption taxes. Id. at 117.

TABLE 3. COUNTRY COMPARISONS OF TAX-TO-GDP, 2007

<i>Country</i>	<i>Income Taxes</i>	<i>Payroll taxes</i>	<i>Consumption Taxes</i>	<i>Total Taxes</i>
Australia	18.4	..	8.2	30.8
Austria	12.7	14.2	11.7	42.3
Belgium	16.5	13.6	11.0	43.9
Canada	16.6	4.8	7.9	33.3
Czech Republic	9.4	16.2	11.1	37.4
Denmark	29.0	1.0	16.3	48.7
Finland	16.9	11.9	12.9	43.0
France	10.4	16.1	10.7	43.5
Germany	11.3	13.2	10.6	36.2
Greece	7.5	11.7	11.4	32.0
Hungary	10.0	12.9	14.9	39.5
Iceland	18.5	3.1	16.5	40.9
Ireland	12.1	4.7	11.1	30.8
Italy	14.7	13.0	11.0	43.5
Japan	10.3	10.3	5.1	28.3
Korea	8.4	5.5	8.3	26.5
Luxembourg	12.8	10.2	9.9	36.5
Mexico	5.0	2.8	9.5	18.0
Netherlands	10.9	13.6	11.2	37.5
New Zealand	22.5	..	11.3	35.7
Norway	21.0	9.1	12.4	43.6
Poland	8.0	12.0	13.3	34.9
Portugal	9.4	11.7	13.7	36.4
Slovak Republic	5.8	11.7	11.3	29.4
Spain	12.4	12.1	9.5	37.2
Sweden	18.7	12.6	12.9	48.3
Switzerland	13.2	6.7	6.5	28.9
Turkey	5.6	5.1	11.3	23.7
United Kingdom	14.3	6.6	10.5	36.1
United States	13.9	6.6	4.7	28.3
OECD Total	13.2	9.1	10.9	35.8

Source: OECD, 2009, 'OECD Tax Database', Paris, [Tax revenue statistics](http://www.oecd.org/document/60/0,3343,en_2649_34533_1942460_1_1_1_1,00.html#trs), tables O.1, O.2, O.3, and O.5, http://www.oecd.org/document/60/0,3343,en_2649_34533_1942460_1_1_1_1,00.html#trs.

Note: "Income taxes" includes taxes on income, profits, and capital gains as percentage of GDP. "Payroll taxes" refers to social security contributions as a percentage of GDP." Consumption taxes" refers to taxes on goods and services as a percentage of GDP. "Total taxes" also includes taxes on property, net wealth, estate, inheritance and gift taxes, and certain other taxes—averaging 1.9 percent of GDP—but not shown here.

As Table 3 shows, countries still differ in the mix of taxes that they use for public finance, with some countries relying on the income tax as their most important source of revenue and other countries relying on payroll taxes or consumption taxes. Broadly speaking, the Scandinavian welfare states have a high overall tax rate and high rates of income taxation. 'Bismarckian' continental European welfare states have high levels of payroll taxation (social security contributions). Anglo-Saxon ('Beveridge') welfare states also rely heavily on income taxes to pay for social welfare benefits; and these

states also typically provide tax subsidies for targeted employees (e.g., the U.S. earned income tax credit). For the newly independent states of Eastern Europe, consumption taxes seem to be an important source of revenue.¹⁵

Kemmerling focused on how the relative mix of income, payroll, and consumption taxes affect labor markets.¹⁶ He found that the shift away from progressive income taxation has resulted in a high tax burden and high marginal tax rates that have hurt low-wage workers. Generally speaking, low-skilled workers do best under income taxes which—because of large exemptions—they do not have to pay; and one of Kemmerling’s principal findings is that countries with higher tax burdens on low-skilled workers have lower employment levels and higher unemployment rates. He explains that “it is not the tax burden, but the tax (and transfer) structure that affects the performance of a labor market.”¹⁷

Pertinent here, earnings subsidies, like the earned income tax credit in the United States, can increase the work effort of participants, at least in the phase-in range of the subsidy.¹⁸ Moreover, an earnings subsidy can increase employment opportunities for low-wage workers. By increasing the compensation paid to low-wage workers at no cost to employers, an earnings subsidy can increase the demand for low-wage labor. Earnings subsidies can also cost less to administer than means-tested transfer programs and can be more effective in reaching targeted beneficiaries.

2. TAXES AND WELFARE IN THE UNITED STATES

Ultimately, the tax and transfer structure of a country depends on the kinds of taxes that it utilizes to raise revenue, on the rate structures inherent in those taxes (including those associated with any tax credits), and on the nature of its welfare system. This Part looks in detail at the tax, tax credit, and welfare systems in the United States. Part 3 then takes a more cursory look at the tax and tax credit systems of some other

¹⁵ Kemmerling also notes that each country’s mix of taxes is “highly persistent” and that “it is politically costly and cumbersome to change the tax mix.” Id. at 18, 19.

¹⁶ See also L. Ohanian, A. Raffo and R. Rogerson, 2008, ‘Long-term changes in labor supply and taxes: Evidence from OECD countries, 1956-2004’, *Journal of Monetary Economics*, Vol. 55 No. 8, November, pp. 1353-1362 (finding that taxes can account for much of the variation in hours worked both over time and across countries); E. Prescott, 2004, ‘Why Do Americans Work So Much More than Europeans?’, *Federal Reserve Bank of Minneapolis Quarterly Review*, Vol. 28 No. 1, July, pp. 2-13.

¹⁷ Kemmerling, note 10, p. 120. Kemmerling’s real contribution comes from his focus on the political conflicts that have arisen among employees and from his analysis as to why trade unions and left-of-center parties have become a lot less supportive of progressive (income) taxation. His research suggests that “in countries where unions are strong and include a large and representative part of the low-wage sector, unions will take interests of low-wage workers into consideration” and will favor a tax mix with relatively more progressive income taxes. Id. at 121. On the other hand, “in countries where there is a huge gap between bargaining coverage and union density, tax progressivity is markedly lower.” Id. at 122.

¹⁸ J. Forman, 2006, *Making America Work*, Urban Institute Press, Washington, D.C., pp. 80-83; N. Eissa and H. Hoynes, 2005, *Behavioral Responses to Taxes: Lessons from the EITC and Labor Supply*, National Bureau of Economic Research Working, Paper No. 11,729, Cambridge, Massachusetts; R. Blundell and A. Shepard, 2009, *Employment, Hours of Work and the Optimal Design of Earned Income Tax Credits* (February 10), <http://microsimula.parisschoolofeconomics.eu/documents/microsimulaworkshop/Shepard.pdf>. See also M. Dahl, T. DeLeire and J. Schwabish, 2009, *Stepping Stone of Dead End? The Effect of the EITC on Earnings Growth*, Institute for the Study of Labor (IZA), Discussion Paper No. 4146, Bonn, Germany, April, <http://ftp.iza.org/dp4146.pdf>.

developed countries, and, finally, Part 4 discusses the best approaches for using refundable tax credits as a redistributive tool.

2.1 Taxes

The U.S. federal government raises virtually all of its revenue from the individual income tax, Social Security and Medicare payroll taxes, the corporate income tax, estate and gift taxes, and excise taxes on selected goods and services. State and local governments raise most of their revenue from income taxes, sales taxes, and property taxes. All in all, taxes take about 30 percent of the United States gross domestic product (GDP), and federal taxes take about two-thirds of that.¹⁹

2.1.1 *The income tax on individuals*

The largest of the federal taxes is the income tax imposed on individuals. The federal income tax is imposed on a taxpayer's taxable income.²⁰ Taxpayers file returns as unmarried individuals, heads of household, married couples filing joint returns, or married couples filing separate returns.

As a starting point, taxpayers first determine the amount of their gross income.²¹ Gross income includes all income from whatever source derived, including (but not limited to) the wages, salaries, tips, gains, dividends, interest, rents, and royalties received by taxpayers during the taxable year.

From gross income, taxpayers subtract certain deductions to get to taxable income. Most taxpayers simply claim a standard deduction and personal exemptions. Many taxpayers, however, claim certain itemized deductions in lieu of the standard deduction. Also, certain other deductions are allowed without regard to whether the taxpayer chooses to itemize.

Each year, the U.S. Department of Treasury indexes the standard deduction amounts, the personal exemption amounts, and the income tax rate tables to reflect the prior year's change in the Consumer Price Index.²² Table 4 shows the basic standard deductions, personal exemptions, and simple income tax thresholds for various taxpayers in calendar year 2010. For example, a married couple with two children can claim a standard deduction of \$11,400 and four \$3,650 personal exemptions. Consequently, the couple will not have any taxable income unless its gross income exceeds \$26,000.

¹⁹ Forman, *Making America Work*, note 18, p. 58. See also Joint Committee on Taxation, 2010, *Present Law and Background Data Related to the Federal Tax System in Effect for 2010 and 2011*, JCX-19-11 (March 22); OECD, Social Policy Division, Directorate of Employment, Labour and Social Affairs, 2010, *United States 2008*, Paris, <http://www.oecd.org/dataoecd/25/1/44429269.pdf>.

²⁰ Internal Revenue Code (I.R.C.) §§ 1, 63.

²¹ I.R.C. § 61.

²² Revenue Procedure 2009-50, 2009-45 *Internal Revenue Bulletin* 617. For 2010, the basic standard deduction amounts are \$11,400 for married couples filing jointly and surviving spouses, \$8,400 for heads of households, and \$5,700 for unmarried individuals and married individuals filing separately. Aged or blind individuals generally are entitled to claim additional standard deduction amounts of \$1,100, except that aged or blind unmarried individuals can claim additional standard deduction amounts of \$1,400. The personal exemption amount is \$3,650.

TABLE 4. STANDARD DEDUCTIONS, PERSONAL EXEMPTIONS, SIMPLE INCOME TAX THRESHOLDS, AND TAX RATE SCHEDULES FOR VARIOUS TAXPAYERS, 2010

	<i>Unmarried individuals</i>	<i>Heads of household with one child</i>	<i>Married couples filing joint returns with two children</i>
Standard deduction	\$5,700	\$ 8,400	\$11,400
Personal exemptions	<u>\$3,650</u>	<u>\$ 7,300 (2 × \$3,650)</u>	<u>\$14,600 (4 × \$3,650)</u>
Simple income tax threshold	\$9,350	\$15,700	\$26,000
<i>Tax rate (imposed on taxable income)</i>	<i>Rate bracket</i>		
10	\$0 to \$8,375	\$0 to \$11,950	\$0 to \$16,750
15	\$8,375 to \$34,000	\$11,950 to \$45,550	\$16,750 to \$68,000
25	\$34,000 to \$82,400	\$45,550 to \$117,650	\$68,000 to \$137,300
28	\$82,400 to \$171,850	\$117,650 to \$190,550	\$137,300 to \$209,250
33	\$171,850 to \$373,650	\$190,550 to \$33,650	\$209,250 to \$373,650
35	Over \$373,650	Over \$373,650	Over \$373,650

Source: Revenue Procedure 2009-50, 2009-45 *Internal Revenue Bulletin* 617.

Table 4 also shows the tax rate schedules for 2010. For a taxpayer with gross income in excess of her simple income tax threshold, her regular tax liability will be determined by applying the 10, 15, 25, 28, 33, and 35 percent rates to taxable income. The maximum tax rate on dividends and net long-term capital gains, however, is just 15 percent.²³

The amount that a taxpayer must actually pay (or, alternatively, will receive as a refund) is equal to the taxpayer's income tax liability minus her allowable tax credits. Pertinent here, certain taxpayers are entitled to claim the refundable earned income tax credit, the partially refundable child tax credit, the nonrefundable dependent care credit, and the new refundable making work pay tax credit.²⁴

The earned income tax credit

The earned income tax credit is a refundable tax credit available to certain low- and moderate-income workers.²⁵ In 2010, for example, a family with three or more qualifying children is entitled to claim an earned income tax credit of up to \$5,666. The credit is computed as 45 percent of the first \$12,590 of earned income. For married couples filing joint returns, the maximum credit is reduced by 21.06 percent

²³ I.R.C. § 1(h). In addition, the maximum tax rate on capital gains and dividends received by moderate-income taxpayers (those in the 10 and 15 percent income brackets) is 0 percent in 2010.

²⁴ More than 40 states and numerous local governments also levy income taxes on individuals. These state income taxes are typically imposed on a variation of federal taxable income, albeit at lower rates. In 2010, for example, the tax rates in Oklahoma range from 0.5 percent to 5.5 percent. Tax Foundation, 2010, *Tax Data: State Individual Income Tax Rates, 2000-2010*, Tax Foundation, Washington, DC (February 1), <http://www.taxfoundation.org/taxdata/show/228.html>.

²⁵ I.R.C. § 32 (as modified by ARRA § 1002).

of earned income (or adjusted gross income, if greater) in excess of \$21,460 and is entirely phased out at \$48,362 of income.²⁶ For heads of household, the maximum credit phases out over the range from \$16,450 to \$43,352.

Similarly, a family with two qualifying children is entitled to claim an earned income tax credit of up to \$5,036.²⁷ A family with one child is entitled to an earned income credit of up to \$3,050.²⁸ Finally, childless individuals between the ages of 25 and 65 are entitled to an earned income credit of up to \$457.²⁹

The child tax credit

Taxpayers with children under the age of 17 can claim a tax credit of up to \$1,000 per child.³⁰ The child tax credit is first applied to offset a taxpayer's income tax liability (if any), and, for taxpayers with earned income in excess of \$3,000 in 2010, a portion of the credit is refundable: the credit is refundable to the extent of 15 percent of the taxpayer's earned income in excess of \$3,000. These child tax credits are phased out once the taxpayer's adjusted gross income reaches \$110,000 for married couples filing joint returns, \$55,000 for married couples filing separately, and \$75,000 for all other taxpayers.

The making work pay tax credit

The new making work pay tax credit is a refundable credit computed as 6.2 percent of earned income, up to a maximum credit of \$400 per individual (\$800 per couple).³¹ Of note, couples can claim the full \$800 credit even if only one spouse works. These making work pay tax credits are phased out once the taxpayer's modified adjusted gross income exceeds \$150,000 for married couples filing joint returns and \$75,000 for other taxpayers.

The dependent care credit

The federal income tax system also provides a nonrefundable dependent care credit to certain taxpayers who incur employment-related expenses to care for children under the age of 13.³² A taxpayer can claim a tax credit of up to \$1,050 (35 percent of \$3,000) a year for one qualifying child, or up to \$2,100 (35 percent of \$6,000) a year for two or more qualifying children. The credit is reduced for taxpayers whose

²⁶ Revenue Procedure 2009-50, note 22.

²⁷ The credit is computed as 40 percent of the first \$12,590 of earned income. For married couples filing joint returns, the maximum credit is reduced by 21.06 percent of earned income (or adjusted gross income, if greater) in excess of \$21,460 and is entirely phased out at \$45,373 of income. For heads of household, the maximum credit phases out over the range from \$16,450 to \$40,363.

²⁸ The credit is computed as 34 percent of the first \$8,970 of earned income. For married couples filing joint returns, the maximum credit is reduced by 15.98 percent of earned income (or adjusted gross income, if greater) in excess of \$21,460 and is entirely phased out at \$40,545 of income. For heads of household, the maximum credit phases out over the range from \$16,450 to \$35,535.

²⁹ The credit is computed as 7.65 percent of the first \$5,980 of earned income. For married couples filing joint returns, the maximum credit is reduced by 7.65 percent of earned income (or adjusted gross income, if greater) in excess of \$12,490 and is entirely phased out at \$18,470 of income. For heads of household and single individuals, the maximum credit phases out over the range from \$7,480 to \$13,460.

³⁰ I.R.C. § 24 (as modified by ARRA § 1003).

³¹ I.R.C. § 36A (added by ARRA § 1001).

³² I.R.C. § 21.

adjusted gross income exceeds \$15,000 until it levels off at \$600 (20 percent of \$3,000) for one qualifying child and \$1,200 (20 percent of \$6,000 for two or more qualifying children for taxpayers with adjusted gross income over \$45,000. Perhaps the biggest limitation is that the dependent care credit is not refundable. That means that the dependent care credit is of no value to those low-income Americans who are exempt from income taxation.

Other tax credits

There are numerous other refundable and nonrefundable tax credits. For example, some first-time homebuyers in 2009 and 2010 could get a refundable credit of up to \$8,000,³³ students can get a partially refundable education tax credit,³⁴ and homeowners can get a tax credit for installing energy efficient windows, doors, or insulation.³⁵

2.1.2 Social Security and Medicare payroll taxes

Social Security and Medicare payroll taxes are levied on earnings in employment and self-employment covered by Social Security, with portions of the total tax allocated by law to the Old-Age and Survivors Insurance trust fund (OASI), the Disability Insurance trust fund (DI), and the Medicare Hospital Insurance trust fund.³⁶ For 2010, employees pay Social Security and Medicare payroll taxes of 7.65 percent on the first \$106,800 of wages and 1.45 percent of wages over \$106,800.³⁷ The lion's share of these payroll taxes is used to finance the OASI program (5.3 percent of wages), and the rest pay for DI (0.9 percent) and Medicare (1.45 percent).³⁸

Employers pay a matching payroll tax of 7.65 percent of up to \$106,800 of wages and 1.45 percent of wages over \$106,800 for each covered employee.³⁹ Employees are not allowed to deduct their portion of payroll taxes for income tax purposes. On the other hand, the employer's portion of payroll taxes is excluded from the employee's income for income tax purposes.⁴⁰

Similarly, self-employed workers pay an equivalent Social Security tax of 15.3 percent on the first \$106,800 of self-employment earnings and 2.9 percent of self-employment earnings over that amount. To put self-employed individuals in an approximately equivalent position as employees, self-employed individuals can deduct half these taxes for both payroll and income tax purposes.⁴¹

³³ I.R.C. § 36 (as expanded by ARRA § 1006).

³⁴ I.R.C. § 25A (as expanded by ARRA § 1004) (now called the "American Opportunity education tax credit").

³⁵ I.R.C. § 25C (added by ARRA § 1121).

³⁶ I.R.C. §§ 1401, 3101, 3111.

³⁷ Social Security Administration, Office of the Commissioner, 2009, 'Cost-of-Living Increase and Other Determinations for 2010', *Federal Register* Vol. 74 (October 28), pp. 55,614-55,618.

³⁸ Board of Trustees, Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, 2010, *2010 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds*, p. 5.

³⁹ I.R.C. §§ 275(a)(1)(A), 3502(a); Treasury Regulations § 1.164-2(a).

⁴⁰ H. REPORT NO. 47, 98th Congress, 1st Session 125-126 (1983), reprinted in 1983 *U.S. Code and Congressional and Administrative News Service* 404, 414-415.

⁴¹ I.R.C. §§ 164(f), 1402(a)(12).

2.1.3 Poverty levels and federal tax thresholds

The best way to understand how the U.S. income tax system uses refundable tax credits to help low-income workers and their families is to consider how the income tax system affects the income of various low-income family units.⁴²

Poverty levels and net federal tax thresholds

At the outset, Table 5 compares the 2010 federal tax thresholds and poverty income guidelines for selected households.⁴³ Consider a family of four consisting of a married couple and two children. Row 1 shows that this family unit's poverty income guideline for 2010 is \$22,050.⁴⁴ Row 2 again shows that this family's simple income tax threshold is \$26,000.⁴⁵

TABLE 5. POVERTY LEVELS AND NET FEDERAL TAX THRESHOLDS IN 2010, FOR SELECTED HOUSEHOLDS

	<i>Unmarried individual</i>	<i>Single parent with one child</i>	<i>Married couple with two children</i>	<i>Married couple with three children</i>
1. Poverty levels	\$10,830	\$14,570	\$22,050	\$25,790
2. Simple income tax threshold (before credits)	\$9,350	\$15,700	\$26,000	\$29,650
3. Income tax threshold after the earned income, making work pay, and child tax credits	\$13,395	\$32,380	\$50,250	\$60,567
4. Employee Social Security and Medicare payroll tax threshold	\$0	\$0	\$0	\$0
5. Combined income and payroll tax threshold (i.e., net federal tax threshold)	\$9,348	\$25,717	\$38,635	\$43,788

⁴² This section updates J. Forman, 2009, '2009 Poverty Levels and Federal Tax Thresholds', *Tax Notes* Vol. 124 No. 2 (July 13), pp. 171-174.

⁴³ The table reflects the assumptions that all family income consists of wages earned by a single worker, that all family members are under age 65 and not blind, that all family units are eligible for the earned income and making work pay tax credits, and that all children qualify for the child tax credit. Also, as a simplifying assumption, only the employee's portion of Social Security and Medicare payroll taxes is considered. In that regard, most economists believe that households do bear the burden of payroll taxes paid by their employers, and, a complete analysis of tax burdens would also consider the incidence of corporate income taxes, excise taxes, etc. See, e.g., Congressional Budget Office, 2005, *Effective Tax Rates: Comparing Annual and Multiyear Measures*, p. 3 (box 1), <http://www.cbo.gov/ftpdocs/60xx/doc6051/01-06-LongitudinalTaxRates.pdf>.

⁴⁴ Department of Health and Human Services, Office of the Secretary, 2010, 'Delayed Annual Update of the HHS Poverty Guidelines for the Remainder of 2010', *Federal Register*, Vol. 75 (August 3), pp. 45,628-45,629.

⁴⁵ See Table 4 and accompanying text.

Row 3 shows each family unit's income tax threshold after taking into account the effects of the earned income credit, the making work pay tax credit and the child tax credit. For example, for 2010, a typical married couple with two young children can claim an earned income tax credit of up to \$5,036, a making work pay tax credit of up to \$800, and two child tax credits worth up to \$1,000 per child. Consequently, taking into account the earned income, making work pay, and child tax credits, a typical married couple with one worker and two children will not actually owe any income tax until the couple's income exceeds \$50,250.⁴⁶

On the other hand, because the payroll tax system has no standard deductions or personal exemptions, family units must pay Social Security and Medicare payroll taxes starting with their first dollar of earned income. Hence, Row 4 shows that zero is the payroll tax threshold for all family units.

Finally, Row 5 shows the combined income and payroll tax threshold (i.e., net federal tax threshold) for various family units. Each threshold occurs at the income level at which the taxpayer's preliminary income tax liability plus employee payroll tax liability minus income tax credits equals zero. For example, a typical married couple with one worker and two children will not actually have a net federal tax liability for 2010 unless its income exceeds \$38,635.⁴⁷

Federal taxes at the poverty level

Table 6 shows the federal tax liabilities of various family units with earnings exactly equal to their respective poverty income guidelines. Again, consider a hypothetical family of four consisting of a married couple with two children. Row 1 again shows that the couple's poverty income guideline in 2010 is \$22,050.

⁴⁶ Each computation in Row 3 involved determining the appropriate equation for computing each family unit's income tax liability after its earned income, making work pay, and child tax credits and solving for the income level at which that income tax liability is equal to zero. For example, for 2010, for a married couple with one worker, two children, and income (I) in excess of the \$42,750 level at which the couple enters the 15 percent income tax bracket and in excess of the \$45,373 level at which the couple's earned income tax credit disappears, the couple's income tax liability (T) can be determined by the following formula:

$$T = \$1,675 + .15 \times (I - \$42,750) - \$800 - (2 \times \$1,000).$$

Setting T equal to zero and solving for I shows that this couple's income tax threshold after the earned income, making work pay, and child tax credits is \$50,250.00.

⁴⁷ Each computation in Row 5 involved determining the appropriate equation for computing each family unit's combined income and employee payroll tax liability after its earned income, making work pay, and child tax credits, and solving for the income level at which that tax liability is equal to zero. For example, for 2010, for a married couple with two children with income (I) in excess of its \$26,000 simple income tax threshold and less than the \$42,750 level at which the couple enters the 15 percent income tax bracket, the couple's combined income and employee payroll tax liability (T) can be determined by the following formula:

$$T = .10 \times (I - \$26,000) + .0765 \times I - (\$5,036 - .2106 \times [I - \$21,460]) - \$800 - (2 \times \$1,000).$$

Setting T equal to zero and solving for I shows that the couple's combined income and employee payroll tax threshold after the earned income and child tax credits is \$38,634.66.

TABLE 6. FEDERAL TAXES AT THE POVERTY LEVEL IN 2010, FOR SELECTED HOUSEHOLDS

	<i>Unmarried individual</i>	<i>Single parent with one child</i>	<i>Married couple with two children</i>	<i>Married couple with three children</i>
1. Poverty levels	\$10,830	\$14,570	\$22,050	\$25,790
2. Income tax at poverty level (after tax credits)	-\$453	-\$4,450	-\$7,712	-\$8,554
3. Employee Social Security and Medicare payroll tax at poverty level	\$829	\$1,115	\$1,687	\$1,973
4. Combined income and employee payroll tax at poverty level	\$376	-\$3,335	-\$6,025	-\$6,581
5. Combined tax as a percent of income at poverty level	3.5%	-22.9%	-27.3%	-25.5%

Assuming that the couple has exactly that much earned income in 2010, Row 2 shows that the couple will be entitled to an income tax refund of \$7,712.⁴⁸

Row 3 shows that the couple's payroll tax liability for 2010 will be \$1,687.⁴⁹ As the couple's income tax refund in Row 2 will be greater than its payroll tax liability in Row 3, the couple will be entitled to receive a net refund of \$6,025 from the federal government, as shown in Row 4.⁵⁰ Finally, Row 5 expresses the couple's net federal tax liability as a percentage of income: for 2010, the couple will have a net federal tax liability equal to -27.3 percent of its poverty-level income.⁵¹

All in all, hardly any low-income workers will owe federal taxes for 2010. Quite simply, the earned income tax credit, the new making work pay tax credit, and the child tax credit will offset the income and payroll tax liabilities of millions of low-

⁴⁸ Each computation in Row 2 involved determining the appropriate equation for computing each family unit's income tax at the poverty level after taking into account its earned income, making work pay, and child tax credits. For example, for 2010, for a married couple with two children with income (I) less than its \$26,000 simple income tax threshold but in excess of the \$21,460 level at which the earned income credit begins to phase out, the couple's income tax refund (R) can be determined by the following formula:

$$R = \$5,036 - .2106 \times (I - \$21,460) + \$800 + (2 \times \$1,000).$$

Setting I equal to \$22,050 and solving for R shows the couple will be entitled to an income tax refund of \$7,711.75.

⁴⁹ Each computation in Row 3 involved multiplying the family unit's poverty-level income times the 7.65 percent employee portion of the Social Security and Medicare payroll tax. For example, a married couple with two children and a poverty-level wages of \$22,050 will owe \$1,687 in payroll taxes for 2010 ($\$1,686.83 = .0765 \times \$22,050$).

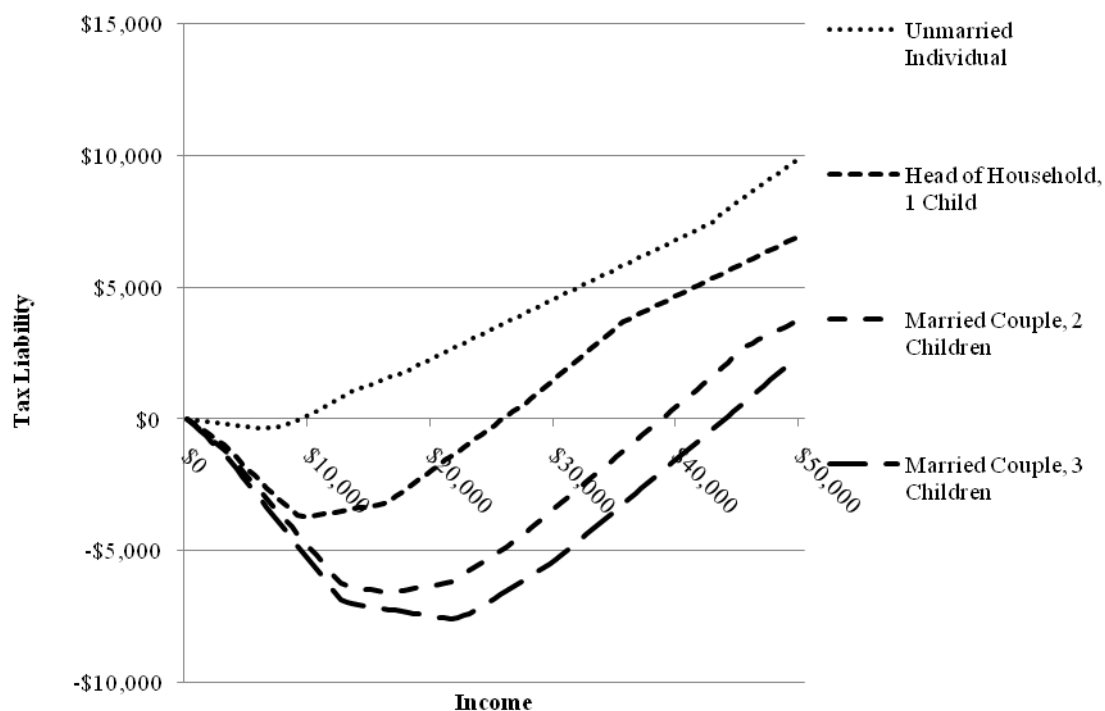
⁵⁰ Each computation in Row 4 involved adding the income tax in Row 2 to the payroll tax in Row 3. For example, a married couple with two children and a poverty-level income of \$22,050 will receive a refund of \$6,025 ($-\$6,024.92 = -\$7,711.75 + \$1,686.83$).

⁵¹ Each computation in Row 5 involved dividing the net tax liability in Row 4 by the poverty-level income in Row 1. For example, a married couple with two children will receive a refund equal to 27.3 percent of its poverty-level income ($-.2732 = -\$6,025 \div \$22,050$).

income workers. In fact, these refundable credits will provide significant subsidies to most low-income workers and their families.

Pertinent here, Figure 1 shows how net federal tax liability changes as household income for selected households increases from \$0 to \$50,000.

FIGURE 1: NET FEDERAL TAX LIABILITIES FOR SELECTED HOUSEHOLDS, 2010



2.2 Welfare

Dozens of federal transfer programs provide assistance to individuals for retirement, disability, health, education, housing, public assistance, employment, and other needs. The vast majority of these programs transfer cash or in-kind benefits (e.g., food or medical care) directly to individuals. Social welfare analysts generally differentiate between transfer programs that are “means-tested” and those that are not. For programs that are means-tested (e.g., family support, Medicaid, and food stamps), eligibility and benefits depend upon an individual’s need, as measured by the individual’s income and assets. For programs that are not means-tested (e.g., social insurance programs like Social Security and Medicare), eligibility is based on other

criteria such as age and work history. Table 7 shows the federal government's outlays for the principal federal transfer programs (including refundable tax credits).⁵²

TABLE 7. OUTLAYS FOR THE PRINCIPAL FEDERAL BENEFIT PROGRAMS IN THE UNITED STATES (BILLIONS OF DOLLARS)

	2009 actual	2015 estimate
Social Security	\$678	\$893
Medicare	425	651
Medicaid	251	336
Unemployment compensation	119	65
Supplemental Security Income	41	52
Earned income tax credit	42	45
Child tax credit	24	26
Making work pay tax credit	<1	n/a
Food assistance	72	89
Family support	26	25
Housing assistance	10	5
General retirement and disability	8	10
Federal employee retirement and disability	118	141
Veterans benefits and services	49	84

Source: Executive Office of the President and Office of Management and Budget, 2010, *Historical Tables, Budget of the United States Government, Fiscal Year 2011*, table 8.5.

2.3 Measuring the impact of taxes and transfers on poverty and inequality

Most government operations have only a slight or indirect impact on the distribution of income. Spending on the military and other government operations, for example, probably has relatively little impact on economic inequality. Even among entitlement programs, relatively few programs are means-tested, and only about 10-15 percent of the federal budget is spent for such explicit redistribution. All in all, government tax and transfer policies currently reduce household income inequality by about 20 percent, as shown in Table 8.⁵³

⁵² For more details about the operations of these transfer programs, see, e.g., Forman, *Making America Work*, note 18, at 73-78.

⁵³ U.S. Census Bureau, 2007, *The Effects of Government Taxes and Transfers on Income and Poverty: 2005*, Current Population Report No. P60-232, March, table 3. The second column of table 5 shows U.S. Census Bureau's estimates of the market's initial distribution of household income before government taxes and transfers, by quintiles of population ("market income"). Before government taxes and transfers, the richest 20 percent American households received 53.83 percent of household income, while the poorest 20 percent received just 1.50 percent. That is a rather unequal distribution of income. The Gini index for the market distribution of household income in the United States in 2005 was a sizeable 0.493.

The third column of table 5 shows the "disposable income" shares that households end up with after government taxes and transfers in the year 2005. Taxes and transfers increased the relative share of income held by the bottom three quintiles at the expense of the share of income held by the top two quintiles, and the Gini index fell to 0.418. Similarly, Table 1, above, showed a decline in the Gini index of household income inequality in the mid2000s from 0.46 before taxes and transfers to 0.38 after taxes and transfers.

TABLE 8. SHARE OF AGGREGATE HOUSEHOLD INCOME IN THE UNITED STATES, BY QUINTILES AND THE GINI INDEX, 2005

	<i>Market income</i>	<i>Disposable income</i>
Quintiles		
Lowest	1.50	4.42
Second	7.26	9.86
Middle	14.00	15.33
Fourth	23.41	23.11
Highest	53.83	47.28
Gini Index	0.493	0.418

Source: U.S. Census Bureau, 2007, *The Effect of Taxes and Transfers on Income and Poverty in the United States: 2005*, Current Population Report No. P60-232, March, table 3.

There is some dispute about how much the U.S. tax and transfer systems affect poverty levels. Some 43.9 million Americans (14.3 percent) were poor in 2009 using the official estimate of poverty (based on money income), up from 36.5 million in 2006 (12.3 percent).⁵⁴ Based on market income, however, the Census Bureau estimated that 18.5 percent of Americans were poor before taxes and transfers in 2006.⁵⁵ After taxes and transfers, the Census Bureau estimated that just 10.2 percent of Americans had disposable income that left them in poverty that year.

On the other hand, a recent comparative study by the economist Timothy M. Smeeding found that the U.S. tax and transfer systems had more modest effects on poverty.⁵⁶ He estimated that the U.S. tax and transfer systems reduced the poverty rate of two-parent families by just 0.5 percentage points in 2000, from 13.7 to 13.2 percent. That was a mere 3.6 percent reduction in two-parent poverty rates, compared with an average reduction of 44 percent across all 11 high-income countries studied (including the United States).

3. REFUNDABLE TAX CREDITS IN OTHER COUNTRIES

3.1 Canada

Canada uses its tax system to provide child, child care, and worker benefits.⁵⁷ The Canada Child Tax Benefit (CCTB) is a tax-free monthly payment to families with

⁵⁴ U.S. Census Bureau, 2010, *Income, Poverty, and Health Insurance Coverage in the United States: 2009*, Current Population Report No. P60-238, September, p. 56 (table B-1).

⁵⁵ U.S. Census Bureau, 2007, *Annual Social and Economic (ASEC) Supplement*, table RD-REV POV01 (December 31), http://pubdb3.census.gov/macro/032007/altpov/newpov01_001.htm.

⁵⁶ T. Smeeding, 2006, 'Poor People in Rich Nations: The United States in Comparative Perspective', *Journal of Economic Perspectives*, Vol. 20 No. 1, pp. 69-90.

⁵⁷ See, e.g., OECD, Social Policy Division, Directorate of Employment, Labour and Social Affairs, 2010, *Canada 2008*, Paris, <http://www.oecd.org/dataoecd/24/3/44428674.pdf>; F. Poschmann, 2008, 'Still High: Marginal Effective Tax Rates on Low-Income Families', C.D. Howe Institute, Backgrounder No. 113, Toronto, February; J. Hacker, 2009, 'Northern Exposure: Learning from Canada's Response to Winner-Take-All Inequality', *Pathways*, Stanford Center for the Study of Poverty and Inequality, Stanford, California, Spring, pp. 24-30; National Council of Welfare, 2007, *Solving Poverty: Four Cornerstones of a Workable National Strategy for Canada*, National Council of Welfare Reports, Vol. No. 126, Ottawa, Winter, <http://www.spckington.ca/Resources/Solving%20Poverty%20Report.pdf>.

children under age 18.⁵⁸ The benefit consists of a basic benefit, a National Child Benefit Supplement, and a Child Disability Benefit. Canada is a federal system, and a variety of additional benefits are available from its provincial governments.

From July 2010 through June 2011, the basic benefit is C\$112.33 per month for each child under the age of 18, plus an additional C\$7.83 per month for the third and each additional child. The basic benefit phases out as family net income exceeds C\$40,970.⁵⁹

The National Child Benefit Supplement (NCBS) amounts are: C\$174.00 per month for the first child, C\$154.00 per month for the second child, and C\$146.50 per month for each additional child. The National Child Benefit Supplements phase out as family net income exceeds C\$23,855.⁶⁰

The Child Disability Benefit (CDB) provides up to C\$205.83 per month for each child eligible for the disability amount.⁶¹

In addition, the Universal Child Care Benefit (UCCB) pays families a taxable C\$100 per month to help cover the costs of child care for children under the age of six.⁶²

Also, the Working Income Tax Benefit (WITB) is a refundable tax credit for eligible low-income individuals and families.⁶³ It consists of a basic amount and a disability supplement. The maximum WITB for 2010 is C\$925 for single individuals with no eligible dependents, or C\$1,680 for families.⁶⁴ The additional disability supplement for each individual was C\$462.50. Eligible individuals or families are also able to apply for WITB advance payments.

Canada also provides a Refundable Medical Expense Supplement for Canadians with disabilities who enter the work force (up to C\$1,067 for 2009).⁶⁵

⁵⁸ Canada Revenue Agency, 2010, *Canada Child Tax Benefit (CCTB)*, <http://www.cra-arc.gc.ca/bnfts/cctb/menu-eng.html>; Canada Revenue Agency, 2010, *Canada Child Tax Benefits: Including related federal, provincial and territorial program*, p. 12, <http://www.cra-arc.gc.ca/E/pub/tg/t4114/t4114-10e.pdf>.

⁵⁹ Benefit phase-out rates vary depending upon the number of children. See, e.g., Canada Revenue Agency, *Canada Child Tax Benefits: Including related federal, provincial and territorial programs*, note 58, at 12.

⁶⁰ Id. at 12-13.

⁶¹ Id. at 13.

⁶² Id. at 16.

⁶³ Canada Revenue Agency, 2009, *Working Income Tax Benefit*, <http://www.cra-arc.gc.ca/E/pub/tg/rc4227/rc4227-09e.pdf>. See also A. Bibbee, *Tax Reform for Efficiency and Fairness in Canada*, OECD, Economic Department Working Paper No. 631, Paris, p. 23, <http://www.sourceoecd.org/vl=312309/cl=15/nw=1/rpsv/cgi-bin/wppdf?file=5kzfxw9hp2q4.pdf> (noting that the U.S. earned income tax credit was the “inspiration” for the WITB).

⁶⁴ Canada Revenue Agency, 2010, *WITB: Calculation and advance payment* (August 10), http://www.cra-arc.gc.ca/bnfts/wtb/fq_pymnts-eng.html. These amounts reflect the Canadian government’s recent enhancement of the WITB to help “lower the welfare wall” by reducing the average effective marginal tax rates on low-income individuals and families. Canada Department of Finance, 2009, *Canada’s Economic Action Plan: Budget 2009* (January 27), at Chapter 3, <http://www.budget.gc.ca/2009/pdf/budget-planbudgetaire-eng.pdf>.

⁶⁵ Canada Revenue Agency, 2010, *Line 452 - Refundable medical expense supplement*, <http://www.cra-arc.gc.ca/tx/ndvds/tpcs/ncm-tx/rtrn/cmptng/ddctns/lns409-485/452-eng.html>; Canada Revenue Agency, 2003, *Medical Expense and Disability Tax Credits and Attendant Care Expense Deduction*, IT519R2 (Consolidated), <http://www.cra-arc.gc.ca/E/pub/tp/it519r2-consolid/it519r2-consolid-e.pdf>.

Canada also has a refundable goods and services tax credit to offset a portion of its national value-added tax and provincial sales taxes. From July 2010 to June 2011, the basic credit is \$250 for a taxpayer, plus another \$250 for a spouse or common-law partner, and C\$131 for each child.⁶⁶ The credit phases out as family net income exceeds C\$32,506. The credit is calculated on the prior year's income and is paid out quarterly.

3.2 United Kingdom

The United Kingdom uses its tax system to provide child, child care, and worker benefits.⁶⁷ The Child Benefit is a tax-free benefit for each child (under 16) or qualifying young person (16-19 and in school full-time) they are responsible for.⁶⁸ From April 5, 2010 on, the weekly benefit is £20.30 per week for the oldest child and £13.40 per week for other children. Child benefits are paid by the Child Benefit Office of HM Revenue & Customs. Benefits are usually direct deposited into the mother's bank account every four weeks.

A Child Tax Credit is also available to low-income families. From April 5, 2010 on, the basic family element is £545 per year for each family with responsibility for one or more children, plus £2,300 for each child, but extra amounts are paid for children that are under age one or disabled. The amount of the Child Tax Credit depends on circumstances and income, but it is available to those with quite high incomes, including those with incomes of over £50,000 a year.

The Working Tax Credit supplements the earnings of low-income workers. From April 5, 2010 on, the basic working tax credit is £1,920 per year if the taxpayer is 16 or over, works more than 16 hours a week, and is responsible for a child.⁶⁹ The Working Tax Credit is also available to individuals without children if they are disabled and work at least 16 hours a week, are over 50 and recently started work, or

⁶⁶ Canada Revenue Agency, 2010, *GST/HST Credit Including related provincial credits and benefits*, <http://www.cra-arc.gc.ca/E/pub/tg/rc4210/rc4210-10e.pdf>.

⁶⁷ See, e.g., OECD, Social Policy Division, Directorate of Employment, Labour and Social Affairs, 2010, *United Kingdom 2008*, Paris, <http://www.oecd.org/dataoecd/25/0/44429259.pdf>; P. Whiteford, M. Mendelson and J. Millar, 2003, *Timing it right? Tax credits and how to respond to income changes*, Joseph Rowntree Foundation, York, UK, <http://www.jrf.org.uk/sites/files/jrf/1859351107.pdf>; P. Gregg, S. Harkness and S. Smith, 2009, 'Welfare Reform and Lone Parents in the UK', *Economic Journal*, Vol. 119 No. 2, pp. F38-F65; M. Francesconi, H. Rainer and W. van der Klaauw, 2009, 'The Effects of In-Work Benefit Reform in Britain on Couples: Theory and Evidence', *Economic Journal*, Vol. 119 No. 2, pp. F66-100; D. Phillips, 'Chapter 14: The impact of tax and benefit reforms to be implemented in April 2008', in R. Chote, C. Emmerson, D. Miles and J. Shaw (Eds), *Green Budget 2008*, Institute for Fiscal Studies London, pp. 268-288.

⁶⁸ Citizens Advice Bureau, 2010, *Adviceguide: Benefits – In England: Benefits for families and children*, London, http://www.adviceguide.org.uk/index/life/benefits/benefits_for_families_and_children.htm#benefits_for_children; HM Revenue & Customs, *Rates and Allowances - Tax Credits/Child Benefit*, <http://www.hmrc.gov.uk/rates/taxcredits.htm>; HM Revenue & Customs, *What is Child Benefit and who qualifies?*, <http://www.hmrc.gov.uk/childbenefit/start/who-qualifies/index.htm>; HM Revenue & Customs, 2010, *A guide to Child Tax Credit and Working Tax Credit (2010)*, <http://www.hmrc.gov.uk/leaflets/wtc2.pdf>.

⁶⁹ Citizens Advice Bureau, 2010, *Adviceguide: Benefits – In England: Benefits and tax credits for people in work*, London, http://www.adviceguide.org.uk/index/life/benefits/benefits_and_tax_credits_for_people_in_work.htm#working_tax_credit; HM Revenue & Customs, 2010, *Working Tax Credit – Help with the costs of childcare*, <http://www.hmrc.gov.uk/leaflets/wtc5.pdf>.

are over 25 and work at least 30 hours a week. Additional Working Tax Credit amounts are also available for child care. Taxpayers can get up to 80 percent of what they pay for child care, up to a maximum of £140 per week for one child or £240 per week for two or more children. The Working Tax Credit is reduced for those whose income exceeds £6,420 per year.

3.3 Australia

Australia also uses its tax system to provide child and child care benefits, although most benefits are now provided through Family Assistance Offices located in Medicare Offices and Centrelink Customer Service Centers across the country.⁷⁰ The basic family tax benefit Part A is designed to help with the cost of raising dependent children. It is available for dependents under 21 years and for older dependent children, aged 21 to 24 years, who are studying full time. Table 9 sets forth the maximum rates for the family tax benefit Part A. In general, if family income exceeds A\$45,114 per year, the family tax benefit is reduced by 20 percent of the excess until it reaches the base rate in Table 9. Finally, if family income exceeds A\$94,316 per year (plus A\$3,796 for each family tax benefit after the first), the family tax benefit is reduced by 30 percent of the excess until it reaches zero.

The family tax benefit Part B provides extra assistance to single-parent families and to two-parent families with one main income where one parent chooses to spend most of her time caring for their children.⁷¹ Table 10 shows the maximum rate of family tax benefit Part B. The benefit is reduced if the higher income earner in a couple, or a single parent, has an income of A\$150,000 per year or more. For two-parent families, the lower earner can have up to A\$4,672 each income year and still receive the maximum benefit.

Family tax benefits can be paid fortnightly to a bank or other financial institution, or as an annual lump sum; however, the option of claiming and receiving an annual lump sum payment through the Australian Taxation Office ceased on July 1, 2009.⁷²

⁷⁰ See, e.g., OECD, Social Policy Division, Directorate of Employment, Labour and Social Affairs, 2010, *Australia 2008*, Paris, <http://www.oecd.org/dataoecd/9/27/44411991.pdf>; Australian Government Centrelink, 2010, *A guide to Australian Government payments*, [http://www.centrelink.gov.au/internet/internet.nsf/filestores/co029_1007/\\$file/co029_1007en.pdf](http://www.centrelink.gov.au/internet/internet.nsf/filestores/co029_1007/$file/co029_1007en.pdf); H. Hodgson, 'Not-so-distant cousins: Family benefits in the United Kingdom and Australia', 2008, *International Social Security Review*, Vol 61 No. 3, pp. 29-46; H. Hodgson, 2005, 'An Historical Analysis of Family Payments in Australia: Are They Fair or Simple?', *Journal of the Australasian Tax Teachers Association*, Vol. 1 No. 2, pp. 318-345 (concluding that despite many reforms, the Australian system is neither equitable nor simple); J. Humphreys, 2005, *Reform 30/30: Rebuilding Australia's Tax and Welfare Systems*, Centre for Independent Studies, Policy Monograph No. 70, St. Leonards, New South Wales, Australia, http://www.cis.org.au/policy_monographs/pm70.pdf.

⁷¹ Australian Government Centrelink, *A guide to Australian Government payments*, note 70, at 4.

⁷² Australian Government, Family Assistance Office, 2010, *Family Assistance Office Guide to Payments*, p. 5, http://www.familyassist.gov.au/resources/documents/FPR006_1007_01714_FAWeb%20July%202010_APPROVED.pdf.

TABLE 9. FAMILY TAX BENEFIT PART A, AS OF JULY 1, 2010

<i>Maximum rates</i>		
<i>For each child</i>	<i>Per fortnight</i>	<i>Per year</i>
Aged under 13 years	A\$160.30	A\$4,905.60
Aged 13-15 years	A\$208.46	A\$6,161.20
Aged 16-17	A\$ 51.24	A\$2,062.25
Aged 18-24	A\$ 68.24	A\$2,518.50
In an approved care organization aged 0-24 years	A\$ 51.24	A\$1,335.90
<i>Base rates</i>		
<i>For each child</i>	<i>Per fortnight</i>	<i>Per year</i>
Aged under 18 years	A\$51.24	A\$2,062.25
Aged 18-24	A\$68.74	A\$2,518.50

Source: Australian Government Centrelink, 2010, *A guide to Australian Government payments*, p. 2, [http://www.centrelink.gov.au/internet/internet.nsf/filestores/co029_1007/\\$file/co029_1007en.pdf](http://www.centrelink.gov.au/internet/internet.nsf/filestores/co029_1007/$file/co029_1007en.pdf).

TABLE 10. FAMILY TAX BENEFIT PART B, AS OF JULY 1, 2010

<i>Maximum rates</i>		
<i>Age of youngest child</i>	<i>Per fortnight</i>	<i>Per year</i>
Under 5 years	A\$136.36	A\$3,909.15
5-15 years (or 16-18 years if a full-time student)	A\$ 95.06	A\$2,832.40

Source: Australian Government Centrelink, 2010, *A guide to Australian Government payments*, p. 4, [http://www.centrelink.gov.au/internet/internet.nsf/filestores/co029_1007/\\$file/co029_1007en.pdf](http://www.centrelink.gov.au/internet/internet.nsf/filestores/co029_1007/$file/co029_1007en.pdf).

Australia also provides a tax-free baby bonus to families with incomes under A\$75,000 in the six months following the birth of a child.⁷³ Effective from July 1, 2010, the baby bonus is A\$5,294 per eligible child paid in 13 fortnightly installments. The baby bonus is not paid through the tax system but is instead a non-taxable payment made into a bank account.

Australia also helps most families pay for child care through an income-tested Child Care Benefit (CCB) (up to A\$184.00 for a 50 hour week) or through a Child Care Rebate (50 percent of out-of-pocket child care expenses for approved care, up to A\$7,778 for 2009-2010).⁷⁴

Of note, the Australian Government is in the midst of a comprehensive review of its tax and transfer system, and major changes could be enacted in coming years.⁷⁸ To be

⁷³ Australian Government Centrelink, *A guide to Australian Government payments*, note 70, at 5.

⁷⁴ Id. at 5-6.

⁷⁸ In 2008, the Australian Government established Australia's Future Tax System Review panel to examine Australia's tax and transfer system and to make recommendations to deal with the demographic, social, economic and environmental challenges that it faces. See generally Treasury of the Australian Government, 2010, *Australia's future tax system*, <http://taxreview.treasury.gov.au/Content/Content.aspx?doc=html/home.htm>; see also Australia's Future Tax System Review Panel, 2008, *Architecture of Australia's Tax and Transfer System*, http://taxreview.treasury.gov.au/content/Paper.aspx?doc=html/publications/papers/report/section_1-02.htm. The Review panel prepared detailed background reports, received more than 1,500 submissions, held a two-day conference in June 2009, and delivered its final report to the Australian

sure, Australian Professors Chris Evans and Richard Krevor note that “Experience suggests that tax reviews rarely lead to successful tax reform,” even as they acknowledge that “Tax Reform in Australia is necessary and overdue.”⁷⁹ In that regard, the government’s initial response, in particular its controversial proposal for tax increases on mining companies, almost certainly played a role in the recent resignation of Prime Minister Kevin Rudd of the Labor party and in his Labor party successor, Prime Minister Julia Gillard, barely being able to form a government after the recent national election.⁸⁰

3.4 Other developed countries

Many other countries also use tax credits to provide benefits for individuals and families.⁸¹ For example, since 2001, France has a tax credit for low-wage workers, the “Prime Pour l’Emploi” (PPE).⁸² The average credit was around €558 in 2003. The Swedish government introduced a nonrefundable in-work credit in 2007 and has extended it several times since.⁸³

4. PROBLEMS AND BEST APPROACHES

This Part discusses some of the problems with using tax credits for redistribution and the best approaches for dealing with those problems.

Government in December 2009. See Australia’s Future Tax System Review Panel, 2010, *Papers* (including the *Final Report*),

http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/pubs_reports.htm. In May 2010, the Government released the Review panel’s *Final Report* and its own initial response, calling for a number of tax and transfer reforms. Australian Government, 2010, *A tax plan for our future: Simple, Fairer, Stronger*, <http://www.futuretax.gov.au/pages/default.aspx>.

⁷⁹ C. Evans and R. Krevor, 2009, ‘Tax Reviews in Australia: A Short Primer’, in C. Evans and R. Krevor (Eds), *Australian Business Tax Reform in Retrospect and Prospect*, The Institute of Chartered Accountants in Australia, Thomson Reuters, London, pp. 3-13, at 12.

⁸⁰ See, e.g., CNN Wire Staff, 2010, ‘Australia’s Gillard cuts deal with mining companies on taxes’, *CNN World*, July 2, <http://www.cnn.com/2010/WORLD/asiapcf/07/01/australia.mining.tax/index.html>; The Diplomat, 2010, ‘Election Special: Australia August 21st, 2010: Top Candidate Profiles’, <http://the-diplomat.com/australian-election-2010/category/candidate-profiles>.

⁸¹ See, e.g., OECD, ‘OECD Family Database’, PF3(Family cash benefits), note 5.

⁸² H. Sinn, C. Holzner, W. Meister, W. Ochel and M. Werding (Eds), 2006, *Redesigning the Welfare State: Germany’s Current Agenda for an Activating Social Assistance*, Edward Elgar Press, Northampton, Massachusetts, at pp. 58-60 (Figure 3.6), [http://vosdroits.service-public.fr/F2882.xhtml](http://books.google.com/books?id=yiqhs1dXrC8C&dq=redesigning+the+welfare+state&printsec=frontcover&source=bl&ots=t-mOITj5Xa&sig=zxTnyzWxoT-Xu-J-06UepN5Dghw&hl=en&ei=EGtbSqHGFircNfCd_UI&sa=X&oi=book_result&ct=result&resnum=1; Service-Public.fr, 2010, ‘Prime pur l’emploi (PPE)’, <a href=); A. Knabe and R. Schöb, 2008, *Minimum Wages and their alternatives: A Critical Assessment*, Center for Economic Studies, CESifo Working Paper No. 2494, Munich, December, http://www.cesifo-group.de/portal/page/portal/ifoHome/b-publ/b3publwp/wp_by_number?p_number=2494.

⁸³ See, e.g., R. Aaberge and L. Flood, 2008, *Evaluation of an In-Work Tax Credit Reform in Sweden: Effects on Labor Supply and Welfare Participation of Single Mothers*, Institute for the Study of Labor (IZA), Discussion Paper No. 3,736, Bonn, September; Government Offices of Sweden, 2008, ‘The budget for 2009: Putting Sweden to work – safeguarding welfare’, Press release, September 22, <http://www.regeringen.se/sb/d/10213/a/111839>; see also Government Offices of Sweden, 2009, ‘The budget for 2010: Working Sweden out of the crisis’, Press release, September 20, <http://www.sweden.gov.se/sb/d/11760/a/132080>.

4.1 Providing benefits through social welfare or tax systems

As an initial matter, policymakers need to decide what benefits to provide. The next decision is whether to provide those benefits through a social welfare program or through the tax system. The answer to this question will vary greatly from country to country because of differing economic, cultural, and political concerns—and because of historical accidents.

Social welfare programs can provide both means-tested benefits (like food stamps in the U.S.) or more universal benefits (like social security). Tax systems typically provide benefits in the form of tax credits and other “tax expenditures.”⁸⁴ These, too, can be “means-tested” by using tax return information about income and family status (like the U.S. earned income tax credit), or they can be relatively universal (like the U.S. personal exemption allowance).

As a practical matter, since tax systems typically work on annual reporting systems, they are simply not capable of providing short-term emergency assistance. Instead, local welfare agencies typically must be the ones to provide that immediate assistance.

On the other hand, nearly universal benefits like family allowances could be provided by either social welfare programs or tax expenditures. Most social security systems are very efficient at providing benefits. For example, in 2009, the U.S. Social Security system paid out more than \$557 billion in benefits to more than 42 million Old-Age and Survivors Insurance program beneficiaries, and the administrative expenses for that program came in at just 0.6 percent of total expenditures.⁸⁵ To be sure, the administrative expenses associated with distributing disability benefits or means-tested benefits, as opposed to universal benefits are significantly higher. For example, the administrative expenses for the U.S. Social Security disability program were 2.3

⁸⁴ So-called “tax expenditures” are spending programs channeled through the tax system. Under a theoretically pure income tax, individuals would pay tax on the sum of the wages, interest, dividends, and other forms of economic income that they earn. Of course, most income taxes deviate from this pure income tax ideal in a number of ways. In the United States, for example, the Congressional Budget and Impoundment Act of 1974 (Public Law No. 93-344) requires the federal government to keep track of the revenue “lost” as a result of deviations from an ideal income tax through tax expenditure budgets prepared annually by the Office of Management and Budget (OMB) and the Joint Committee on Taxation. See, e.g., Executive Office of the President and Office of Management and Budget, 2010, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2011*, Chapter 16, ‘Tax Expenditures’, pp. 207-243; Joint Committee on Taxation, 2010, *Estimates of Federal Tax Expenditures for Fiscal Years 2009-2013*, JCS-1-10 (January 11). See also U.S. Senate Committee on the Budget, 2008, *Tax Expenditures: Compendium of Background Materials on Individual Provisions*, Senate Print No. 110-667, 110th Congress, 2d Session, December.

The Congressional Budget and Impoundment Act of 1974 defines tax expenditures as “those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.” Public Law No. 93-344, at § 3(a)(3).

The Congressional Budget Act of 1974 does not, however, actually specify the ideal structure of a tax law, so deciding which provisions are special or preferential is necessarily a matter of judgment, over which there is often much debate. See, e.g., B. Bittker, 1969, ‘Accounting for Federal “Tax Subsidies” in the National Budget’, *National Tax Journal*, Vol. 22 No. 2, June, pp. 244-261; S. Surrey, and W. Hellmuth, 1969, ‘The Tax Expenditure Budget B Response to Professor Bittker’, *National Tax Journal*, Vol. 22 No. 4, December, pp. 528-537; B. Bittker, 1969, ‘The Tax Expenditure Budget B A Reply to Professors Surrey and Hellmuth’, *National Tax Journal*, Vol. 22 No. 4, December, pp. 538-542.

⁸⁵ Board of Trustees, Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, note 38, at 23, 32, 53.

percent of total expenditures in 2009,⁸⁶ meanwhile, the administrative costs associated with the U.S. Supplemental Nutrition Assistance Program (SNAP, previously known as food stamps) run around 15.8 percent of benefits issued.⁸⁷

Of course, taxing authorities are also fairly efficient at dealing with millions of individuals, at least when it comes to collecting taxes. For example, in fiscal year 2008, the Internal Revenue Service (IRS) handled more than 250 million tax returns and collected more than \$2.3 trillion in taxes, all while spending an average of just 50 cents for each \$100 of revenue.⁸⁸ Each year, the IRS processes some 142 million individual income tax returns—claiming more than 282 million personal exemptions.⁸⁹ That puts the IRS in direct contact with nearly the entire population of the United States (310 million in 2010).⁹⁰ Also of note, 22.3 million individual income tax returns claimed the earned income tax credit for the 2008 tax year, and 26.0 million claimed the child tax credit.⁹¹

Dependent care and health care benefits, too, could be provided either through social welfare programs or through tax expenditures. The United States, for example, offers both child care financial assistance for certain low-income families and a more widely utilized dependent care tax credit.⁹²

The United States also uses both appropriations and tax expenditures for health care.⁹³ In addition to Medicare and Medicaid, the current exclusion for employer contributions for medical insurance premiums and medical care is one of the largest tax expenditures (\$160-billion in Fiscal Year 2010).⁹⁴ Pertinent here, President Barack Obama's new national health care legislation provides relies heavily on new tax credits to help individuals and small employers pay for health care coverage.⁹⁵

⁸⁶ Id. at 32.

⁸⁷ J. Isaacs, 2009, *The Costs of Benefit Delivery in the Food Stamp Program: Lessons From a Cross-Program Analysis*, United States Department of Agriculture, Contractor and Cooperator Report No. 29, pp. vi, 8
http://www.brookings.edu/~media/Files/rc/reports/2008/03_food_stamp_isaacs/03_food_stamp_isaacs.pdf.

⁸⁸ Internal Revenue Service, 2010, *Data Book, 2009*, March, at 4 (table 23), 66 (table 29).

⁸⁹ Internal Revenue Service, 2010, *Individual Income Tax Returns 2008*, IRS Publication No. 1304, at 89 (table 2.3).

⁹⁰ According to the U.S. Census Bureau, the resident population of the United States projected to November 28, 2010, at 14:37 UTC (EST+5) was 310,804,836. U.S. Census Bureau, 2010, *U.S. POPClock Projection* (November 28), <http://www.census.gov/population/www/popclockus.html>.

⁹¹ Internal Revenue Service, 2010, *Individual Income Tax Returns 2008*, note 89, at 8-9 (table A).

⁹² Forman, *Making America Work*, note 18, at 170-171.

⁹³ Id. at 243-261.

⁹⁴ Executive Office of the President and Office of Management and Budget, note 84, at 209, 211 (table 16-1).

⁹⁵ Starting in 2010, certain small employers that purchase health insurance for their employees can claim a new tax credit (I.R.C. § 45R), and starting in 2014, certain low- and moderate-income individuals will qualify for a new premium assistance tax credit (I.R.C. § 36B). See, e.g., E. Zelinsky, 2010, 'The Health-Related Tax Provisions of PPACA and HCERA: Contingent, Complex, Incremental and Lacking Cost Controls', http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1633556; A. Nevus, 2010, 'Health Care Reform Reshapes Tax Code', *Journal of Accountancy* (April 1), <http://www.journalofaccountancy.com/Issues/2010/May/20102731.htm>; 'Tax Provisions in the Health Care Act', 2010, *Journal of Accountancy* (March 22), <http://www.journalofaccountancy.com/Web/20102724.htm>; Henry J. Kaiser Family Foundation, 2010, 'Focus on Health Care: Summary of New Health Reform Law',

All in all, social welfare benefits can be efficiently distributed by either a social welfare agency or a taxing authority.⁹⁶ These days, however, the pendulum is swinging towards refundable tax credits and away from social welfare agencies. It turns out that, in many countries, it is easier to enact new tax expenditures than new spending programs. For example, in the United States, new tax credits and other tax expenditures are treated as tax cuts—and everyone likes tax cuts; meanwhile, new welfare programs are typically counted as new spending.⁹⁷ Not surprisingly, over the past few decades, tax credits and other tax expenditures have grown dramatically as a percentage of the U.S. gross domestic product, and these now represent a very large part of U.S. government spending.⁹⁸

4.2 High Marginal Tax Rates

Another problem that policymakers need to be sensitive to is the problem of high marginal tax rates. Particular attention needs to be paid to the coordination of tax systems with other transfer programs as it is the cumulative marginal tax rates on the earnings of low-wage workers that will affect their decisions about labor supply and work effort.⁹⁹ So it is not enough just to keep the *tax system's* marginal tax rates low; the cumulative effective marginal rates that result from the combination of tax rates and benefit-reductions must be kept low.

For example, in the United States, a 2004 report by the House Committee on Ways and Means identified 85 programs that provide income-tested welfare benefits to low-income families.¹⁰⁰ To keep costs down, virtually every one of these programs phases benefits out as family income increases. Unfortunately, these phase-outs often combine with income and payroll taxes to subject beneficiaries to confiscatory tax rates.¹⁰¹ See Figure 2.

<http://www.kff.org/healthreform/upload/8061.pdf>; White House, 2010, 'Small Business Health Care Tax Credit', <http://www.whitehouse.gov/healthreform/small-business/tax-credit>; 'Tax Credit for Employee Health Insurance Expenses of Small Employers', Notice 2010-44, 2010-22 *Internal Revenue Bulletin* 717.

⁹⁶ See also D. Weisbach and J. Nussim, 2004, 'The Integration of Tax and Spending Programs', *Yale Law Journal*, Vol. 113 No. 5, March, pp. 955-1028; P. Haan and K. Wrohlich, 2007, *Optimal Taxation: The Design of Child Related Cash- and In-Kind-Benefits*, Institute for the Study of Labor (IZA), Discussion Paper No. 3,128, Bonn, October; M. Kornhauser 'Cognitive Theory and the Delivery of Welfare Benefits', *Loyola University Chicago Law Journal*, Vol. 40 No. 2, Winter, pp. 253-296.

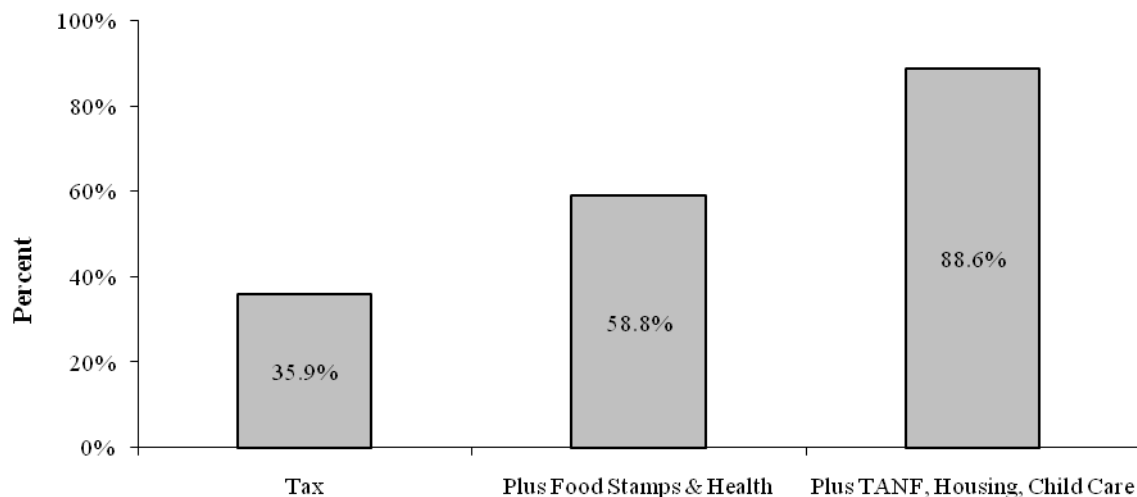
⁹⁷ See, e.g., E. Kleinbard, 2009, The Congress Within a Congress: How Tax Expenditures Distort Our Budget and Our Political Processes, *Ohio Northern University Law Review*, Vol. 36 No. 1, pp. 1-30; R. Altshuler and R. Dietz, 2008, *Reconsidering Tax Expenditure Estimation: Challenges and Reforms*, National Bureau of Economic Research, Working Paper No. 14,263, Cambridge, Massachusetts,. See also Joint Committee on Taxation, 2008, *A Reconsideration of Tax Expenditure Analysis*, JCX-37-08 (May 12).

⁹⁸ See, e.g., L. Burman, C. Geissler and E. Toder, 2008, 'How Big Are Total Individual Income Tax Expenditures, and Who Benefits from Them?', *American Economic Review: Papers and Proceedings* Vol. 98 No. 2, pp.79-83.

⁹⁹ Work disincentives can be especially large when redistribution "takes the form of paying subsidies to people who are not working." OECD, *Growing Unequal? Income Distribution and Poverty in OECD Countries*, note 4, at 306.

¹⁰⁰ U.S. House of Representatives, Committee on Ways and Means, 2004 *Green Book: Background Material and Data on Programs within the Jurisdiction of the Committee on Ways and Means* (2004), K-10—K-12.

¹⁰¹ A. Carasso & C. Steuerle, 2005, 'The True Tax Rates Confronting Families with Children', *Tax Notes*, Vol. 109 (October 10), p. 253. At some points between \$10,000 and \$25,000 of income, the cumulative

FIGURE 2: AVERAGE CUMULATIVE TAX RATES CONFRONTING LOW-TO-MODERATE-INCOME FAMILIES (\$10K - \$40K).

Source: Carasso, A., and C. E. Steuerle, 2005, 'The True Tax Rates Confronting Families with Children', *Tax Notes*, Vol. 109 (October 10), p. 253.

The solution to the problem of high cumulative tax rates is to better integrate a country's tax and transfer systems.¹⁰² To be sure, there are tremendous obstacles to achieving coordination, let alone integration, among current social welfare programs and tax provisions. The sheer number of agencies, organizations, and legislative committees involved in administering and overseeing the tax and transfer systems in most countries makes even simple coordination efforts difficult, let alone synchronization and integration efforts. Still, in the short-term, policymakers need to identify overlapping programs and work to achieve better coordination among them. And in the long-run, policymakers should struggle to achieve a fully integrated tax and transfer system.

4.3 Marriage penalties

The interaction of a country's tax and transfer system with marriage can also present problems.¹⁰³ Because marriage results in the pooling of income by a husband and

tax rate on a single parent can even exceed 100 percent. D. Shaviro, 1997, 'The Minimum Wage, the Earned Income Tax Credit, and Optimal Subsidy Policy', *University of Chicago Law Review*, Vol. 64 No. 2, pp. 405-481. See also L. Kotlikoff and D. Rapson, 2006, 'Does it pay, at the margin, to work and save? Measuring effective marginal tax rates on Americans' labor supply and saving', National Bureau of Economic Research, Working Paper No. 12,533, Cambridge, Massachusetts; See also Poschmann, note 57 (discussing high cumulative marginal tax rates in Canada); Bibbee, note 63, at 24 (finding that marginal effective tax rates can reach 100 percent for families on social assistance in Canada).

¹⁰² See, e.g., J. Forman, 1993, 'Administrative Savings from Synchronizing Social Welfare Programs and Tax Provisions', *Journal of the National Association of Administrative Law Judges*, Vol. 13 No. 1, pp. 5-76.

¹⁰³ See, e.g., J. Forman, 1996, 'What Can Be Done About Marriage Penalties?', 30 *Family Law Quarterly*, Vol. 30, pp. 1-22; J. Kesselman, 2008, 'Income Splitting and Joint Taxation of Couples:

wife, marriage can often result in “marriage penalties” and “bonuses” that can affect marriage incentives and family well-being. There is probably relatively little need overall to worry about the occasional marriage bonus for low-income welfare recipients, as marriage is often a way out of poverty. On the other hand, policymakers should be concerned about marriage penalties. Promoting marriage—or, at least, not discouraging it—could help reduce poverty and promote greater economic justice.

In the United States, for example, marriage plays a significant role in both the tax and transfer systems. Within the tax system, some of the largest marriage bonuses and penalties are those associated with the earned income tax credit. In 2010, for example, if a woman with no income and two children marries a childless man with \$15,000 of earned income, the couple will get a marriage bonus or more than \$7,000, as together they will now be eligible for an earned income tax credit of \$5,036, two \$1,000 child tax credits, and an \$800 making work pay tax credit (up from just \$400).¹⁰⁴ On the other hand, if a single father with two children and \$15,000 of earnings marries a single mother with two children and \$15,000 of earnings, the couple will face a hefty marriage penalty. Before that marriage, each individual could claim a \$5,036 earned income tax credit; but after the marriage, the couple is eligible for a single earned income tax credit of just \$3,867.¹⁰⁵

Perhaps the best way to solve the problem of marriage penalties and bonuses is to base tax rates, tax credits, and welfare benefits on individual income rather than family income. In the United States, for example, there is generally no marriage penalty associated with the new making work pay tax credit. Single workers can typically claim a \$400 credit, while married couples can typically claim an \$800 credit.¹⁰⁶

4.4 Administrative problems

Refundable tax credit regimes also present a variety of administrative problems.

4.4.1 Participation, noncompliance, and simplification

Taxing authorities want to maximize participation by eligible beneficiaries while minimizing overpayments. The complexity of most refundable tax credit regimes, however, works against achieving either result. Moreover, as collecting taxes is the core mission of taxing authorities, they can find it awkward to instead be called upon

What’s Fair?’, *Choices*, Vol. 14 No. 1, Institute for Research on Public Policy, Montreal, <http://www.irpp.org/choices/archive/vol14no1.pdf>; H. Hodgson, 2008, ‘More than Just DNA – Tax, Welfare and the Family: An examination of the concept of family in the Tax Transfer system, with particular reference to family benefits’, *Australian Journal of Social Issues*, Vol. 43 No. 4, Summer, pp. 601-614.

¹⁰⁴ See also C. Renshaw and K. Milani, 2009, ‘Penalizing Marriage: A Persistent Problem for the Working Poor’, *Tax Notes*, Vol. 125 (October 19), p. 329.

¹⁰⁵ $\$3,867.48 = \$5,666 - .2106 \times (\$30,000 - \$21,460)$.

¹⁰⁶ On the other hand, there can be a small marriage bonus. For example, when a single worker marries a nonworker, the making work pay tax credit can increase from \$400 before marriage to \$800 after marriage. To avoid both marriage penalties and bonuses, the credit should be structured as a \$400 per worker credit. High-income couples can also face marriage penalties in the phase-out range for the credit.

to make payments that exceed the amount of taxes owed. In short, both participation and noncompliance are problems for tax credit regimes.¹⁰⁷

With respect to participation, for example, the U.S. Government Accounting Office found that some 4.3 million eligible households fail to claim the earned income tax credit in a typical year.¹⁰⁸ On the other hand, with respect to noncompliance, the U.S. Treasury Inspector General for Taxation Administration estimates that approximately 25 percent of earned income tax credit payments are attributable to overclaims (\$10 to \$12 billion erroneous earned income tax credit payments out of \$43.7 billion total claims for the 2006 tax year).¹⁰⁹ Needless to say, even before the American Recovery and Reinvestment Act of 2009 expanded the universe of refundable tax credits, the IRS faced significant challenges in the administration of refundable tax credits.¹¹⁰ The Act exacerbated those challenges, and it is no wonder that the IRS National Taxpayer Advocate recently highlighted the administrative challenges posed by refundable tax credits in her annual report to the U.S. Congress.¹¹¹

Obviously, simplification of a country's refundable tax credit regime would greatly improve both participation and compliance. In particular, it would make sense to eliminate complex eligibility requirements and simplify or eliminate the income phase-outs. Simplification of a country's tax credit regime will probably work best if

¹⁰⁷ To be sure, participation and compliance probably present even greater problems for traditional welfare programs. See, e.g., J. Currie, 2006, 'The Take-Up of Social Benefits', in A. Auerbach, D. Card and J. Quigley (Eds), *Poverty, the Distribution of Income, and Public Policy*, Russell Sage Foundation, New York, pp. 80-148.

¹⁰⁸ U.S. Government Accounting Office, 2001, *Earned Income Tax Credit Eligibility and Participation*, GAO-02-290R.

¹⁰⁹ Treasury Inspector General for Taxation Administration, 2008, *The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments*, Reference No. 2009-40-024 (December 31), at 1, <http://www.treas.gov/tigta/auditreports/2009reports/200940024fr.pdf>. To be sure, not all overclaims are due to fraud. The earned income tax credit eligibility rules are complicated, and approximately one-third of earned income tax credit claimants each year are intermittent or first-time claimants who, no doubt, have difficulty understanding the complicated eligibility rules. Id. at 2. See also L. Book, 2002, 'The IRS's EITC Compliance Regime: Taxpayers Caught in the Net', *Oregon Law Review*, Vol. 81 No. 2, Summer, pp. 351-428; J. Infranca, 2008, 'Note: The Earned Income Tax Credit as an Incentive to Report: Engaging the Informal Economy through Tax Policy', *New York University Law Review*, Vol. 83 No. 1, April, pp. 203-238. To be sure, both refundable tax credits and welfare benefits provide opportunities for fraud. See, e.g., M. Halla and F. Schneider, 2008, *Taxes and Benefits: Two Distinct Options to Cheat on the State?*, Institute for the Study of Labor (IZA), Discussion Paper No. 3,536, Bonn, June.

¹¹⁰ Pertinent here, in 2003, the IRS announced plans to require precertification of certain individuals claiming the earned income tax credit. See, e.g., U.S. General Accounting Office, 2003, *Earned Income Credit: Qualifying Child Certification Test Appears Justified, but Evaluation Plan Is Incomplete*, GAO-03-794; C. Scott, 2007, *The Earned Income Tax Credit (EITC): Legislative Issues*, Congressional Research Service, Report for Congress No. RS21477 (July 17), at 3; J. Bird-Pollan, 2009, 'Who's Afraid of Redistribution? An Analysis of the Earned Income Tax Credit', *Missouri Law Review*, Vol. 74 No. 2, Spring, pp. 251-285, at 276-77. Under the precertification plan, before filing their returns, certain "higher risk" taxpayers would have been required to prove their relationships with any children they were claiming for the earned income tax credit and the residency of those children. The precertification initiative generated a lot of criticism and never got past the pilot study stage. Marguerite Casey Foundation, 2005, 'The Earned Income Tax Credit: Analysis and Proposals for Reform', *Tax Notes*, Vol. 109 (December 26), pp. 1,669-1,686, at 1,673-1,674.

¹¹¹ National Taxpayer Advocate, 2009, *Report to Congress: Fiscal Year 2010 Objectives*, at xix-xxiii. See also N. Duarte, 2009, 'Refundable Credits Force IRS to Implement Social Policy', *Tax Notes*, Vol. 123 (May 26), p. 988.

it is coordinated with simultaneous simplification of the country's tax system, at least simplification for low- and moderate-income taxpayers.¹¹²

In that regard, many analysts suggest moving towards having just two principal types of refundable tax credits: a family tax credit and a worker tax credit.¹¹³ Elsewhere, I have suggested that we could replace most of the U.S. tax and transfer system with an even simpler system—one with a *per person* tax credit and a *per worker* tax credit, and no phaseouts.¹¹⁴ For example, imagine a simple, integrated tax and transfer system with \$2,000 per person refundable tax credits, \$2,000 per worker refundable earned income credits (computed as 20 percent of the first \$10,000 of earned income), and two tax rates: 20 percent of the first \$50,000 of income and 35 percent on income above \$50,000. Assume further that there is no phaseout of either the personal tax credits or the worker credits. To keep tax rates this low, the system would not have many other credits or deductions.

Table 11 shows how such an integrated tax and transfer system would work for single parents with two children making from \$0 to \$200,000, and Figure 3 illustrates how this system would affect those families' post-tax, post-transfer incomes. For example, a single parent earning \$10,000 a year would be entitled to three \$2,000 personal tax credits and a \$2,000 worker credit. She would owe \$2,000 in taxes on her \$10,000 of pre-transfer earnings, and that would leave her with a \$16,000 disposable income after taxes and transfers.

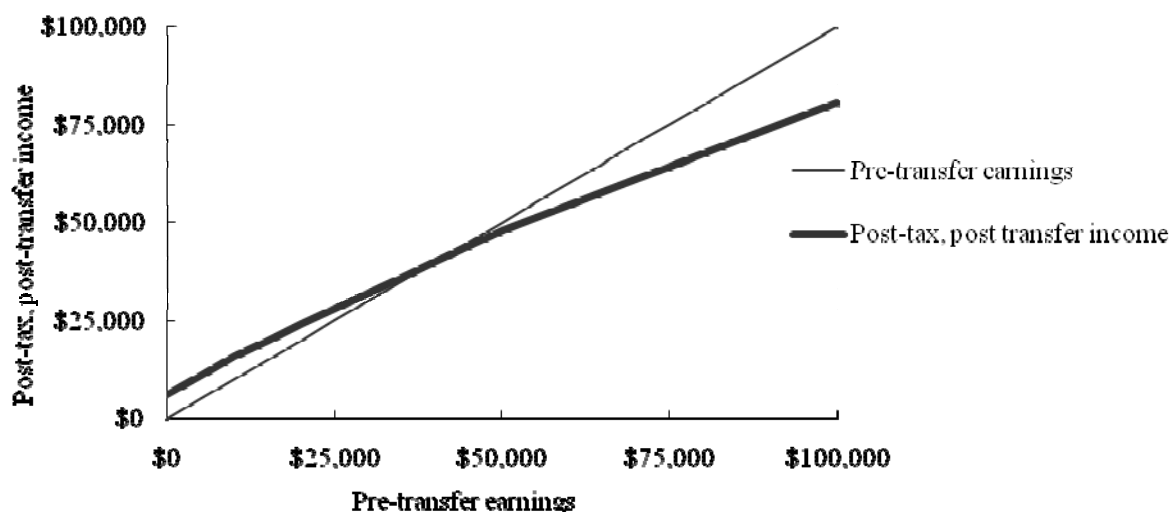
¹¹² See, e.g., President's Economic Recovery Advisory Board, 2010, *The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation*, August, at 4-24; J. Forman, 2001, 'Simplification for Low Income Taxpayers: 2001', in Joint Committee on Taxation, 2001, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, Vol. 3, pp. 10, 14-18, <http://www.house.gov/jct/s-3-01vol3.pdf>; N. Wilson-Rogers and D. Pinto, 2009, 'Tax Reform: A Matter of Principle? An Integrated Framework for the Review of Australian Taxes', *eJournal of Tax Research*, Vol. 7 No. 1, June, pp. 72-105; Commonwealth of Australia, 2008, *Australia's future tax system: Consultation paper*, December, http://www.taxreview.treasury.gov.au/content/ConsultationPaper.aspx?doc=html/Publications/Papers/Consultation_Paper_Summary/index.htm; OECD, 2008, *Economic Survey of Canada 2008*, Paris (June 11), Chapter 3, 'Tax reform for efficiency and fairness', http://www.oecd.org/document/25/0,3343,en_2649_34597_40747673_1_1_1_1,00.html#Contents; Institute for Fiscal Studies, 2010, 'Mirrlees Review: Reforming the tax system for the 21st century', *Related publications web page*, <http://www.ifs.org.uk/mirrleesReview/publications>.

¹¹³ See, e.g., President's Advisory Panel on Federal Tax Reform, 2005, *Simple, Fair, & Pro-Growth: Proposals to Fix America's Tax System*, at 63-64 (combining six of the current credits and deductions aimed at families into two credits: a family credit and a work credit); President's Economic Recovery Advisory Board, note 112, at 6-10; Bird-Pollan, note 110, at 281-283; S. Young, 2009, 'Conversion credit: Leonard E. Burman', *Tax Notes*, Vol. 124 (July 27), pp. 325-330, at 327-328. For other recent tax credit reform proposals, see, e.g., S. Hoffman, and L. Seidman, 2002, *Helping Working Families: The Earned Income Tax Credit*, W.E. Upjohn Institute for Employment Research, Kalamazoo, Michigan; L. Batchelder, F. Goldberg, Jr., and P. Orszag, 2006, 'Efficiency and Tax Incentives: The Case for Refundable Tax Credits', *Stanford Law Review*, Vol. 59 No. 1, December, pp. 23-76; Marguerite Casey Foundation, note 110; D. Gitterman, L. Gorham and J. Dorrance, 2008, 'Expanding the EITC for Single Workers and Couples Without Children: Tax Relief for All Low-Wage Workers', *Georgetown Journal on Poverty Law & Policy*, Vol. 15, Summer, pp. 245-280; G. Berlin, 2009, 'Transforming the EITC to Reduce Poverty and Inequality', *Pathways*, Stanford Center for the Study of Poverty and Inequality, Winter, pp. 28-32; L. Wheaton and E. Sorenson, 2009, *Extending the EITC to Noncustodial Parents: Potential Impacts and Design Considerations*, Urban Institute (May 23), <http://www.taxpolicycenter.org/publications/url.cfm?ID=411906>.

¹¹⁴ Forman, *Making America Work*, note 18, at 286-287.

TABLE 11. HOW AN INTEGRATED TAX AND TRANSFER SYSTEM WOULD AFFECT A SINGLE PARENT WITH TWO CHILDREN (\$2,000 PERSONAL TAX CREDITS, \$2,000 PER WORKER CREDITS, AND 20 AND 35 PERCENT TAX RATES)

<i>Pre-transfer earnings</i>	<i>Plus personal credits</i>	<i>tax</i>	<i>Plus credit</i>	<i>worker</i>	<i>Less imposed</i>	<i>tax</i>	<i>After-tax income</i>
0	\$6,000			0		0	\$6,000
\$5,000	\$6,000		\$1,000		\$1,000		\$11,000
\$10,000	\$6,000		\$2,000		\$2,000		\$16,000
\$20,000	\$6,000		\$2,000		\$4,000		\$24,000
\$30,000	\$6,000		\$2,000		\$6,000		\$32,000
\$40,000	\$6,000		\$2,000		\$8,000		\$40,000
\$50,000	\$6,000		\$2,000		\$10,000		\$48,000
\$100,000	\$6,000		\$2,000		\$27,500		\$80,500
\$150,000	\$6,000		\$2,000		\$45,000		\$113,000
\$200,000	\$6,000		\$2,000		\$62,500		\$145,500

FIGURE 3: HOW AN INTEGRATED TAX AND TRANSFER SYSTEM WOULD AFFECT A SINGLE PARENT WITH TWO CHILDREN (\$2,000 PERSONAL TAX CREDITS, \$2,000 PER WORKER CREDITS, AND 20 AND 35 PERCENT TAX RATES).

To be sure, some additional tax credits would probably be needed to help low-wage families. In the United States, for example, it would make sense to expand the current dependent care tax credit and make it refundable.¹¹⁵ Child care costs are a challenge for low-income parents who are trying to work, and the tax system could be used to reimburse low-income parents for 50 percent or even 80 percent of their child-care costs. Tax credits can also be used to help low-income families pay for health care. In that regard, the Health Coverage Tax Credit already pays up to 80 percent of

¹¹⁵ Id. at 170-171.

qualified health insurance premiums for certain displaced workers,¹¹⁶ and President Barack Obama's new national health care legislation provides new tax credits for individuals and for small businesses.¹¹⁷

Ideally, all these refundable tax credits would be paid out on a monthly basis. Each individual would present something like the current IRS Form W-4, Employee's Withholding Allowance Certificate, to her employer—or to a bank. Employees would then receive advance payment of their credits from their employers in the form of reduced withholding, while other beneficiaries would have their payments directly deposited into their bank accounts.

This comprehensive tax and transfer system would be simpler than the current system, it would encourage low-skilled workers to enter and remain in the workforce, and it would minimize marriage penalties. Also, it would make it easier to ensure that low-income families and individuals actually get the benefits they need and without any welfare stigma or loss of privacy.

4.4.2 Timing and timeliness of payments

Another problem with tax credit regimes has to do with the timing and timeliness of benefit payments. Ideally, a transfer system should provide families with income assistance when they need it, for example, when another child is born or when a family's earnings decline. Responding to such changes is inherently difficult for tax systems, as they are usually based on annual filing requirements. Full responsiveness would probably require monthly or weekly income-testing.¹¹⁸

At the outset, countries need to make decisions about the responsiveness of benefits to changes in family income and status. Generally, this turns on whether benefits are based on current income and family status or on the prior year's income and family status. In Canada, for example, child tax benefits for the current year are based on the prior year's income and family status: filing a return thus determines the benefits that are paid periodically throughout the following year. The system has virtually no overpayments and very low compliance costs for beneficiaries, but benefits can be seriously out of date. According to Whiteford, Mendelson, & Millar, "Canadians have accepted the one large trade-off of a lengthy time lag to achieve an extraordinary simple system."¹¹⁹ On the other hand, in Australia, the United Kingdom, and the United States, tax credits can be adjusted to reflect current circumstances, but that makes these systems more complicated, and many families receive overpayments that must be recovered somehow.

Countries also need to decide how and when to distribute benefits. Payments can be made annually as lump-sum refunds or periodically throughout the year. Pertinent here, the periodic payment of family allowances makes it easier for families to pay their current living expenses. Periodic payments of work-conditioned tax credits also provide better work incentives than lump-sum payments. On the other hand, periodic

¹¹⁶ I.R.C. § 35; Internal Revenue Service, 2010, *HCTC: Eligibility Requirements and How to Receive the HCTC*, <http://www.irs.gov/individuals/article/0,,id=185800,00.html>.

¹¹⁷ See note 95.

¹¹⁸ Whiteford, Mendelson, & Millar, note 67, at 21-22.

¹¹⁹ *Id.* at 21.

payment systems are more complicated, especially if annual reconciliation forces families to return overpayments.

Australia, the United Kingdom, and Canada all have systems that successfully distribute benefits to most recipients through periodic payments made throughout the year. And, as mentioned, the Canadian system largely avoids the problems of overpayments by basing benefits on prior-year income and family status.

For years, the United States also had an advance payment mechanism, but hardly anyone used it.¹²⁰ For example, the U.S. Government Accountability Office found that only about 3 percent of those eligible for advance payment received it during the 2002 through 2004 tax years—about 514,000 out of the 17 million potentially eligible individuals each year.¹²¹ Moreover, the United States had serious administrative problems with those relatively few families that did use the advance payment mechanism.¹²² In any event, in August of 2010, Congress repealed the advance payment mechanism.¹²³ Presumably, revenue considerations were at least as important as administrative considerations, as the repeal is projected to generate \$1.1 billion in revenue over the next ten years.¹²⁴

4.4.3 Tax return preparation costs

Another problem with tax credit regimes has to do with the complexity of the tax return process needed to claim refundable tax credits. In the United States, for example, almost everybody's eyes glaze over at the mention of taxes, and about 60 percent of taxpayers pay someone to prepare their income tax returns, including around 70 percent of earned income tax credit recipients.¹²⁵ Earned income tax credit

¹²⁰ S. Holt, 2006, *The Earned Income Tax Credit at Age 30: What We Know*, Brookings Institution, Washington, D.C., at 6, http://www.brookings.edu/reports/2006/02childrenfamilies_holt.aspx.

¹²¹ U.S. Government Accountability Office, 2007, *Advance Earned Income Tax Credit: Low Use and Small Dollars Paid Impede IRS's Efforts to Reduce High Noncompliance*, GAO-07-1110. To be sure, some research suggests that most earned income tax credit beneficiaries would rather get a large annual refund than small increases in their weekly take-home pay. J. Romich and T. Weisner, 2000, 'How Families View and Use the Earned Income Tax Credit: Advance Payment versus Lump Sum Delivery', *National Tax Journal*, Vol. 53 No. 4 Part 2, December, pp. 1,245-1,264. Also of note, millions of low-income Americans are "unbanked": they have no financial institution that could accept periodic payments. See, e.g., T. Desmond and C. Spenger, 2007, 'Estimating the Cost of Being Unbanked', *Communities & Banking* (Federal Reserve Bank of Boston), Vol. 18 No. 2, Spring, pp. 24-26, <http://www.bos.frb.org/commdev/c&b/2007/spring/article9.pdf>; A. Kim, 2001, *Taking the Poor Into Account: What Banks Can Do to Better Serve Low-Income Markets*, Progressive Policy Institute, Policy Report, Washington, D.C., July, http://www.ppionline.org/documents/Banks_080601.pdf.

¹²² In that regard, the U.S. Government Accountability Office found that around 80 percent of earned income tax credit advance payment recipients failed to comply with at least one of the program's requirements during the years 2002 through 2004. Almost 20 percent had an invalid Social Security number, and 40 percent failed to file the required tax return. U.S. Government Accountability Office, *Advance Earned Income Tax Credit: Low Use and Small Dollars Paid Impede IRS's Efforts to Reduce High Noncompliance*, note 121.

¹²³ The Education Jobs and Medicaid Assistance Act of 2010, Public Law No. 111-226, § 219 (August 10, 2010) (repealing I.R.C. § 3507).

¹²⁴ Joint Committee on Taxation, 2010, *Estimated Budget Effects of H.R. 5893, The "Investing in American Jobs and Closing Tax Loopholes Act of 2010," Scheduled for Consideration by the House of Representatives on July 29, 2010*, JCX-40-10.

¹²⁵ President's Economic Recovery Advisory Board, note 112, at 3; A. Berube, 2006, *The Earned Income Tax Credit at Age 30: An Overview*, Brookings Institution, Washington D.C., at 31, http://www.brookings.edu/speeches/2006/0208childrenfamilies_berube.aspx. Tax fraud is also a problem with at least some tax preparers. See, e.g., Treasury Inspector General for Taxation

beneficiaries typically have to pay \$100 or more to commercial preparers in order to file returns to get their benefits.

Governments need to make it easier for low-income individuals and families to receive their benefits. Simplifying tax returns and providing free tax preparation software or on-line filing capabilities could help, but, perhaps, governments should actually help low-income individuals and families prepare and file their tax returns, just like welfare offices typically do for welfare beneficiaries.

4.5 Other tax credit design issues

4.5.1 Adequacy

Ultimately, every country needs to decide how much inequality and poverty it will tolerate. As Table 1 showed, before taxes and transfers, virtually all of the OECD countries have significant levels of both income inequality and poverty. Through various mixes of taxes, tax credits, and social welfare programs, every country has reduced its levels of inequality and poverty, but most should strive for even greater reductions. For example, it could make sense to tie the level of refundable tax credits to the poverty level, the minimum wage, and inflation.¹²⁶

4.5.2 Taxation of Benefits

Another issue for policymakers involves the tax treatment of benefits. For example, some countries include benefits in income for tax purposes, and others do not.¹²⁷ In the United States, for example, most welfare benefits are excluded from income.¹²⁸ If benefits are taxable, policymakers need to be careful to limit the cumulative effective marginal rates that result from the combined imposition of taxes and benefit-reductions.

5. CONCLUSION

Refundable tax credits have proven that they can be powerful tools for reducing inequality and poverty. All in all, however, governments need to simplify their tax credit regimes, simplify the process for claiming those tax credits, and ensure that families and individuals receive adequate benefits in a timely fashion.

Administration, 2008, *Inadequate Data on Paid Preparers Impedes Effective Oversight*, Reference No. 2009-40-098 (July 14), at 1, <http://www.treas.gov/tigta/auditreports/2009reports/200940098fr.pdf>.

¹²⁶ See, e.g., Marguerite Casey Foundation, note 110, at 1,680.

¹²⁷ See, e.g., OECD, 2005, 'Tax treatment of benefits, 2005', Paris, http://www.oecd.org/document/3/0,3343,en_2649_34637_39617987_1_1_1_1,00.html.

¹²⁸ See, e.g., J. Forman, 1994, 'The Income Tax Treatment of Social Welfare Benefits', *University of Michigan Journal of Law Reform*, Vol. 26 No. 4, pp. 785-816; T. Seto and S. Buhai, 2006, 'Taxes and Disability: Ability to Pay and the Taxation of Difference', *University of Pennsylvania Law Review*, Vol. 154 No. 5, pp. 1,053-1,145; C. Crane, 2006, 'Government Transfer Payments and Assistance: A Challenge for the Design of Broad-based Tax', *Southern Methodist University Law Review*, Vol. 59 No. 2, Spring, pp. 589-616; R. Wood, 2009, 'Updating General Welfare Exception Authorities', *Tax Notes*, Vol. 123 (June 22), pp. 1,443-1,447.

The Hardship Discretion – Building Bridges with the Community

Rodney Fisher and Cynthia Coleman*

1. INTRODUCTION AND SCOPE

Under the *Income Tax Assessment Act* (ITAA) 1997, the Commissioner of Taxation is charged with responsibility for administration of the taxation system,¹ and a major part of this function comprises the responsibility for the collection of tax which has been validly assessed. However, the legislative scheme also provides the Commissioner with a discretion not to collect taxes, but rather to provide relief from the tax due, in whole or in part. This discretion arises in the situation when the collection of tax would, in the opinion of the Commissioner, cause hardship to the taxpayer.

The purpose of this paper is to examine the nature and scope of the Commissioner's discretion to provide relief to taxpayers in circumstances of hardship. The paper initially examines the considerations which go towards establishing hardship, being the threshold test for the exercise of the Commissioner's discretion to grant relief. Given the broad nature of the discretion, the paper reviews the principles which traditionally surround the exercise of such discretionary powers, focusing on those matters which would be considered in determining whether or not to exercise the discretion in a particular case.

The paper finally considers how the scope of the discretion fits within the broad administration of the tax system. As part of this discussion, consideration is given as to the potential impact the exercise of the discretion may have on taxpayer attitudes to compliance.

2. LEGISLATIVE FRAMEWORK

The current legislative basis for relief from a taxation liability on the basis of hardship was introduced by *Taxation Laws Amendment Act (No 6)* (Act 67 2003), which enacted Div 340 in Part 4-50 of Schedule 1 of the *Tax Administration Act* 1953 (TAA). These provisions replaced the previous s 265 *Income Tax Assessment Act*

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¹ Section 8 *Income Tax Assessment Act* 1936; s 3A *Tax Administration Act*.

1936 (ITAA 1936) which had provided a discretion for the Tax Relief Board to release taxpayers from a tax liability in the case of hardship. The new provisions in Div 340 TAA granted the discretion to release taxpayers in cases of hardship directly to the Commissioner.

The operative provision in the new regime provided for individuals to be released from a taxation liability if meeting the liability would cause serious hardship, and for trustees of deceased estates to be released from a liability if dependants of the deceased would suffer serious hardship if required to satisfy the liability.² Application must be made for release from the taxation liability,³ with the taxes from which release may be sought including:

- income tax;
- fringe benefits tax or a Fringe Benefit Tax (FBT) instalment;
- Medicare levy including the surcharge;
- Pay As You Go (PAYG) instalments; and
- additional taxes, penalties and interest charges associated with these taxes.⁴

The new provisions also allowed for review of the Commissioner's discretion decision through the objection and review procedures in Part IVC TAA.⁵

The Explanatory Memorandum (EM) accompanying the new measures explained that the purpose of the amendment was to streamline the decision process, as the previous requirement for a three-member Tax Relief Board to convene to consider hardship cases had become resource intensive and inflexible, leading to backlogs and delays in

² Section 340-5(3) Sch 1 TAA Release by the Commissioner

The Commissioner may release you, in whole or in part, from the liability if you are an entity specified in the column headed "Entity" of the following table and the condition specified in the column headed "Condition" of the table is satisfied.

Entity and condition		
Item	Entity	Condition
1	an individual	you would suffer serious hardship if you were required to satisfy the liability
2	a trustee of the estate of a deceased individual	the dependants of the deceased individual would suffer serious hardship if you were required to satisfy the liability
Person and condition		
Item	Person	Condition
1	an *individual	you would suffer serious hardship if you were required to satisfy the liability
2	a *trustee of the estate of a deceased person	the dependants of the deceased person would suffer serious hardship if you were required to satisfy the liability

³ Section 340-5(1)&(2) Sch 1 TAA.

⁴ Section 340-10(1)&(2) Sch 1 TAA.

⁵ Section 340-5(7) Sch 1 TAA.

considering applications.⁶ The sole criteria for release from a taxation liability remained serious hardship, with the EM suggesting that release from a liability would not normally be granted where the release would not relieve the hardship, an example being where the existence of other creditors made bankruptcy inevitable, and a release would advantage other creditors at the expense of the Australian Taxation Office (ATO).⁷

While the EM provides no guidance as to the circumstances which may be sufficient to establish serious hardship, it does specify that the onus is on the applicant to furnish sufficient information to satisfy the Commissioner that a release on the basis of serious hardship would be appropriate.⁸

3. APPLYING THE LEGISLATION

In a consideration of the operation of the previous s 265 ITAA 1936, which had dealt with the serious hardship discretion, Hill J looked to the language of the section, and previous authorities, in determining that the application of the provision required a two-step process.⁹ The first required a determination of whether circumstances were such that payment of the taxation liability would result in serious hardship. If such a determination could be made, his Honour considered the second step as an exercise of the discretion available to decide whether there should be release of the liability. As his Honour explained:

As the language of s.265 discloses, and as is clear from what was said in *Trebilco*, the Board acting under s.265 must proceed in two steps. Where, as here, the case is one arising after the death of a taxpayer the Board must first decide whether owing to the death of the original taxpayer that person's dependants are in such circumstances that the exaction of the full amount of tax would entail serious hardship. If that question is answered favourably to the applicant for relief the Board must then address the next set of issues, namely whether there should be release in the circumstances and if so whether that release will be of the whole or part of the liability. It is obvious that the factors that may be relevant to the second of these steps could be a great deal wider than the factors which are relevant to the first of the steps.¹⁰

In relation to the new provision in s 340-5(3), the Administrative Appeals Tribunal (AAT) in *Re Filsell and Commissioner of Taxation*¹¹ adopted a similar position:

In the Tribunal's opinion, the language of the legislation requires a two stage approach. First, the decision-maker must decide whether the settlement of the liability will result in serious hardship. If that decision is favourable to the applicant, the discretion offered by sub-section 340-5(3) then falls for consideration. In reaching the decision to release in whole or part, the question to be addressed is whether, in all the circumstances, it is just and proper to provide the requested relief. Matters pertaining to the incidence and consequence of the tax and the effect of its exaction upon the affairs of the person will bear upon the issue of whether the relief is just and proper. Support for the two stage approach is to be found in the decision of

⁶ EM at para 4.4.

⁷ Ibid at para 4.26.

⁸ Ibid at para 4.28.

⁹ *Powell v Evreniades* [1989] FCA 114

¹⁰ Ibid at para 40.

¹¹ [2004] AATA 1012.

the High Court in *Rex v Trebilco; ex parte F.S. Falkiner & Sons Ltd* (1936) 56 CLR 20.

The discussion in this paper follows this two step process, initially examining the factors in establishing serious hardship, before analysing the exercise of the Commissioner's discretion as to whether to release the taxpayer from the taxation liability.

4. ESTABLISHING SERIOUS HARDSHIP

No legislation formulation is provided as to the establishing of serious hardship, and no guidance is available from the EM. As noted by Hill J in *Powell v Evreniades*:

There is no definition in s.265 of what is meant by "serious hardship" nor would one expect there to be. Each of the words in the phrase is an ordinary English word having a well understood meaning. The context in which the words appear makes it clear that the Relief Board is to consider whether the exaction of the full amount of tax would involve the dependants of a deceased taxpayer in financial difficulty which in all the circumstances can be said to be serious. The financial difficulty will be such that the dependants will be in significant need warranting action by the Relief Board to relieve their condition.¹²

His Honour was of the view that the circumstances of each particular case would be indicative of the level of hardship in that case, suggesting that it would be inappropriate to attempt an abstract test:

It would seem that the expression "serious hardship" has not been the subject of judicial comment in the present context. Counsel for the respondents referred me to the decision of Williams A.M. of the Supreme Court of Victoria in *Deputy Commissioner of Taxation (Vic.) v. Hoare* (1987) 19 ATR 772. That case concerned an application for a stay of judgment by a taxpayer who had been sued by the Commissioner for outstanding tax. Among the criteria relevant to the exercise of the discretion of the court in stay proceedings is clearly financial hardship to the defendant if the stay were refused. It was in this context that Williams A.M. considered the issue of financial hardship. However, I find the case quite unhelpful for two reasons. The first is that the context in which the analysis of financial hardship arose is completely different to that in s.265. Second, the phrase is not a statutory one but merely an expression of a factor relevant to the exercise of a judicial discretion, which factor is in other parts of the judgment referred to as "extreme" financial hardship. Clearly, there is a distinction between, on the one hand hardship which is serious, and on the other hand, hardship which may be said to be extreme although it is obvious enough that what will constitute either will depend upon the circumstances of a given case.

It is inappropriate to endeavour in the abstract to state tests of what will and what will not constitute serious hardship within the context of s.265. Clearly there would be severe financial hardship if the dependants of a deceased person were left destitute

¹² Above note 9 at para 19.

without any means of support. That is not to say that in any particular case something less than that will not constitute serious hardship.¹³

In relation to the previous operation of the Taxation Relief Boards, The Commissioner had issued Tax Ruling IT2440 which set out some of the guidelines which the Relief Board could follow in determining whether serious hardship existed. The ruling noted that the term ‘serious hardship’ had not been defined in the law, and that while the ruling could not prescribe an exhaustive list of factors to consider, the ruling was intended to identify some of the circumstances which may or may not indicate serious hardship.¹⁴

The ruling clarified that tests applied

... follow from a conceptual position that the term serious hardship has connotations of unduly burdensome consequences, the magnitude of which would be likely to lead to persons being deprived of necessities according to normal community standards. Thus, serious hardship would be seen to exist where payment of a tax liability would result in the taxpayer being left without the means to achieve reasonable acquisitions of food, clothing, medical supplies, accommodation, education for children and other basic requirements.¹⁵

In circumstances where payment of a tax liability would lead to such consequences as a limitation of social activities or entertainment, or loss of access to goods and services of a more luxurious nature or standard, the ruling suggested that the element of hardship may be seen as marginal or minor rather than serious.¹⁶ Additionally, where the taxpayer’s circumstances alone may indicate that meeting the tax liability may create serious hardship, the ruling also suggested that the income or assets of other family members could be relevant to assessing the taxpayer’s overall financial circumstances.¹⁷

The ruling provides a three-step process by which the Relief Board would evaluate the merits of an individual case:

The tests under this heading are concerned with quantifying the taxpayer’s capacity to meet the tax liability from his or her current income. The tests in sequence are:

- Firstly, what is the taxpayer’s capacity to pay, as measured by the income and outgoings stated in the application or supporting documents. i.e., what net income remains after deducting total outgoings from total income?
- Secondly, does the Board accept that the income and outgoings stated are accurate and that the outgoings are necessary, or is there scope to increase the net income available to meet the tax debt without serious detriment to living standards?

¹³ Ibid at paras 20 – 21.

¹⁴ IT2440 para 5.

¹⁵ Ibid at para 6.

¹⁶ Ibid at para 7.

¹⁷ Ibid at para 9.

- Thirdly, if there is a margin by which available income exceeds reasonable outgoings, is it sufficient to allow the liability to be met within an acceptable time scale?¹⁸

The case of *Re Ferguson and Ferguson v Commissioner of Taxation*¹⁹ saw the AAT interpret IT2440 as signifying that ‘serious hardship’ was “... less severe than extreme financial hardship but, nevertheless, hardship of a significant kind in terms of normal community standards.”²⁰ In the later AAT case *Re The Taxpayer and Commissioner of Taxation*,²¹ the AAT rejected an application for severe financial hardship in relation to a Higher Education Contribution Scheme (HECS) debt where the taxpayer could have reorganised her affairs but did not do so. The AAT suggested that “... plainly hardship is to be assessed in relation to the assessed amount,”²² indicating that the issue was whether payment of the particular assessed amount would cause the taxpayer to suffer actual, hypothetical or prospective serious hardship.

In a test case brought before the Federal Court,²³ Stone J considered the meaning that should attach to ‘serious hardship’. Her Honour had regard to the examples given by Hill J in *Powell*, that there would be severe financial hardship if persons were left destitute without any means of support, and the elucidation in ruling IT2440 para 6 extracted above. Her Honour saw no inconsistency between these examples, but did highlight the fact that these were only examples, and they did not exclude the possibility that something less than destitution would constitute serious financial hardship. The AAT had noted that what was needed for proper maintenance and support was a relative question “... that could only be answered with regard to the whole of the taxpayer’s circumstances,”²⁴ and in this case her Honour found nothing to suggest that the AAT had misunderstood the meaning of serious hardship.²⁵

A matter for consideration in this case had been whether the AAT had concluded that bankruptcy itself would constitute serious hardship. The Commissioner argued that a finding of serious hardship was not open to the Tribunal on the evidence, with the Commissioner submitting that even if the taxpayer were forced to bankruptcy, there was nothing to suggest that bankruptcy, of itself, constituted serious hardship.²⁶ Stone J applied the ‘whole of circumstance’ approach in concluding that in considering the consequences of bankruptcy, the Tribunal “... quite properly concentrated on the whole of the respondent’s individual circumstances,”²⁷ and this had been by reference to normal community standards.²⁸ On this basis her Honour was able to conclude that the Tribunal did not, in effect, find that bankruptcy per se would constitute serious hardship.²⁹

¹⁸ Ibid at para 11.

¹⁹ [2004] AATA 779.

²⁰ Ibid at para 35.

²¹ *Re Taxpayer*[2004] AATA 1073.

²² Ibid at para 24

²³ *Commissioner of Taxation v A Taxpayer* [2006]FCA 888.

²⁴ Ibid at para 19.

²⁵ Ibid at para 20.

²⁶ Ibid at para 52.

²⁷ Ibid at para 53.

²⁸ Ibid at para 55.

²⁹ Ibid at para 55.

A further issue for judicial consideration has been whether the existence of an unresolved objection or appeal against an assessment may be used to find serious hardship by the payment of the disputed amount. The courts have displayed a marked reluctance to prevent collection of taxes pending resolution of a dispute as to the assessment.

Asprey J in *DCT v Niblett*³⁰ observed that:

It may be thought to be a hardship that a taxpayer should have to pay the tax assessed when an objection to the assessment has not been decided upon but there are obvious financial considerations of high policy that must be weighed in the balance against cases of individual hardship with which the Commissioner through the appropriate use of his powers under [the Assessment Act] can cope ... Where the meaning of the words of a statute is clear 'it is not open to the Court to narrow or whittle down the operation of the Act by seeming considerations of hardship or of business convenience or the like' – *Attorney-General v Carlton Bank*.³¹

In the decision in *DCT v Roma Industries*,³² Bowen CJ in Eq commented on this issue in terms that "...Such a statutory provision may in some cases lead to hardship on a taxpayer, particularly where he has paid the amount of tax assessed and later wins his appeal."³³

Along similar lines, Mason and Wilson JJ have remarked in *FJ Bloeman Pty Ltd v FCT*³⁴ that the legislation:

contains large powers to enable the recovery of tax; powers the exercise of which may make life uncomfortable both for the taxpayer and perhaps others who owe money to the taxpayer. So much may be conceded, but [the Assessment Act] does not proceed upon the hypothesis that the Commissioner will be motivated in the exercise of his powers by improper or collateral purposes.³⁵

Given such a strong line of authority it would be surprising for a taxpayer to be able to establish serious hardship solely on the basis that the taxation assessment was subject to an unresolved objection or appeal.

5. EXERCISING THE COMMISSIONER'S DISCRETION

If a taxpayer has been able to establish that payment of the tax liability would create a circumstance of serious hardship, the second step identified is for the Commissioner to exercise the legislation discretion in determining whether or not to release the taxpayer from the tax liability. As noted by Stone J in *A Taxpayer*, "The Tribunal's conclusion as to 'serious hardship' does not conclude the matter. The decision to release the respondent from his tax obligation is clearly discretionary."³⁶

The matter at issue which has arisen on a number of occasions in this regard relates to the matters which may be considered in determining how the discretion should be

³⁰ (1965) 83 WN (Pt 1) (NSW) 405

³¹ *Ibid* at 411.

³² (1976) 6 ATR 54.

³³ *Ibid* at 57.

³⁴ (1981) 147 CLR 360.

³⁵ *Ibid* at 375.

³⁶ Above, note 23 at para 58.

exercised. In the decision in *Powell*, Hill J took the view that the factors considered in relation to exercising the discretion to release the debt would be at large, and “... could be a great deal wider than the factors which are relevant in determining the first of the steps [serious hardship].”³⁷

It follows from *Trebilco* that in the course of consideration of the release of tax under s.265 the Board may consider not only such matters as go to the issue of serious hardship but also other matters which in the discretion of the Board may be relevant, those other matters being merely proscribed by the general principle that the discretion must be exercised bona fide and for the purposes for which it was conferred, there being jurisdiction in this Court to intervene if in the overall exercise of the discretion the Board does take into account considerations which, having regard to the purposes served by s.265, can be seen to be irrelevant.³⁸

Further, Hill J referred to the dictum of Windeyer J in *Giris Pty Ltd v FCT*³⁹ concerning the need, when exercising a discretion, “... to be guided and controlled by the policy and purpose of the enactment, so far as that is manifest in it [and to] exclude from ... consideration any matter which it would be unlawful ... to take as a criterion.”⁴⁰

In reviewing which matters could be considered by a decision-maker in exercising an unfettered discretion, Mason J in *Minister for Aboriginal Affairs v Peko Wallsend Ltd*⁴¹ had made a similar finding:

In the context of judicial review on the ground of taking into account irrelevant considerations, this Court has held that, where a statute confers a discretion which in its terms is unconfined, the factors that may be taken into account in the exercise of the discretion are similarly unconfined, except in so far as there may be found in the subject-matter, scope and purpose of the statute some implied limitation on the factors to which the decision-maker may legitimately have regard: ... By analogy, where the ground of review is that a relevant consideration has not been taken into account and the discretion is unconfined by the terms of the statute, the court will not find that the decision-maker is bound to take a particular matter into account unless an implication that he is bound to do so is to be found in the subject-matter, scope and purpose of the Act.⁴²

In the taxation context,⁴³ French J in *FCT v Swift*⁴⁴ noted that:

Instead of endeavouring to spell out the circumstances in which burdens imposed by the legislation might be lifted, the Parliament has provided for a dispensation that is capable of exercise by reference to the widest range of factors. In this context, the scope and purpose of the Act can be seen as the collection of company tax subject to a dispensing power. The dispensing power is incidental and ancillary to the primary object of the legislation. On the spectrum of cases in which it could conceivably be

³⁷ Above, note 9 at para 40.

³⁸ Ibid at para 36.

³⁹ (1969) 119 CLR 365.

⁴⁰ Ibid at 384 in *Powell* at para 36.

⁴¹ (1986) 162 CLR 24.

⁴² Ibid at page 40.

⁴³ Concerning the discretionary powers in the *Taxation (Unpaid Company Tax) Assessment Act 1982*.

⁴⁴ (1989) 89 ATC 5101.

exercised, there will be a threshold beyond which it would defeat the primary object of the legislation.⁴⁵

While the discretion provided to the Commissioner would appear to be at large, there are broadly stated limits on the discretion to be exercised by the Commissioner. Windeyer J in *Giris Pty Ltd v FCT*⁴⁶ spoke of the need, when exercising a discretion, “... to be guided and controlled by the policy and purpose of the enactment, so far as that is manifest in it [and to] exclude from ... consideration any matter which it would be unlawful ... to take as a criterion.”⁴⁷

There have been attempts to outline the types of factors which would be expected to be considered. In *Re Wilson v Minister for Territories*,⁴⁸ Deputy President Hall said:

The considerations that will be relevant to the proper exercise of the discretion whether or not to grant remission when undue hardship is established will vary from case to case. However, in my view, relevant considerations are likely to include the circumstances out of which the hardship arose; whether those circumstances were within the capacity of the applicant to have foreseen and controlled; whether the applicant has over-committed himself financially; whether the applicant or any of his dependants has suffered serious illness or accident involving irrevocable financial loss to the applicant; whether the applicant has been in regular employment; whether the circumstances of the hardship are likely to be of a temporary or recurring nature; and whether a decision to remit the rates would, as a matter of administrative justice and fairness be appropriate having regard to the fact that ratepayers, other than pensioners, are normally obliged to pay their rates in full ...⁴⁹

The matter highlighted by this passage, and a matter which has proven significant in a number of decisions, is the degree of culpability by the taxpayer in contributing to the ‘severe hardship’ in which they find themselves. As stated by Wilcox J in *Corlette v Mackenzie & Ors*,⁵⁰ “It would be extremely odd if a taxpayer who was the author of his or her misfortunes, through imprudent or extravagant expenditure, was entitled, as a matter of right, to a release of unpaid income tax.”⁵¹

The significance of this factor was highlighted by Deputy President Block in *Rollason v FCT*⁵² when noting that in the cases of *A Taxpayer* and *Milne*, in both of which relief was granted, the taxpayers were able to establish both serious hardship, and the fact that hardship arose from misfortune for which they were not responsible.⁵³

Taxpayer behaviour which may contribute to the hardship condition is one matter listed in ruling IT2440 as a factor to consider in the exercise of the discretion. The ruling recognises that, in exercising the discretion, the decision-maker “... is obliged to act reasonably and responsibly, and should not act arbitrarily or capriciously.”⁵⁴ As

⁴⁵ Ibid at 5116.

⁴⁶ Above, note 39.

⁴⁷ Above, note 39 at 384 in *Powell* at para 36.

⁴⁸ (1985) 7 ALD 225.

⁴⁹ Ibid at para 24.

⁵⁰ (1996) 62 FCR 597.

⁵¹ Ibid at 598.

⁵² [2006] AATA 962.

⁵³ Ibid at para 44.

⁵⁴ Above, note 14 at para 19.

a guide to the types of factors which may result in the exercise of the discretion to grant relief against a taxpayer suffering hardship, the examples provided by the ruling encompass such factors as:

- whether the taxpayer has disposed of funds without making provision for tax liabilities;
- whether granting relief would not reduce hardship, such as where there was a prospect of bankruptcy, and relief would only serve to advantage other creditors;
- whether the taxpayer has failed to pursue debts,;
- whether the hardship is associated with a single event or short term outcome.

While three of these factors relate to the taxpayer personally, the second factor is arguably wider, and takes into account the greater public interest in the collection of revenue, and not serve to advantage creditors to the detriment of the revenue if the taxpayer is declared bankrupt.

Given the wider scope of this second factor, it may appear somewhat surprising that in *A Taxpayer* the Commissioner had argued that the discretion in s 340-5(3) allowed the Commissioner to take into account only matters relating to the particular taxpayer. The argument of the Commissioner suggested that by taking into account the public interest in the taxpayer continuing in a highly paid position and paying tax at the top marginal rate, the AAT had erred in law by considering an irrelevant consideration.

Stone J agreed that the ‘public interest’ would be an irrelevant consideration in determining the first issue of whether the taxpayer faced severe hardship, but her Honour was satisfied it was not irrelevant to the exercise of the discretion as to where to provide relief.⁵⁵

If the greater public interest is an element for consideration in exercising the discretion as to the granting of relief, a further aspect of this is arguably the impact the exercise of the discretion may have on taxpayer perceptions, and the potential for impact on future taxpayer compliance.

That such is the case has been recognised by the current Commissioner in noting that:

In the foreseeable future, tax administrators will need to be even more careful in balancing the need to be fair, efficient and effective. On the one hand, they must be vigilant for abusive tax practices so as to provide a level playing field, but at the same time empathetic to taxpayers facing real hardship.⁵⁶

The final part of this paper considers the potential for an overly-restrictive exercise of the relief discretion to impact on taxpayer perceptions and resultant compliance behaviour.

⁵⁵ Above, note 23 at para 63.

⁵⁶ D’Ascenzo M, “Sustaining good practice tax administration,” (2009) 38 *AT Rev* 76 at 85.

6. IMPACT ON COMPLIANCE

Given that the “... taxpayer experience of dealing with the tax system is at the heart of good tax administration,”⁵⁷ it may be expected that taxpayer perceptions of their treatment when applying for relief will potentially influence their future degree of compliance.

It would be expected that taxpayers approach the hardship relief application from a range of perspectives. While it must be conceded that for some taxpayers an application for hardship relief may be less than genuine and little more than a cynical exploitation of the system, for many the hardship relief application would be at least embarrassing, and at worst traumatic, depending on the circumstances which had driven them to the situation. In such circumstances, the approach taken in evaluating their application, and exercising the discretion in relation to relief, must have a real potential to colour the taxpayer’s perception of the ATO, and influence future compliance behaviour.

The evidence in this area would suggest that, in dealings with authority, people who feel that they have been treated fairly by an organization would be more likely to trust the organisation and be inclined to accept its decisions and follow its directions.⁵⁸ When people believe that an authority is trying to be fair and deal fairly with them, they are more likely to trust the motives of the authority and develop a long-term commitment to accepting its decisions.⁵⁹

In relation to treatment by revenue authorities, “... tax studies in general suggest that individuals do not react to authorities primarily or exclusively in terms of what they do or do not receive from these authorities. Instead they react on how they are treated.”⁶⁰ In particular, the suggestion is that taxpayers are generally more compliant when they consider that they have been treated fairly and respectfully by a tax authority.⁶¹

In the current context of an application for hardship relief, genuine taxpayers would generally be expected to feel at a disadvantage in dealing with a large organization, at a time when they are in distressed financial circumstances. In such a situation it may be expected that the treatment by the revenue authority may potentially have a significant impact on the lasting perception of the ATO, and the future compliance of the taxpayer.

This is not to suggest that any and all applications for hardship relief should be granted. The suggestion is that the manner in which the discretion to grant relief is exercised has the potential to impact on the future compliance of the taxpayer. Given the wide scope of the discretion, the onus must be on the Commissioner to show not only a bona fide exercise of the discretion, but if the discretion is exercised against a taxpayer the manner of exercising the discretion should not be such as to see the taxpayer ‘lost’ to the tax system.

⁵⁷ Ibid at 84.

⁵⁸ Lind EA and Tyler TR, *The Social Psychology of Procedural Justice*, 1988, Plenum Press, NY.

⁵⁹ Murphy K, “Procedural justice and tax compliance”, *Australian Journal of Social Issues*, Vol 38, No 3, August 2003 at 381.

⁶⁰ Ibid at 383.

⁶¹ Ibid.

7. APPLYING THE DISCRETION

With the discretion associated with hardship claims now vesting exclusively with the ATO, the question arises as to how the discretion has been exercised. In Issues Paper No 4 issued by the Inspector General of Tax, the Inspector General noted that “There is concern that some tax officials in the ATO do not recognise the rights of taxpayers to apply for hardship relief and will not assist in lodgement of an application. There is a perception in the private sector that hardship applications are mostly rejected.”⁶²

While this may have been the perception at the time of the Issues Paper, there is evidence that the percentage of individual applicants being granted release on the basis of serious hardship has increased. In the 2002-2003 financial year, of the 1600 applications received, 49% were granted full or partial release from taxation debts.⁶³ In 2003, responsibility for administering the hardship provision was transferred to the ATO. Of more recent times, in 2007-2008, the percentage of individuals granted full or partial release on the basis of serious hardship had risen to 80%, with the number in 2008-2009 being 78% of the 2334 applicants.⁶⁴

This increase in both the number of applications, and more significantly in the percentage of applications being granted release in whole or part, would appear to lend credence to the Commissioner’s stated aim that “Our approach to compliance has been to strike a balance between efficiency and fairness.”⁶⁵

8. HARDSHIP VERSUS HARD TIMES

The ATO is aware that voluntary compliance is a key feature of good tax administration and assists taxpayers to meet their obligations when they have encountered hard times which are out of their control. This is separate from the specific hardship legislation. Obvious examples of hard times are drought, flood, bushfire and other natural disasters. Media Releases are issued after one of these disasters occurs encouraging taxpayers to call an ATO emergency support line, offering advice and extending due dates for lodgment and payment of activity statements.

These media statements contain a standard checklist of the type of assistance offered:⁶⁶

- fast tracking refunds
- giving people extra time to pay debts—without interest charges
- giving more time to meet BAS and other lodgment obligations—without penalties

⁶² Inspector-General of Taxation, Issues Paper No 4 ATO Law Enforcement and Governance, para 41, http://www.igt.gov.au/content/Issues_Papers/Issues_Paper_4.asp accessed 21/10/2010.

⁶³ Ibid at para 42.

⁶⁴ Commissioner of Taxation, Annual Report 2008-09 page 56.

⁶⁵ D’Ascenzo M, “Do you see what I see?” Speech to the 22nd Australasian Tax Teachers Association Conference, <http://www.ato.gov.au/corporate/content.asp?doc=content/00228656.htm> accessed 21/10/2010.

⁶⁶ More tax help for people affected by bushfires and floods, 24 Feb 2009 <http://www.ato.gov.au/corporate/content.asp?doc=/content/00181433.htm>

- helping reconstruct tax records where documents have been destroyed
- offering visits from field officers to help reconcile lost records, and
- helping them claim tax hardship concessions.

9. NON COMMERCIAL LOSSES

Division 35 of ITAA 1997 restricts losses from a non-commercial business activity from being offset against income from other sources unless the activity satisfies one of the commerciality tests⁶⁷ or the Commissioner exercises his discretion under s35-55 (1) not to apply the rule. Section 35-55(1) provides that the Commissioner may exercise his discretion not to apply the rule on the grounds it would be unreasonable to do so because (a) the business activity was or will be affected by special circumstances outside the control of the operators of the business activity, including drought, flood, bushfire or some other natural disaster. This may include earthquakes, pest plagues, hailstorms or diseases destroying livestock or crops. The Commissioner's approach is discussed in Taxation Ruling TR 2007/6 paragraphs 8 and 29(1)(a). This is a further example of the ATO taking taxpayers' individual circumstances into account even when they do not technically qualify for the hardship relief.

10. CONCLUDING REMARKS

Tax administration relies on voluntary compliance. Research has consistently demonstrated that the treatment of taxpayers by the revenue authority can assist in improving voluntary compliance. This would suggest that the exercise of the hardship discretion may have an influence on the future compliance of taxpayers who are in a position of having to seek release from taxation debts.

The specific hardship legislation, in addition to the use of the Commissioner's discretion in hard times and under Division 35 demonstrates that the ATO is committed to supporting taxpayers in their effort to meet their obligations under Australia's tax legislation.

⁶⁷ Sections 35-30, 35-35, 35-40, 35-45. ITAA 1997.

Future Global Challenges to Achieve Fairness in Environmental Taxation: Moving Beyond the Dimensions of Horizontal and Vertical Equity

Ann Hansford¹ and Margaret McKerchar²

Abstract

Fairness is recognised, almost universally, as the most fundamental ideal of any tax system. With tax systems around the globe being increasingly utilised to implement policies to change emissions behaviour and address the causes of climate change, it is imperative that fairness be a primary consideration. The paper sets out to explore the dilemma of what is meant by 'fairness' in the context of environmental taxation. It begins by first establishing the urgent need for climate change mitigation and establishes the role that environmental taxation has to play. It then considers the extent to which the traditional philosophical and moral approaches to decision making can provide a contemporary and relevant framework by which 'fairness' can be judged. The tax literature generally recognises fairness as having only two dimensions, namely horizontal and vertical equity. The requirement for the 'fair sharing' of the cost of climate change mitigation is considered and additional dimensions of fairness are discussed including the need to look beyond national borders and the current generation of taxpayers. The paper considers the potential conflict that may arise from taking this more holistic and enduring view of fairness and explores the distributional concerns, the dilemma of justice in the international community and the notion of procedural fairness. The paper concludes by acknowledging the complexity of the task facing governments and policy makers in implementing environmental tax systems that reflect a more responsible approach to the concept of fairness. The required changes are identified, including the need within the global arena to show greater leadership and the acknowledgement of the rights of others, both now and in the future.

1. INTRODUCTION

Climate change is a growing global problem and there has been much debate about how it should be addressed and the urgency required, about who should bear the responsibility and the cost. Many countries have relied on their tax systems to assist in changing emission behaviour and promoting more environmentally-friendly practices by which climate change can be mitigated. However, tax systems are generally confined by domestic boundaries, and this presents challenges in dealing with climate change which is clearly a global issue and one that transcends the current generation of taxpayers. A fundamental and arguably universal principle of a good tax system is its inherent fairness, or equity and this principle relates directly to the debate

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surrounding bearing responsibility and cost. However, fairness is a somewhat nebulous concept and its meaning may vary with the perspective of the beholder.

The purpose of this paper is twofold. Firstly, it explores the concept of fairness, and in particular, considers the existence of additional dimensions beyond the considerations of vertical and horizontal equity that have traditionally dominated the tax literature. Secondly, the paper considers the likely constraints to the implementation of global measures of environmental taxation,³ assuming that a common understanding of the fairness principle could be reached. The paper is presented in 5 parts. Following on from this introduction, the role of environmental taxation is discussed in part 2. In part 3 the underlying philosophical dilemmas and the concept of 'fairness' in the context of environmental taxation are considered. Part 4 of the paper then reflects on the practical implications of 'fairness' as a guiding principle in the implementation of environmental taxation internationally. Concluding comments are contained in part 5.

2 WHERE DOES ENVIRONMENTAL TAXATION FIT INTO THE CLIMATE CHANGE DEBATE?

The signing of the Kyoto Protocol in 1997 resulted in countries around the world accepting the need to make significant changes to address the pressing problems of climate change. Kyoto was expected to provide "an evolving regime that can effectively tackle climate change over the course of the century" (Grubb, 2003, p.157). A significant milestone in the United Kingdom (UK) was the publication of The Stern Report in 2006, which resulted in the government accepting that immediate action needed to be taken, including the use of taxes and market trading schemes to establish the economic cost of carbon emissions. In contrast, other countries such as Australia have struggled in determining an appropriate course of action that is coherent and consistent.

The Australian Government first released draft legislation on a carbon pollution reduction scheme (i.e. an emissions trading scheme) for public comment in March 2009. The Government then set itself the ambitious target of finalising and passing the legislation in 2009 with the first year of liability for emissions proposed to start on 1 July 2010 (Wong, 2009), however, the legislation was ultimately defeated in the Senate in 2010. The Federal Treasury simultaneously was undertaking a major review⁴ into the Australian tax system which was released by the Federal Government in May 2010. The extent to which these activities have been co-ordinated is unclear.

Before considering environmental taxation in detail it is worth briefly reflecting on some of the alternatives. Voluntary agreements are just that – voluntary - and without legally binding obligations, there is no requirement to make significant changes. However, it must be recognized that voluntary agreements play an invaluable role in the policy mix, an example of which is the recently concluded pact between the forestry industry and the conservationists in Tasmania relating to the shift from old growth forests logging to plantation logging. Such voluntary agreements will not, in

³ Environmental taxation in general encompasses a wide range of taxes. However, in the context of this paper, it refers primarily to measures aimed at mitigating climate change, for example, carbon taxes, climate change levy and emissions trading schemes.

⁴ See the Henry Review available at:

<http://taxreview.treasury.gov.au/Content/Content.aspx?doc=html/home.htm>

themselves, be sufficient to address the problems identified since Kyoto and the scientific evidence put forward to support the need for change.

Regulation can be useful in addressing problems of large point sources of pollution and industrial effluents (Hewett, 1999). However, regulations set a minimum standard and there is no benefit or reward for those organisations that do more and so innovation will not be encouraged. There is also the inherent problem of monitoring the regulations and making sure the regulations evolve in keeping with changing scientific and technological developments. In practice, many countries employ a policy mix of complementary measures, including direct regulation, voluntary agreements and market-based instruments, to mitigate climate change. It seems different measures serve different roles although environmental taxation has recently assumed a key role in such policy mixes.

Theoretical arguments indicate that the use of economic instruments, by creating direct price signals to producers and consumers, should be more effective in changing behaviour (OECD, 2001). Economic instruments used in environmental taxation, or 'eco taxes', are designed to encourage firms and end users of resources to limit pollution and thereby protect the environment by internalising the cost of environmental degradation. Pizer (1999) argued that despite emission trading being the Kyoto preferred approach, the price fixing approach of carbon taxes would be more effective in changing behaviour and thus protecting the environment. Carbon tax is a means by which fossil fuels are taxed at a rate according to carbon content, and thus their potential to inflict damage. A carbon tax ensures that the price of carbon is fixed and it is the amount of the emissions of CO₂ or other greenhouse gasses that adjust. Carbon taxes are used in many countries including Denmark, Finland and Germany in contrast to emissions trading schemes as used in New Zealand and recently legislated in the United States (US).⁵

The discussion in this section of the paper has focused on the economic instruments by which climate change can be addressed. However, it is clear that environmental taxes are determined by domestic boundaries as a means to address a global problem, that is, one that defies these same boundaries. This is a unique and challenging situation for tax policy makers. Against this background, the next part of the paper considers the moral dilemmas, including fairness, of who should bear the responsibility of addressing climate change.

3 PHILOSOPHICAL CONSIDERATIONS AND FAIRNESS

There are a number of philosophical and moral dilemmas arising from the climate change debate which naturally lead into a discussion on fairness. Addressing climate change can be analysed in greater depth by considering the 'is-ought' gap; which in essence is the distinction between statements of fact and moral judgements. In the context of environmental taxation then the 'is' element, the fact, is based on the scientific evidence and the 'ought' element is the moral judgment that something should be done. In the context of climate change, there does appear to be agreement

⁵ The [American Clean Energy and Security Act](http://energycommerce.house.gov/index.php?option=com_content&view=category&layout=blog&id=171&Itemid=93&limitstart=11) (H.R. 2454) was passed on June 26 2009 in the House of Representatives by a vote of 219-212. See http://energycommerce.house.gov/index.php?option=com_content&view=category&layout=blog&id=171&Itemid=93&limitstart=11 accessed 10 November 2010.

on the fact that something needs to be done, so the 'is' is agreed. Therefore the focus of attention should be on the 'ought' which involves a three-fold debate, what ought to be done, and by whom, and over what timeframe?

The philosopher Hume, as discussed by MacIntyre (1959), has been credited with initially raising the 'is-ought' question and others have discussed and challenged his interpretation. Reflecting on the debate, Hudson (1983) summed up Hume's position as "...set within the context of his moral philosophy as a whole, simply raises, but does not answer, the question of how wants and interests are related to obligations." (p.265). This was developed by Searle (1964) who proposed a five stage process of derivation from the statement of "I promise to pay you five dollars" to "I ought to pay you five dollars". Based on whether they take a prescriptivist or descriptivist stance, philosophers have argued and disputed the logical process by which this was achieved. How this has been developed is beyond the remit of this paper on environmental taxation, but suffice to state that there appears to be a link between the scientific statements and the requirement or obligation to address the problems of climate change nationally and internationally, and also to address current and future consequences.

Another important moral issue pertinent to environmental taxation is the 'harm principle' initially set out in the famous essay 'On Liberty' by John Stuart Mill (1859). Put simply, J S Mill maintained that individually or collectively we are only able to interfere with the liberty of action of anyone else, against their will, in order to prevent harm to others. Mill's principle built on the 'is-ought' debate in that the obligation to take action should not be prevented or avoided by individual countries on the basis that they are at liberty to take actions beneficial for them alone. If harm is being done to others then, following the arguments of J S Mill, the 'ought' requirement is for effective action to be taken and cannot be denied on the basis of individual self-interests. In Mill's famous essay on Utilitarianism, he established two principles - the greatest happiness principle and the equity principle (Hudson, 1983). Heated debate followed about how 'greatest happiness' could be measured and assessed. The equity principle stated that there should be no distinction between individuals when deciding what ought to be done.

The importance of equity as a guiding principle has long been recognised in the tax literature with the desired features of a good tax system generally considered to have evolved from the historic writings of Adam Smith in 1776 (Heilbronger, 1986; Head, 1992). Smith identified three duties of government. The first was to protect society from violence and invasion of other independent societies. The second was to protect every member of society from injustice or oppression. The third was to erect and maintain those public institutions and those public works that are useful, but not capable of bringing in a profit to individuals. These three duties still remain relevant today and particularly so in the context of dealing with climate change.

In considering how the cost of public institutions could be defrayed, Smith argued for tolls and other user-pay charges rather than the burden being placed upon the general revenue of society, particularly where the user was able to use the public good to make a personal profit. That is, Smith recognised that taxation could be used to regulate certain activities or provide for the long-term good of society, in addition to simply raising revenue. Smith espoused four maxims for effective and equitable taxation: equality (interpreted in more modern contexts as meaning 'fairness'), certainty,

convenience of payment, and economy in collection, with the greatest importance being place on certainty (Heilbronger, 1986).

On fairness, Smith argued that the subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state (Heilbronger, 1986). In a more modern-day, Australian context, the Committee led by Asprey (1975) considered the desirable features of a tax system to be efficiency, fairness and simplicity; but highlighted that these features were conflicting and that the policymaker had to repeatedly choose between simplicity and efficiency, or fairness and simplicity, or fairness and efficiency. The Asprey Committee described fairness as an ideal, exceedingly difficult to define and harder still to measure. The terms fairness and equity were regarded as being interchangeable. Equity could be distinguished as having both horizontal and vertical dimensions. These dimensions required that persons in the same situation should be treated equally, and those in different situations be treated differently, with those more favorably placed being able to pay more. This ability to pay approach to fairness was in accord with Smith's view. Smith argued that ability to pay was most fairly determined in accordance with revenue enjoyed. While the Asprey Committee agreed that income was the best measure of economic well being, income was viewed as only the starting point. The Committee questioned the fairness of an individual and a family having the same level of income and being required to pay the same amount of tax.

In contrast to Smith, the Asprey Committee regarded fairness as the most universally sought after quality in a tax system. This view was consistent with earlier authors who had argued strongly that that equity should be the "touchstone" of the Australian tax system (Downing *et al*, 1964, p.v). The eminent UK scholar Cedric Sandford (1992) advocated that that the four features of a good tax system (equity, ability to pay, efficiency and simplicity) were in conflict with each other and required a practical compromise to be reached. Sandford did not identify a dominant feature, but recognised that conflict was most likely to arise between simplicity and equity and between equity and efficiency. Similarly, Meade (1978) in the review of the UK's tax system concluded that a good tax system must take into account many factors including the economic incentives provided, its fairness and its distributional effects between rich and poor.

From the discussion thus far it appears that, in principle, a good tax system should reflect the underlying principles of fairness. However, in the context of environmental taxation, it must be recognised that fairness can have many dimensions, well beyond the traditional concepts of vertical and horizontal equity. Vertical equity requires that person in unequal circumstances be treated with an appropriate degree of inequality. Horizontal equity requires that persons earning the same amount and having similar obligations (such as the number of dependants) should pay the same amount of tax. By their very nature vertical and horizontal fairness are measured as at point of time and interpersonally. When it comes to environmental taxation, there exist further dimensions. For example, the dimension of intergenerational or future equity needs to be considered. That is, is it fair for the current generation of taxpayers to expect the future generation of taxpayers to bear the expected future cost of climate change, particularly where no action is taken to abate the current level of emissions? Further,

there is the dimension of sovereignty, in that is it fair for one country or region to bear the cost of climate change caused by the actions of another?

Clearly there are other aspects of fairness when it comes to climate change and these have been subject to considerable discussion in the literature. It has been said that climate change is a serious business and that fairness demands that countries 'step up to the plate' (Clausen & McNeilly, 1998, p.ii), but the issue remains as to which countries and to what extent they should be prepared to step up. In accordance with Smith's view of fairness, ability to pay (as reflected by revenue enjoyed) implies that those countries that reap the greatest financial reward from activities that give rise to climate change, should be prepared to bear its cost. However, this may be too simplistic an approach given the nature of the problem and the reality that the environmental taxation can only contribute in part to the solution.

As identified by Adam Rose (1990), efficiency-based policies would be inappropriate (though not always necessarily in conflict with equity principles) in dealing with climate change as they would result in disparate costs and benefits among nations and thus hinder cooperation. Similarly, the 'polluter pays' principle was recognised as not having universal appeal. Rose argued that an equity principle, whereby there was an internationally fair sharing of abatement costs and benefits, would be the most effective alternative. However, Rose acknowledged that the concept of equity and 'fair sharing' was problematic. It brought into consideration ethical propositions that incorporated elements of efficiency and equity, concerns about sustainable development, and the potential conflict in objectives of nations around the globe.

Rose also identified other approaches to equity including market justice (whereby the free market system is considered to be a fair system of allocation and distribution); consensus equity (but considered to be suspect given the influence of economic and political power); compensation (by which winners are required to compensate losers) and a spirit of co-operation (which would require special consideration to be given to the poorest group of nations). Rather than be dismayed by the array of interpretations of equity as a guiding principle in the debate on how best to mitigate global warming, Rose advocated that it had potential to be a unifying principle. Rose *et al* (1998) highlighted that while equity considerations were usually accorded a secondary role in economic policymaking, in the case of global warming, they may in fact be crucial.

However, Cazorla and Toman (2000) noted that neither history nor philosophy provide a definitive guide to what would constitute a fair distribution of burden in the context of climate change, and assert that approaches that adjust responsibilities over time on the basis of more than one criterion may offer more promise for successful negotiation over the longer term. For example, Claussen and McNeilly (1998) advocated that three criteria should be used to differentiate responsibilities in respect of fair sharing of the cost of climate change: responsibility for the emissions that can cause climate change, standard of living (or the ability to pay for climate change mitigation), and opportunity to reduce emissions. They suggested that countries could be divided into three groups: those that must act now, those that should act now, but differently; and those that could act now, if feasible. However, the dilemma remains that climate change is a global public good and that whilst divergence exists between national actions and global interests, the incentive to 'free ride' remains. Paradoxically, the greater the global net benefits of cooperation in mitigating global warming, the stronger is this incentive (Cazorla & Toman, 2000). It remains as no

great surprise that debate over a long-term equitable sharing of the burden of climate change continues in spite of the signing of the Kyoto Protocol.

However, current debate on equitable distribution of the burden of climate change has focused primarily on distributional concerns as they are perceived to currently exist (i.e. around developed and developing countries), more so than consideration of intergenerational fairness and other less tangible manifestations such as the dilemma of justice to the international community (Paavola & Adger, 2002). There is also a concern that procedural fairness takes place in the negotiating process (Rose, 1998); that there is adequate representation (Albin, 2001); and that more emphasis is needed on the art of negotiating the steps necessary to bring about the necessary changes (Sagar, 2000).

More recently, Raymond (2006) has argued that alternative ideas of fairness, such as the distinction between subsistence and luxury emissions, offer a more flexible mix of egalitarian and other allocation principles. This argument is premised on the wide acceptance of a shared perception of fairness as a prerequisite to the success of an international environmental treaty. Raymond explored one prominent and controversial view in the debate – the idea that each person is entitled to an equal share of atmospheric capacity to absorb greenhouse gas (GHG) emissions and that an allocation framework can provide the basis for equitable distribution (see for example Sagar (2000)). Raymond believed this view to be enticing because of its simplicity and clarity, and to hold promise as a fair outcome. However, it was recognised that defining fairness in terms of a positive environmental right posed important theoretical and practical problems that could unduly inhibit climate change negotiations. Raymond concluded that crafting an equitable resolution to the climate change problem was a monumental task that remains critical to any long-term resolution of the problem (Raymond, 2006). That is, the debate on what constitutes ‘fairness’ in the context of environmental taxation requires urgent resolution.

Alternative responses to addressing climate change that attempt to sidestep the fairness debate include attempts to measure the costs and benefits of climate change mitigation policies. However, such studies have demonstrated that present-day policymakers must weigh reasonably certain current period costs against uncertain future benefits, which gives rise to an ethical dilemma. Leach (2009) highlighted that under such conditions the choice of policies which balance intergenerational allocations of costs and benefits may be critical to gaining support for adoption. That is, there is growing acceptance that policymakers must look beyond immediate economic and self-serving considerations when addressing the issue of climate change.

More recently scholars have attempted to move towards a more systematic coevolutionary theory as a framework for the analysis of the linked development of ecosystems and economies. Waring (2010) argued that while ecological economists have criticised the traditional economic model, they have yet to develop an appropriate evolutionary theoretical foundation. Further, Waring argued that it may be that capitalism (as a cultural innovation that exploits the tribal social instincts and enables competitive social evolution without loss of life) could offer potential for society to progress more quickly towards a sustainable economy.

What is clear from the literature, as was previously described by Head (1992) in the case of tax systems more generally, is that the extremely controversial and potentially

divisive issues of justice and fairness must intrinsically be of central concern to tax policy makers. Arguably, this is even more so in the case of tax systems directed at addressing global concerns about climate change. The framework for international negotiation as proposed by Albin (2001) may help resolve some of these issues. Albin (2001) argued that giving due consideration to each of the phases of negotiation, including structure, process, procedures, outcome and post-agreement, could help in achieving a balanced settlement of conflicting claims. However, in spite of the importance of fairness in the process, it was clear that international agreements were not driven by considerations of fairness and justice alone. Factors such as knowledge (or lack of it) and the exercise of leadership may ultimately be more effective in terms of bringing about beneficial change (Albin, 2001).

4 PRACTICAL CONSIDERATIONS AND INTERNATIONAL PERSPECTIVES

Against the philosophical and moral dilemmas and consideration of fairness, the challenge of who should take responsibility for assessing climate change and the cost remains unresolved. Even so and as discussed previously, some countries are moving forward and implementing various forms of environmental taxation. This does give rise to the need to consider some of the practical implications of these reforms and their international consequences. Dresner *et al* (2006) considered the history and social response to environmental tax reform in the UK and suggested that many are sceptical as it is seen as just another way of the government collecting revenue from organisations and society. Tax revenue raising and pollution reduction are inconsistent goals (Hsu 2008). Further, Oates (2002) maintained that environmental tax rates should be determined by environmental objectives, not by revenue considerations.

However, others have dismissed such concerns and consider that industry has nothing to lose and everything to gain from environmental taxation. They have maintained that arguments such as taxation being opposed to the goals of economic expansion were based on the self-interests of a few. Tindale and Holtham (1996) suggested there were powerful interests, such as the fossil fuel and chemical industries, who opposed any change in the pattern of economic behaviour and whose lobbying operations were well-resourced, well-organised and not overly-principled. Environmental measures could spur firms to develop more resource-efficient methods of production and reduce costs.

The practical issues that arise from introducing environmental taxation have been addressed in some countries such as the UK. “When the tax is implemented, large firms and associations of energy users may be exempted, provided they commit in negotiated agreements to lower their CO₂ emissions” (Thalmann & Barazini, 2008, p.54). Concerns from energy intensive users in the UK were addressed through Climate Change Agreements and although there was some relaxation in the regulations, only approximately 60 per cent of manufacturing processes qualified (Pocklington, 2001). Agreements take a considerable time to complete and some which were concluded quickly have been considered to be less effective environmentally (Shaw, 2001). Enhanced capital allowances for energy efficient plant have had a mixed response (Hansford & Woodward, 2008). Whilst these allowances can provide businesses with a cash flow boost and an incentive to invest in energy-saving equipment, the lengthy administrative process can be off-putting for small and medium sized businesses.

Environmental taxation, requiring individual governments to set the tax rate and tax base, raised issues of international competition (Ekins & Barker, 2001; Hansford & McKerchar, 2008). In support of the argument in favour of direct environmental taxation, positive experiences within Northern Europe (e.g. Scandinavia) have been cited to indicate that they could be introduced and uncompetitive effects successfully avoided. Where taxes were introduced or increased on a national scale only, there was a risk that particular industries would suffer (Smith, 1993). Following the introduction of the UK Climate Change Levy (CCL) in 2001, the UK Confederation of British Industry (CBI), together with the Engineering Employers Federation (EEF), calculated that the UK CCL had resulted in manufacturing industries being the worst affected and that in the year since the introduction of CCL the sector faced a £328m increase in energy bills and a net £143m rise in costs (EEF/CBI, 2002).

Concerns about competitiveness were recognised in the UK following the changes brought about in 2001. John Prescott, then Deputy Prime Minister maintained, when introducing measures to cushion the effects of the CCL upon industry, that the government wanted to work closely with industry to ensure climate change objectives and improve energy efficiency were met in a way which helps rather than hinders overall competitiveness.

The use of indirect, input taxation on the purchase of energy has the advantage of administrative simplicity, as no expensive monitoring of pollution outputs is required, and it was one of the options adopted by the UK government (HM Treasury, 2006). There have been mixed results from research into the benefits of hypothecating environmental tax revenues. When the environmental tax revenue is not 'ring fenced' for environmental purposes, it can be 'recycled' by reducing other taxes, for example on income, labour, capital etc. within that country (Hansford *et al*, 2004). Alternatively, or additionally, it can also be used to reduce any regressive or distributional impacts. The Swiss experience warned about assuming too much could be achieved by hypothecation where full recycling of revenues was not sufficient to make a green tax acceptable (Thalmann & Barazini, 2008).

5 CONCLUSIONS

The philosophical framework initially suggested by Hume – the 'is-ought' question - has been used in this paper in order to reflect upon whether environmental taxation can ever be considered as fair. This paper has taken as a given the 'is'; that climate change is a fact that few scientists now challenge, with the initially reluctant US finally 'joining the club' and seeing the need to take action. The main body of the paper has focused on the 'ought' requirement; how the obligations to address the issues of climate change can be met fairly, internationally and over time.

The standard fairness assessment of 'ability to pay' is insufficient as there is added complexity for environmental taxation. The requirement to 'step up to the plate' implies that those countries that reap the greatest financial benefits should be prepared to bear the cost. The requirement for 'fair sharing' in environmental terms is problematic as it raises issues about sustainable development and the potential conflict of objectives of different nations. In addition there are the distributional concerns and the dilemma of justice in the international community. Procedural fairness brings into focus whether there is adequate representation internationally. In resolving these wide ranging issues more emphasis on the art of negotiating steps to bring about the necessary change is needed.

Recent alternative assessments of fairness have been extended to the distinction between subsistence and luxury emissions, with each individual being 'entitled' to an equal share. Although this is a monumental task, it is considered by some to be critical to any long-term solution. Mitigation policies that attempt to measure and reduce the impact of climate change need to address the impact in the future as well as currently. This is of particular interest when considering inter generational equity and will be a fascinating area for further research.

Practical concerns include the hypothecation of environmental taxes. Governments can find the taxes generated through 'good' environmental practice irresistible and so favour including them in general taxation. When the tax burden falls on specific sectors within national boundaries then that will generate hostility from those affected. Governments can take steps to enact legislation to mitigate the impact on affected sectors, but the devil is in the detail and there are cases of tax reduction strategies not achieving their goals. Scholars have maintained that social welfare can be improved by imposing a tax on the good, where the production or consumption results in a negative external effect. Empirical studies have shown that environmental taxation measures can result in the engagement of employees with first hand knowledge of ways to reduce pollution, within their particular industry. Rather than governments dictate how the reduction can be made, supporters of carbon tax maintain that it is more nimble, allowing the experience and expertise of skilled scientific practitioners to develop optimal solutions, thus using the wide range of knowledge 'insider IP' that is so important to many innovative companies. By using these companies as 'champions' then this can give an additional impetus for the wider adoption of environmentally sound practices and behaviour. Environmental tax pushes energy efficiency up the agenda of many industries by providing a clear financial message and encouraging the use of exempt or more efficient energy sources.

The various perspectives of fairness of environmental tax discussed in this paper highlight the complexity of the tasks facing governments and policy makers. With the scientific evidence of the impact of climate change irrefutable then those responsible need to consider appropriate changes that will affect current and future generations of tax payers. Strong leadership that takes responsibility and implements change has never been more important in order to address this particular 'is-ought' gap.

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The Impact of the Global Financial Crisis on Broadly Based Indirect Taxation: A Chinese Case Study

Xu Yan* and Andrew Halkyard**

1. INTRODUCTION

The global financial crisis (GFC) has brought unprecedented challenges to the world economy and numerous demands for regulatory improvements of its financial architecture. China has not been immune from these challenges. Their impact upon its domestic economy has been profound. Like many countries that developed broad stimulus packages to combat the effects of the GFC, China embarked upon various changes and reforms to its taxation system. In the past two years, reforms included structural and targeted tax reductions (corporate taxation and Consumption Tax, CT) and a significant shift to move China's most important indirect tax (Value Added Tax, VAT) towards a consumption-type system.

To what extent are these reforms directly responsive to the effects of the GFC? Using China as a case study, is it possible to propose an effective universal tax response to financial turmoil or economic difficulties generally? Although scholars have argued that, from a tax policy perspective, the conclusion must be that manipulating tax rates as a source of subsidizing finance for distressed business is ill-conceived,¹ does this hold good in China's case which is now only developing a fully mature tax system and whose recent reforms might best be evaluated as key steps in its long-held desire to

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¹ See, e.g., R. Krever, "Taxation Responses to Financial Turmoil" (1998) *Asia-Pacific Tax Bulletin* 452 at p. 454. This conclusion was reached in the context of discussing whether rates of corporate tax (but not indirect taxes which are the focus of this article) generally should rise or fall in response to conditions of economic crisis. Krever notes, however, at p. 452 that: "Different nations will seek different trade-offs between differing objectives. There is, therefore, no universal tax response to financial turmoil or economic difficulties generally."

simplify its taxation system, move towards a broader tax collection base, lower tax rates and enhance tax collection?²

This article seeks to answer these questions. It concludes that some targeted tax reforms in economically stressed times can be implemented swiftly and produce immediate and positive benefits. In this regard, particular attention is paid to China's indirect taxation system, especially the imposition of VAT and CT, since this is critical to its overall tax collections (providing more than half of the taxation revenue obtained by the Central Government) and which directly impacts upon the consumption of all manner of goods.

The article is divided into five parts. Following this Introduction, Part 2 provides a brief account of the genesis of the GFC and its immediate effects on China's economy. Part 3 proceeds to analyze recent reforms in China's indirect taxation system in the post-GFC period in the following areas: (1) reduction in certain tax rates, (2) the move to a consumption-type VAT system and (3) more generally, critiquing that system in light of the imperative to fund and improve its social security system (for instance, reforming medical care insurance and extending the national pension scheme to Chinese rural residents). Part 4 evaluates the effects of the recent reforms and changes to the indirect taxation system, by reference to China's economic performance and tax collections in the post-GFC period. Part 5 concludes that the GFC has had both direct and indirect impacts upon China's taxation system, particularly in relation to indirect taxation. When evaluated from the context of promoting structural reform, the tax responses adopted by China, in particular reducing tax rates to promote consumption in times of economic turmoil, although not necessarily a universal cure for all ills, were not ill-conceived.

2. THE GENESIS OF THE GLOBAL FINANCIAL CRISIS AND ITS IMPACT ON CHINA'S ECONOMY

The outbreak of the GFC in 2008 was abrupt but not entirely unpredictable. Prior to this time, some insightful observers³ had become increasingly pessimistic as a result of the convergence of recession-related phenomena emanating from the United States (US)—such as the escalating deficit in its current account, the tidal wave of speculation on financial derivatives, and the vast number of subprime mortgage loans provided to unqualified borrowers. However, very few members of this sagacious

² A broad summary of China's taxation reforms in recent years is provided at www.chinadaily.com.cn/bizchina/2009-10/26/content_8851299.htm (interview with the Chinese Minister of Finance, Xie Xuren, prior to the opening of the third International Tax Dialogue, held in Beijing in October 2009; accessed 28 January 2010). In this interview, Xie Xuren highlighted the function of taxation as a means for adjusting China's macro economic policy, noting that this "played a major role in boosting the investment capacity in the business sector, enhancing consumer demand, driving growth and shaping [China's] economic development mode."

³ For the US current account deficit, see, e.g., Maurice Obstfeld and Kenneth Rogoff, "The Unsustainable US Current Account Position Revisited" in Richard Clarida (ed.), *G7 Current Account Imbalances: Sustainability and Adjustment* (University of Chicago Press, 2007). For the housing market bubble, see, e.g., Karl E. Case and Robert J. Shiller, "Is there a Bubble in the Housing Market?", *Cowles Foundation for Research in Economics of Yale University*, No.1089, 2004, available at <http://www.econ.yale.edu/~shiller/pubs/p1089.pdf> (accessed 3 February 2010). For the speculative nature of financial markets, see, e.g., Robert J. Shiller, *Irrational Exuberance* (2nd ed., Princeton University Press, 2005).

group foresaw that the US\$1 trillion subprime mess could, one day, paralyze the US\$60 trillion global economy.

To a certain extent, the financial crisis provided a prototype of how turmoil within global financial markets was contagious to virtually all sectors of the world economy and had the capacity to be massively destructive. The crisis, originating within the US, quickly spread worldwide. Not only were financial institutions in many countries forced to accept large amounts of government funding, or go bankrupt, due to the difficulty in obtaining liquidity from the market, but other firms, especially small and medium enterprises, were hard hit by the credit crunch. In response to the unavailability of credit, many firms needed to cut back their investments, lay off employees, or at least freeze payrolls for cost control purposes. The end victims were apparently average persons, whose disposable income stagnated as a result of large scale layoffs and frozen payrolls, and whose household wealth was fiercely attacked by the abruptly sagging equity, bond and housing markets. Under the impact of these financial shocks upon their income and wealth, many households, particularly those in the US, were forced to slash, extensively, their consumption. Combined with reduced investment, heavy downward pressure on global aggregate economic activity was inevitable.⁴

As was the case in many emerging markets, the Chinese economy was not isolated from this catastrophe. Transmission of the crisis to China was primarily effected in two ways—through the problems besetting the complex, intertwined global financial system and the dramatic fall in international trade.

2.1 Financial Channel

Prior to the emergence of the GFC, several large Chinese financial institutions had accumulated sizable holdings of subprime-related assets for “yield chasing”. When the quality of these assets deteriorated, those institutions obviously incurred losses. In part as a result of the Central Government’s strict regulation upon capital outflows, the amount of losses⁵ attributed to subprime-related assets held by China’s financial institutions was much smaller when compared to those suffered by their peers in the US, the United Kingdom (UK) and the European Union (EU). Furthermore, China’s enormous level of foreign reserves, which grew under conditions of continuous surpluses derived from international trade, made the losses relatively affordable. In the event, the GFC did not pose a systemic threat to the strength of China’s financial system and did not affect the availability of credit to the same extent as in other countries (such as those in Eastern Europe).⁶

The advent of the GFC did, however, disrupt the level of foreign direct investment (FDI), which had long functioned as an engine for economic growth in China. After

⁴ See generally, Andrew K. Rose and Mark M. Spiegel, “Cross-Country Causes and Consequences of the 2008 Crisis: International Linkages and American Exposure”, *The National Bureau of Economic Research (NBER) Working Paper* No. 15358, September 2009.

⁵ See Mingchun Sun, “China: Unscathed through the Global Financial Tsunami” (2009) *China & World Economy*, Vol. 17, Issue 6, at pp. 24-42.

⁶ See The International Monetary Foundation (IMF), “Global Financial Stability Report: Responding to the Financial Crisis and Measuring Systemic Risks”, April 2009, available at <http://www.imf.org/external/pubs/ft/gfsr/2009/01/pdf/text.pdf> (accessed 3 February 2010).

the GFC took hold, China experienced a period of negative FDI growth for ten consecutive months from October 2008 to July 2009.⁷ This result was the worst since the Asian Financial Crisis of 1997-1998. Concurrently, China's stock markets were affected by lingering pessimism about the strength of foreign financial markets, and in Shanghai the exchange index plummeted almost 70 percent from its historical peak.⁸ Many investors were forced to dispose of their assets and substantial losses eventuated.

2.2 International Trade Channel

The most serious effect of the financial tsunami upon the Chinese economy can be seen through the prism of international trade. Prior to the onset of the GFC, China's international trade had been in a phase of continuous expansion. According to statistics published by the World Trade Organization (WTO), the average annual growth rate of world trade between 2000 and 2008 amounted to 5 percent, a figure significantly higher than the world aggregate GDP growth rate of 3 percent.⁹ The seeming prosperity of this expansion was, however, largely fueled by the appetite of US consumers, who accounted for tremendous levels of imports (from lower cost countries such as China). This resulted in spirally increasing deficits in the US current account (after netting out its relatively lower level of exports). For example, in 2006 the US current account deficit was about 7 percent of its GDP.¹⁰ Obviously, the US current account deficit corresponded to an equivalent amount of surplus in other countries' current accounts. Of these countries, China stood out for its remarkably high percentage of net exports to total GDP, which since 2005 amounted to almost 33 percent. Table 1 below shows the proportion of exports to GDP in China from 1994 to 2009.¹¹

The GFC interrupted the pattern of "China-produce and US-consume". Nearly all of China's major trading partners, including the US, Japan, the EU and member countries

⁷ See the Ministry of Commerce of the People's Republic of China (MOC), "Statistical Data for the Foreign Direct Investment", available at <http://www.mofcom.gov.cn/static/v/tongjiziliao/v.html/1> (accessed 3 February 2010).

⁸ Although it has been widely acknowledged that certain bubble components in China's stock markets existed before the onset of the GFC, the extent of the slump in market prices appears to represent an overreaction by panicked investors rather than a normal correction. This can be reflected by the sharp fall and rebound of the Shanghai Stock Exchange Composite Index (SSECI). After the demise of Lehman Brothers in September 2008, the SSECI plunged to the level of 1664 on 28 October 2008. However, by the end of 2009 the SSECI had already climbed above the 3000 level. Historical Data on the SSECI is available at <http://www.google.cn/finance/historical?cid=7521596&startdate=2008-07-04&enddate=2010-02-03&start=300&num=30> (accessed 4 February 2010).

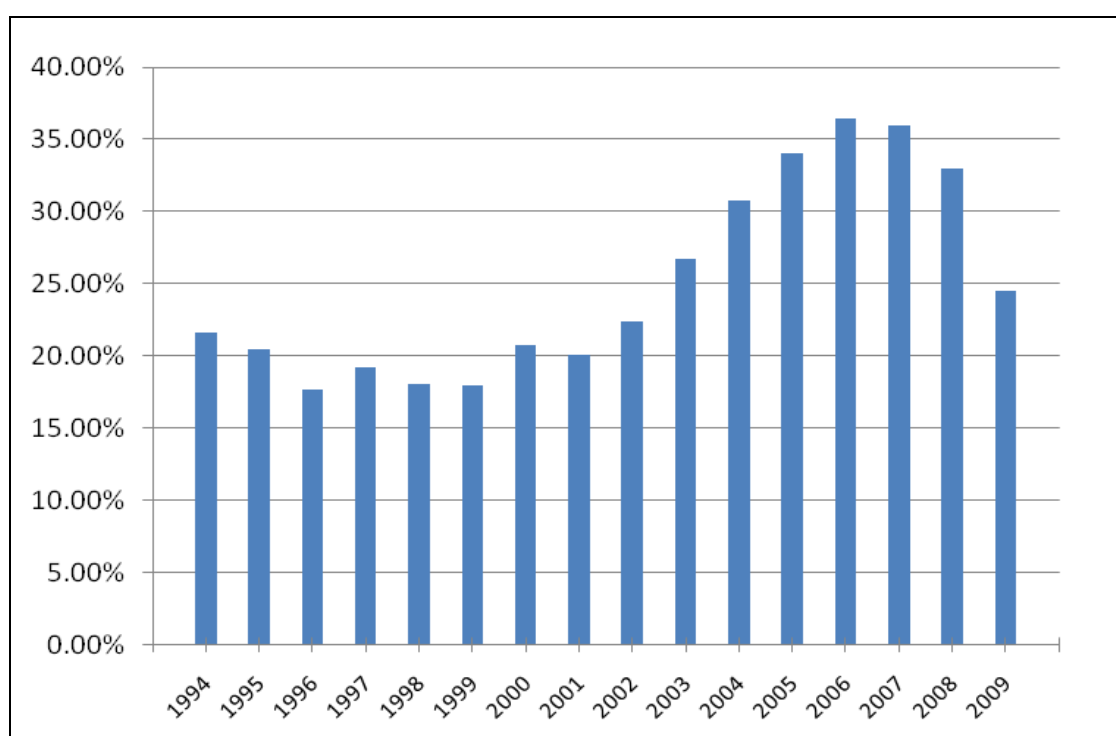
⁹ See The World Trade Organization (WTO), "International Trade Statistics 2009", Chapter 1, available at http://www.wto.org/english/res_e/statistics_e/its2009_e/its09_world_trade_dev_e.pdf (accessed 3 February 2010).

¹⁰ See Robert E. Scott, "Current Account Picture; March 14, 2006", *Economic Policy Institute*, available at http://www.epi.org/publications/entry/webfeat_econindicators_capict_20060314/ (accessed 3 February 2010).

¹¹ Data from 1994 to 2008 is sourced from the MOC, "Export and Import Data", available at <http://zhs.mofcom.gov.cn/tongji.shtml> (accessed 3 February 2010); see also the National Bureau of Statistics of China (NBS), "GDP Data" in *Online Statistics Database*, available at <http://219.235.129.58/indicatorYearQuery.do> (accessed 3 February 2010). Data in 2009 is sourced from the NBS, "National Economy and Social Development Report 2009", 25 February 2010, available at http://www.stats.gov.cn/tjgb/ndtjgb/qgndtjgb/t20100225_402622945.htm (accessed 20 April 2010) [hereinafter 2009 NESD Report].

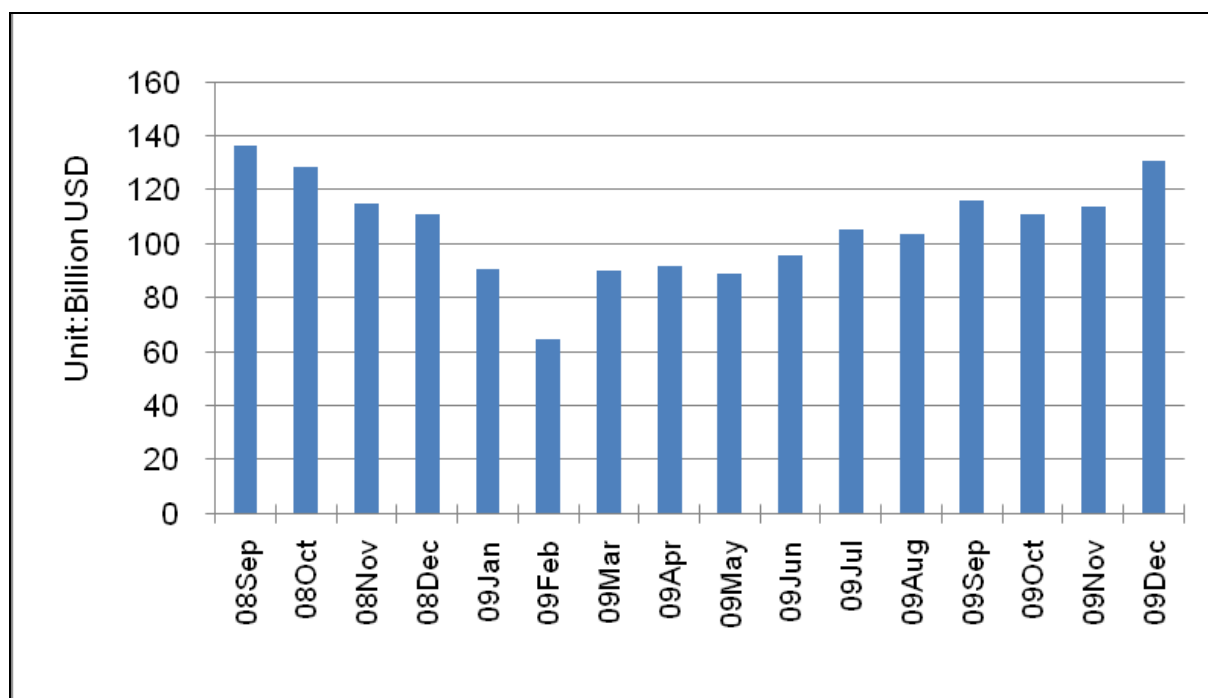
of the Association of Southeast Asian Nations (ASEAN) abruptly slashed their demand for “Made-in-China”. This was largely attributable to the shrinking disposable income of the domestic households in these countries and the reduced investment capabilities of their enterprises. China’s export sector suddenly lost steam. According to China’s Ministry of Commerce, China’s total level of exports in 2009 was 16 percent lower than that for 2008. Table 2 shows China’s exports in the post-GFC period.¹² The decrease in China’s exports further dragged down the growth rate of China’s GDP. Having recognized the significant adverse impact this would have on the economy, the Central Government decided to reset the economic growth target for 2009 at a modest level of 8 percent, a figure significantly lower than the double digit growth achieved in previous years.¹³

TABLE 1: PROPORTION OF EXPORTS TO GDP IN CHINA 1994-2009



¹² Data is sourced from the MOC, “Export and Import Data 2008-2009”, available at <http://zhs.mofcom.gov.cn/tongji.shtml> (accessed 3 February 2010).

¹³ See, e.g., Kevin Hamlin and Jun Luo, “China Says 8% Economic Growth Target Within Reach Amid Crisis”, *Bloomberg Press Online*, 27 February 2009, available at <http://www.bloomberg.com/apps/news?pid=20601089&sid=aL.PytK78PwUw&refer=china> (accessed 3 February 2010).

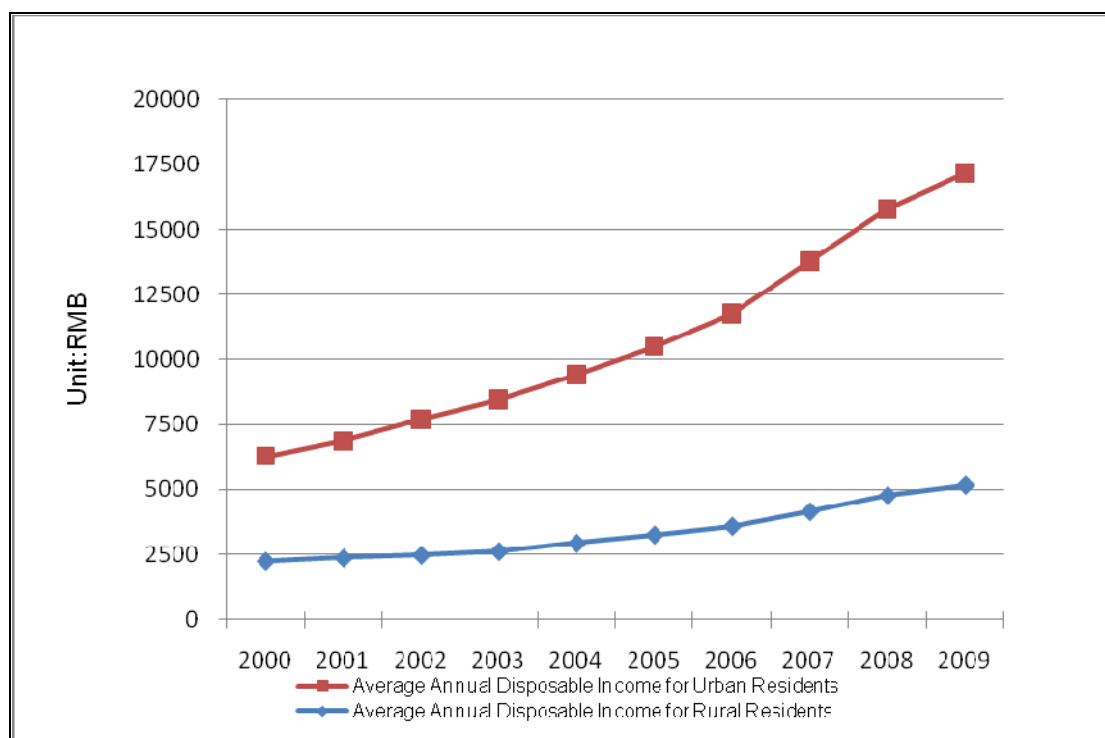
TABLE 2: CHINA'S EXPORTS POST-GFC

The GFC had other far-reaching effects on China's economy and society which cannot be fully reflected by its GDP and export figures alone. As the largest transitional economy in the world, China has a very high ratio of rural to urban population, 53.4 percent (or 713 million people) at the end of 2009.¹⁴ For various historical reasons, the development of China's rural areas has lagged far behind that of its urban areas. This gave rise to substantial disparities in wealth distribution. It goes without saying that the average disposable income of urban Chinese residents is much higher than that of rural Chinese residents (as shown in Table 3) and the living standard in urban China is generally higher than that in rural China.¹⁵ The Central Government has acknowledged these matters as serious social problems and has long endeavored to narrow the gap.¹⁶ To date, however, the effectiveness of these remedial measures appears far from ideal, as indicated in Part III C below.

¹⁴ See the NBS, 2009 NESD Report, *supra* note 11.

¹⁵ For data from 2000 to 2008, see the NBS, "Data of Average Annual Disposable Income of Urban Residents" and "Data of Average Annual Disposable Income of Rural Residents" in *Online Statistics Database*, available at <http://219.235.129.58/indicatorYearQuery.do> (accessed 3 February 2010). For data in 2009, see the NBS, 2009 NESD Report, *supra* note 11. Table 3 is based on the data from these sources.

¹⁶ See the Outline of the Tenth Five-Year Plan for National Economic and Social Development of the People's Republic of China [hereinafter 10th FYP], passed by the 9th National People's Congress on 15 March 2001; and the Outline of the Eleventh Five-Year Plan for National Economic and Social Development of the People's Republic of China [hereinafter 11th FYP], passed by the 10th National People's Congress on 14 March 2006. The Central Government is in the process of drafting its 12th FYP which covers the period from 2011 to 2015. The issue of narrowing rural and urban wealth disparity is mentioned in the Suggested Outline describing the broad themes of the 12th FYP, which has been passed by the 5th Plenary Session of the 17th Central Committee of The Communist Party of China (CPC) on 18 October 2010, http://news.xinhuanet.com/politics/2010-10/27/c_12708501.htm. For

TABLE 3: INCOME DISTRIBUTION BETWEEN URBAN AND RURAL RESIDENTS IN CHINA

In the pursuit of a better life, millions of rural residents left their homes to work in cities and townships. This was, perhaps, the only avenue open to them to find opportunities to relieve poverty and to help their families. Unfortunately, the economic sector most hard-hit by the GFC, the small and medium enterprises (SMEs) in China, happened to be the major employers of these rural migrant workers. With the resulting increase in the number of bankruptcies among SMEs, a large number of rural migrant workers found real difficulty in obtaining jobs in cities and towns and had to return to their rural homes. Such a phenomenon was particularly conspicuous in the Pearl River Delta¹⁷ which, over the past three decades, has been home to China's most concentrated manufacturing base absorbing a vast number of lower paid workers. It has been estimated that in late 2008, nationwide, around 20,000,000 rural migrant workers were unemployed.¹⁸ The immense scale of layoffs of such workers may

a general summary of the Outline, see, e.g., "Premier-To-Be Expounds The Five-Year Plan", *Wall Street Journal*, available at http://chinese.wsj.com/big5/20101118/rlw181156_ENversion.shtml (accessed 22 November 2010).

¹⁷ The Pearl River Delta is in southern China. The delta covers nine prefectures of Guangdong province, and the Hong Kong Special Administrative Region and Macau Special Administrative Region. Since economic liberalization took place in China in the late 1970s, the delta has become one of the leading economic regions and a major manufacturing centre of China. For the economy in the delta during the GFC, see Huang Yanjie and Chen Shaofen, "Crisis of Industrialization in the Pearl River Delta", *EAI Background Brief* No. 444, available at <http://www.eai.nus.edu.sg/BB444.pdf> (accessed 3 February 2010).

¹⁸ See "Chen Xiwen: Around 20 Million Rural Migrant Workers Unemployed and Government Responds Actively", *Xinhua News*, available at http://news.xinhuanet.com/politics/2009-02/02/content_10750425.htm (accessed 22 November 2010). Because of the GFC it has been reported that 40 percent of SMEs went into bankruptcy, and another 40 percent were struggling to make ends

indicate that only a relatively small percentage of China's rural residents could harness the so-called miracle economic growth to promote their living standards. In the event, one likely consequence of the GFC in China has been to aggravate the inequality in wealth distribution between urban and rural residents, fueling the risk of social unrest.

3. CHINA'S TAX RESPONSE TO THE GFC: RECENT REFORMS IN THE INDIRECT TAXATION SYSTEM

Like many countries that developed stimulus packages to fight the GFC, China adopted tax reform as part of a plan to offset the adverse effects of the GFC on the economy. As will be shown below, some of those reforms – particularly those related to indirect taxes affecting consumption – were implemented swiftly and had immediate effect. Given the importance of China's indirect tax regime in terms of the Central Government's total tax collections, Part III of this article focuses upon that regime. Table 4 below shows the tax revenue referable to indirect taxation (VAT, Business Tax (BT) and CT) as compared to direct tax revenue (Enterprise Income Tax and Individual Income Tax).

How then did China's indirect taxation system change as a result of the GFC? In short, this involved: (1) a reduction in certain tax rates (and allowing various forms of tax relief) particularly in relation to CT and VAT, (2) the transformation from a production-based VAT into a consumption-based VAT, and (3) an appreciation of the necessity to improve – and of course fund – the social security system for transition to a consumption-led economic development model.

Before embarking upon our analysis, it is useful to provide some background from which we can appreciate the implementation of the reforms summarized above. It is now accepted in Beijing that China's economic development model of export-oriented, high input, high consumption, high pollution, but low output in terms of energy intensity,¹⁹ is no longer affordable or sustainable. Accordingly, the Central Government resolved to shift the balance of growth from reliance upon exports towards promoting domestic spending.²⁰ Indeed, the proportion of consumption to GDP in China has been on the decline from 2000 to 2008 (as Table 5 below shows), even though China's GDP showed substantial increases throughout this period. There was, however, a slight increase in the ratio of consumption to GDP in 2009. This was

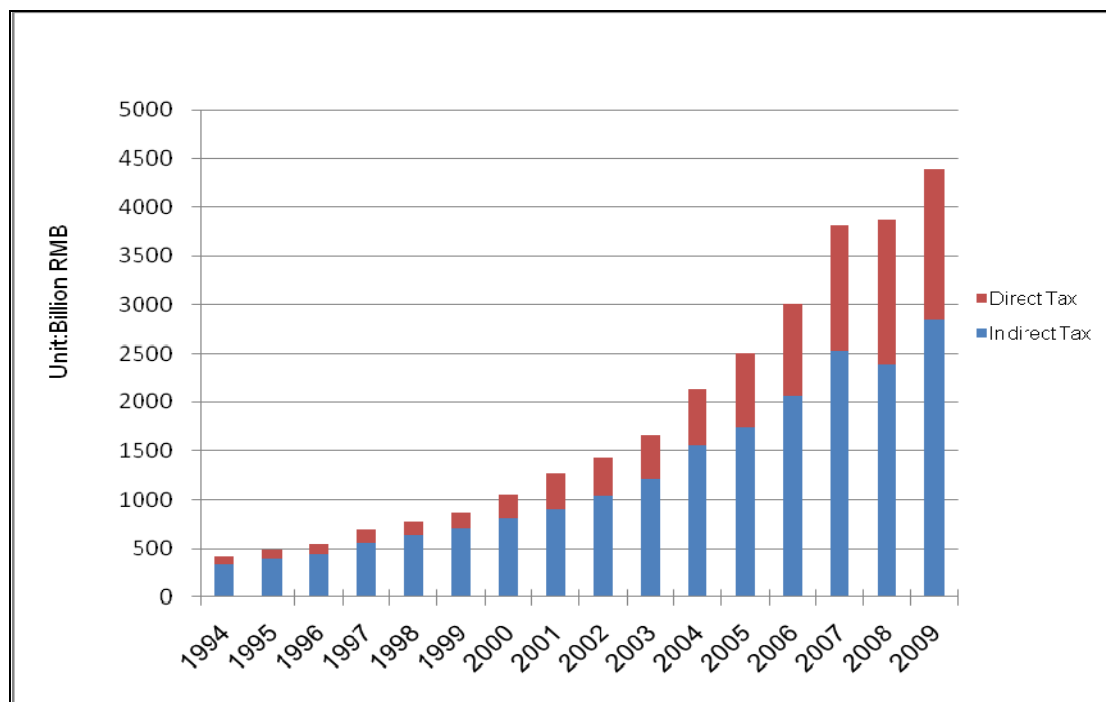
meet, see "Tax Cut for Low-Profit Small Enterprises", *China Daily*, 15 December 2009, http://www.chinadaily.com.cn/bizchina/2009-12/15/content_9181949.htm (accessed 22 November 2010).

¹⁹ Energy intensity is a measure of the energy efficiency of a nation's economy, which is calculated as units of energy per unit of gross domestic product (GDP). High energy intensity indicates a high price or cost of converting energy into GDP. A nation that is highly economically productive will have a far lower energy intensity than a nation that is economically unproductive. According to some studies, energy consumption in 2000 in China was 14.32 billion tons of coal equivalent (tce) and in 2005 was 22.25 billions tce, which represents an average annual increase of 11.1 percent. There was a significant deterioration in energy use efficiency in China compared to the preceding 20 years during which a 400 percent increase in GDP was accompanied by an increase in energy consumption of only 200 percent. See the Asian Development Bank (ADB), *Country Environmental Analysis for the People's Republic of China*, May 2007, available at <http://www.adb.org/Documents/Produced-Under-TA/39079/39079-PRC-DPTA.pdf> (accessed 2 February 2010).

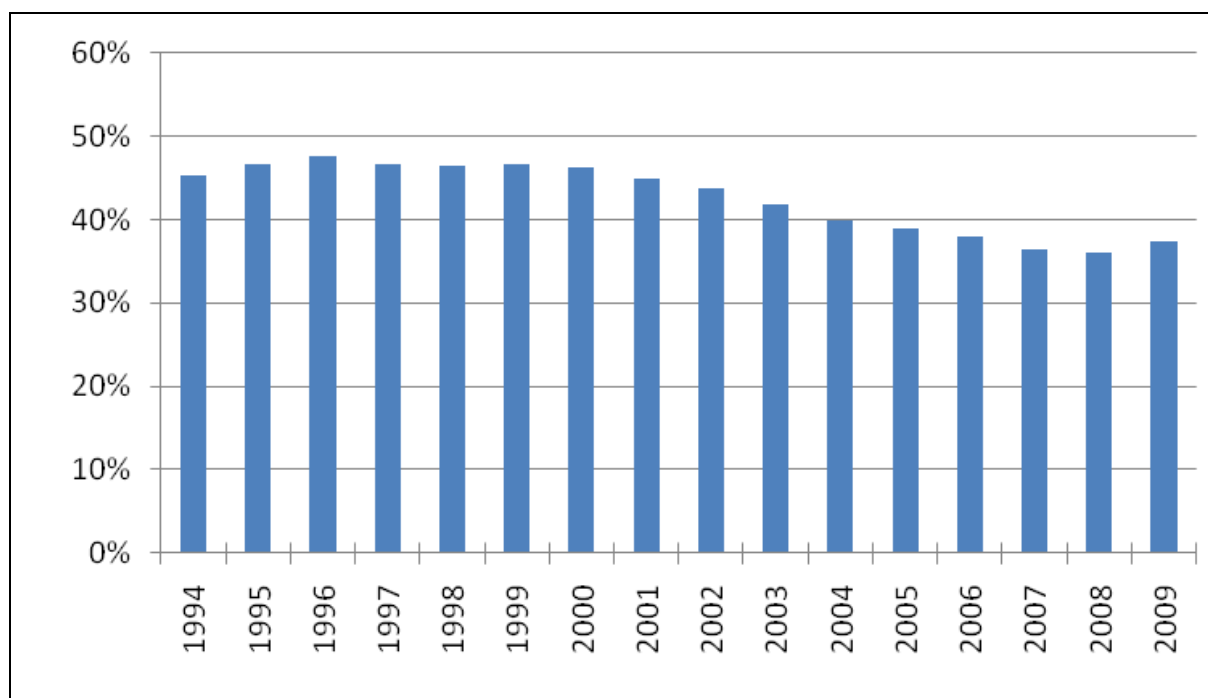
²⁰ See Premier Wen Jiabao, "Government Report 2008 for the 11th National People's Congress" (in Chinese), 5 March 2008, available at <http://www.xinhuanet.com/2008lh/gzbg/20080305.htm> (accessed 1 February 2010).

most probably attributable to the Central Government's stimulus measures (which, in part, incorporated the indirect tax reforms discussed below) for expanding domestic consumption as part of its overall plan to deal with the GFC.

TABLE 4: TAX REVENUE COMPOSITION IN CHINA²¹



²¹ For the purposes of this comparison, direct tax revenue only includes revenue from Enterprise Income Tax and Individual Income Tax; indirect tax revenue only includes revenue from VAT, BT, CT, and revenue from Customs' collection of VAT and CT on imported goods (after deduction of export tax refunds). For data, see the SAT, "Statistical Data of Tax Revenues from 1994 to 2008", available at <http://www.chinatax.gov.cn/n8136506/n8136593/n8137633/n8138817/index.html> (accessed 5 February 2010). For data in 2009, see the Tax Policy Department of the Ministry of Finance of China (MOF), "Analysis on the Increase in Tax Revenues in 2009" (in Chinese), published by the MOF, available at http://szs.mof.gov.cn/zhengwuxinxi/gongzuodongtai/201002/t20100211_270552.html (accessed 24 March 2010) [hereinafter 2009 Tax Analysis].

TABLE 5: PROPORTION OF CONSUMPTION TO GDP IN CHINA²²

China's focus upon increasing exports to promote economic growth proved problematic however, as shown by the consequences of the GFC's impact on China's major trading partners such as the US, the UK and the EU. Moreover, there is an insufficient level of domestic demand in China.²³ And, in this regard, an imbalance exists between urban and rural household consumption. To help deal with the increased difficulties facing China's economy brought about by the GFC (specifically, the shrinkage in exports and consumption), the Central Government decided to implement important reforms to China's indirect tax system (as one part of its stimulus package).

3.1 Reduction in Certain Tax Rates

China's Central Government is clearly determined to increase domestic consumption as a key to maintaining long-term, sustainable development. Indeed, at an early stage it provided a host of incentives to boost domestic household consumption as a means of dealing with the adverse effects of the GFC.

One of the most significant of these incentives was to cut certain tax rates. For instance, the rate of vehicle acquisition tax on cars with a capacity of less than 1.6 liters was reduced from 10 percent to 5 percent during the period from 20 January

²² For data from 1994 to 2008, see the NBS, "GDP Data" in *Online Statistics Database*, available at <http://219.235.129.58/indicatorYearQuery.do> (accessed 6 February 2010). For data in 2009, see the NBS, 2009 NESD Report, *supra* note 11.

²³ See Xiaolu Wang and Fan Gang, "Economic Crisis, Keynesianism and Structural Imbalance in China", 8 July 2009, available at http://epress.anu.edu.au/china_new_place/pdf/ch08.pdf (accessed 21 April 2010).

2009 to 31 December 2009. The reduction was continued throughout 2010, albeit at the rate of 7.5 percent.²⁴ The CT rate on cars with a capacity of less than 1 liter was also reduced from 3 percent to 1 percent by the CT reforms introduced at the end of 2008.²⁵ By way of contrast, the CT rates on motor cars with a capacity of 3 liters to 4 liters and more than 4 liters have been increased by 10 and 20 percent, respectively.

The 2008 CT reforms also changed the tax rate structure on fuel products. Previously, petrol was taxed at RMB 0.2 per liter without differentiating whether it was leaded or non-leaded.²⁶ After the reforms, leaded petrol was taxed at RMB 0.28 per liter, but non-leaded petrol remained taxed at RMB 0.2 per liter.²⁷ Although the CT rate was not altered drastically, new taxable items including aviation kerosene, fuel oil, solvents and lubricant oil were added to the category of taxable oil products.

Soon after these reforms were implemented however, CT on petrol was increased by up to seven-fold starting from 1 January 2009, as part of a broader reform relating to fuel taxation and pricing approved by the State Council.²⁸ The tax rate for leaded petrol climbed to RMB 1.4 per liter from RMB 0.28. Importantly, this figure is higher than the rate for unleaded petrol of RMB 1 per liter and the rate for diesel of RMB 0.8 per liter.²⁹ Concomitant with the increase of the tax rate on oil products, six types of government charges were waived, namely, road maintenance fee, channel maintenance fee, administration fee for highway transportation, highway transportation surcharges, administration fee for water transportation, and water transportation surcharges. Phasing out these administrative charges was intended to offset the increased burden borne by the public for fuel consumption as well as to simplify the tax (and fee) regimes relating to fuel. As stated in the Notice promulgated by the State Council, the intention is to promote energy-saving, cut pollution in cities and reduce oil imports.³⁰ The adjustment of CT on oil products is also aimed at playing a role in promoting economic restructuring, standardizing the imposition of administrative charges, and ensuring equal sharing of the tax burden among users.³¹ To counterbalance the effect of these tax increases, government subsidies were provided for certain sectors such as public transportation and particularly affected groups of people such as grain-producing farmers.

The fuel taxation and pricing reforms described above constitute one part of the Central Government's fiscal and tax policy to respond to the numerous challenges produced by the GFC on China's domestic economy. In short, increasing energy efficiency and reducing dependence on external resources through the mechanism of

²⁴ See the MOF and the State Administration of Taxation (SAT) Notice No. 154, 2009.

²⁵ The Provisional Regulations on Consumption Tax (CT Regulations) were issued by the State Council on 13 December 1993, and amended on 5 November 2008 by the State Council Order No. 539. The Regulations came into effect on 1 January 2009. For the tax rate on cars, see Amended CT Regulations, Schedule of Tax Items and Tax Rates, item 9 (1).

²⁶ CT Regulations, Schedule of Tax Items and Tax Rates, item 7.

²⁷ Amended CT Regulations, Schedule of Tax Items and Tax Rates, item 6 (1).

²⁸ See the State Council Notice of Implementing the Reform on Fuel Taxation and Pricing, No. 37, 2008 [hereinafter SCN Fuel Reform].

²⁹ The MOF and SAT Notice of Increasing the Consumption Tax Rates on Fuel Products, No. 167, 2008, Art. 1.

³⁰ See the SCN Fuel Reform, Sec. 1, *supra* note 28.

³¹ *Id.*

taxation are intended to play a positive role in responding to the ongoing impacts of the GFC on China's economy and in furthering China's long-term development plan.

In addition to these tax reforms, an array of fiscal incentives has been provided for rural residents to buy vehicles, appliances and agricultural machines, and other goods such as refrigerators and computers. Urban residents can also receive a subsidy if they trade in cars and home appliances for new goods.³²

Apart from reducing taxes on motor vehicle acquisitions, the Central Government *increased* tax rates on selected items. For example, from 1 October 2009 the CT rates on certain tobacco products were increased by varying amounts. An additional 5 percent surtax based on the sales value of tobacco products is now also charged at the wholesale stage. Furthermore, with effect from 1 August 2009 the method for imposing CT on alcohol (white spirits) has been adjusted to combat avoidance.³³ This adjustment was made to regulate spirit producers, usually large-scale enterprises who set up their own agencies to manipulate "transfer prices". The protection of the tax base and the efforts to combat tax avoidance and tax evasion (which are not limited to the imposition of CT on spirits) were deemed necessary in difficult economic times.

In summary, it is obvious that the reformed CT rates relating to motor vehicles and fuel encourages the purchase and use of smaller low emission cars and discriminates against larger high emission cars. This change illustrates that the Central Government intends to employ economic instruments, in particular taxation, to foster China's economic development in a sustainable manner, but without creating too great an impact on the economy especially during times of economic difficulty.

3.2 Move to a Consumption-based Value Added Tax System

VAT, together with BT and CT, was formally introduced in China during the 1994 tax reform. VAT applies to goods and certain services involving the provision of labour,³⁴ BT applies to most other services as well as to the transfer of intangible assets and immovable property,³⁵ and CT applies to, typically, luxury goods (such as cigarettes, wine, and expensive jewelry, as well as motor vehicles and fuel) in addition to VAT.³⁶ The imposition of VAT and BT are mutually exclusive, and in combination they cover the scope of a classic VAT system (such as the European-style VAT).

³² See "China's Expanding Domestic Consumption is Helpful to Balance Global Economic Development" (in Chinese), *The Xinhua News Agency*, 12 November 2008, available at http://www.gov.cn/wszb/zhibo281/content_1148168.htm (accessed 1 February 2010); see also "Shopaholics Wanted", *Economist*, 25 June 2009; and Laurence E. Lipsher, "Asian Tax Review: A Fast and Furious Tax Year-End in China" *Tax Notes International* (18 January 2010), at p. 261. Lipsher states: "Starting in January 2010, those trading in will get between RMB 5,000 to RMB 18,000, a substantial stimulus. In effect, this will create a used car business the likes of which [in China] has never existed ..."

³³ See the SAT, Circular for Strengthening Tax Administration on Spirits Consumption Tax and the appended Management Measure for the Approval of Minimum Prices for Tax Assessment of Spirits Consumption Tax, SAT Circular No. 380, 2009.

³⁴ VAT Regulations, Art. 1.

³⁵ BT Regulations, Art. 1.

³⁶ CT Regulations, Art. 1; Schedule of Tax Items and Tax Rates.

The standard VAT rate of 17 percent was imposed on most taxable activities including selling or importing goods and supplying services involving the provision of labour.³⁷ It is largely restricted to manufacturing activity and is supplemented by a low rate of 3 percent for BT imposed on the provision of key service items including transportation, post and telecommunications, as well as a rate of 5 percent for professional and financial services.³⁸ A reduced VAT rate of 13 percent applies to a range of goods including basic staples and household necessities such as food, fuel, electricity, books, newspapers and magazines and agricultural products.³⁹ There is a notional zero rate scheme for exports⁴⁰ but in practice, this is not applied and instead a completely separate export rebate system has been established. There are two types of taxable persons under the VAT law, and a taxpayer's status may affect its VAT liabilities. The first category comprises general taxpayers who have the right to deduct input tax while the second category, small-scale taxpayers, have no such right (although reduced tax rates can apply to their taxable activities). Initially, the VAT rate for small-scale taxpayers engaging in commercial activities was 4 percent,⁴¹ and 6 percent for small-scale taxpayers engaging mainly in production activities.⁴²

The most distinctive characteristic of the 1994 Chinese VAT is that it was a production-based not consumption-based tax—since the VAT paid on the purchase of capital goods such as equipment and fixed assets was not allowed to be credited against VAT payable.⁴³ The non-allowance of input tax for purchased capital assets added to the cost and sale price of manufactured goods within the production and distribution chain. This led to duplicated VAT levies through the supply chain in the entire business cycle and increased the tax burden on enterprises in general. In particular, it penalized the purchase of fixed assets by a business, and more broadly penalized capital-intensive production techniques. Though the standard VAT rate is 17 percent, the effective tax rate could amount to around 23 percent when converting the production-based VAT into the consumption-based VAT. Thus, this production-type VAT had, perhaps unintentionally, become a negative factor in promoting the upgrading of technology and economic growth in China, further weakening the competitive edge of Chinese enterprises in international markets. This issue became particularly severe in the face of economic adversity brought on by the GFC.

In order to encourage investment in infrastructure, reduce the tax burden on capital investment by enterprises, and accelerate technology development within the overall context of adjusting China's industry structure and transforming the pattern of its

³⁷ VAT Regulations, Art. 2 (1) and (4).

³⁸ BT Regulations, Art.2, para.1; and Schedule of Tax Items and Tax Rates.

³⁹ VAT Regulations, Art. 2 (2).

⁴⁰ VAT Regulations, Art. 2 (3).

⁴¹ In 1998 the tax rate for small-scale taxpayers was divided into two types. The tax rate for small-scale taxpayers engaging in commercial activities was reduced to 4 percent, while for all other small-scale taxpayers the tax rate remained at 6 percent. *See* The MOF and SAT Notice on the Tax Policy for Small-Scale Commercial VAT Taxpayers, No. 113, 1998; *see also* the State Council, MOF and SAT, "Press Conference on Amending the VAT Regulations, BT Regulations, and CT Regulations" (in Chinese), available at <http://61.152.208.78/gate/big5/www.csj.sh.gov.cn/gb/csj/szpd/xfs/node5357/userobject7ai35530.html> (accessed 3 February 2010).

⁴² VAT Regulations, Art. 12.

⁴³ VAT Regulations, Art. 10; VAT Rules, Art. 19.

economic growth,⁴⁴ towards the end of 2008 the Central Government decided to reform the VAT, along with BT and CT. It should be noted, however, that the most significant element of the VAT reform (namely, enacting a nationwide consumption-based VAT) was planned well before the GFC, but was only implemented after 2008. Specifically, this change allowed registered VAT general taxpayers to credit input tax incurred on purchases of equipment and other non-real property fixed assets against output VAT levied on their taxable supplies.⁴⁵ Input VAT is not however creditable for (1) fixed assets used solely for tax exempt activities, (2) activities not subject to VAT or (3) personal consumption.⁴⁶ Concurrently, VAT exemptions for imported equipment and VAT refunds for domestically produced equipment purchased by qualified foreign invested enterprises were abolished, although Customs Duty exemptions continue to apply.⁴⁷ All these reforms came into effect on 1 January 2009. Although purchase of real property and intangible property still fall outside the scope of this reform, the change marks a major step in relieving the tax burden on enterprises in China in general and on capital-intensive industries in particular. At the same time, the VAT rate for small-scale taxpayers in all industries was reduced and standardized to 3 percent and the VAT rate on some mineral resources reverted to the standard rate of 17 percent (previously 13 percent) since VAT payers in the mineral industry were allowed to deduct input tax when purchasing fixed assets.

Another important instrument of tax policy concerning the imposition of VAT in China relates to the adjustment of the VAT refund rate for exports. As indicated

⁴⁴ Conceptually, a country's industrial structure may be defined as the relative distribution of its resources and total output among industries differentiated by the raw materials they use, their productive processes, and the finished products that they turn out. Industrial structure has a bearing upon a country's total output, namely, its national income or product, so far as differences among industries are seen as differences in the basic pattern of social and economic institutions under whose aegis the industries are carried on. See Simon Kuznets, "National Income and Industrial Structure" (1949) *Econometrica*, Vol. 17, at pp. 205-241. In the 10th FYP, the Central Government admitted that China has entered into a stage that only by making structural adjustments can the economy be developed further. It decided in the 10th FYP to optimize and upgrade the industrial structure and to strengthen China's international competitiveness. The major targets set in the 10th FYP were to achieve growth for the primary, secondary and tertiary industries at the rates of 13, 51, 36 percent, respectively, of GDP, and to improve national economic and social information technologies as well. In the 11th FYP, the Central Government stated that to maintain balanced, sustainable economic and social development, six principles should be adhered to, among which, speeding up the transformation of economic growth pattern and improving the capacity of independent innovation stand out. China's shortage of natural resources has posed a serious constraint on its economic development. The government is determined to transform China's economy into a "recycling economy", accelerating the construction of a resource-saving and environmentally-friendly society. It has decided to promote information technology development and adopt a new mode of industrialization based on the principles of conserving energy and protecting the environment. See the 10th FYP and the 11th FYP, *supra* note 16.

⁴⁵ See Amended VAT Regulations, Arts. 8 and 10; Amended VAT Rules, Arts. 21 and 25 (issued respectively by the State Council on 10 November 2008 and the MOF on 18 December 2008). According to these provisions, the term "fixed assets" includes machinery, transport vehicles and other equipment, tools and apparatus for production and operation use which have a useful life of more than 12 months. The term "fixed assets" does not however include motor vehicles, motorcycles, boats or yachts which are subject to CT and those for private use.

⁴⁶ Amended VAT Rules, Art. 21, para. 1.

⁴⁷ See the Decree Regarding the Adjustments to Some Preferential Import Tax Policies Jointly Issued by the MOF, SAT and the General Administration of Customs of the PRC (GAC), No. 43, 2008 and the Notice Regarding the Abolition of VAT Refund Policy on the Purchase of Domestically Manufactured Equipment by Foreign Invested Enterprises, The MOF and SAT No. 176, 2008.

above, China notionally practices zero-rating on exports (as do most countries), but the Central Government frequently adjusts the rates at which input taxes are credited or rebated.⁴⁸ The government may increase the refund amount when it desires to encourage exports but reduce the amount when budgetary demands dictate or when it seeks to avoid conflicts with foreign trade partners.⁴⁹ From 1 August 2008 to 1 June 2009, the State Administration of Taxation of the PRC (SAT) adjusted the VAT refund rate for exports no fewer than seven times. The object was to support China's export enterprises in a context of global economic downturn. For instance, on 1 June 2009 the export tax rebate was raised in varying degrees for selected items, in particular for farm produce and labor-intensive products such as luggage, shoes, and household electrical appliances, and for certain products manufactured with a higher level of technology.⁵⁰ It is worth noting that these adjustments were not made simply for stimulating exports. They were also made for stabilizing China's foreign trade situation and facilitating changes to the country's industrial structure. This purpose can be gleaned from examining the different rebate rates among commodities that were eligible for export refunds—for example, mechanical and electrical goods produced with a high level of technology were given the highest rebate rate of 17 percent while steel products with high energy consumption were given the much lower rate of 9 percent.⁵¹

A further taxation policy designed to stimulate China's declining export sector as a result of a deteriorating global economy should be noted. In the Export Duty Notice published on 13 November 2008 Customs Duty was abolished on 68 types of base metals and articles of base metal, and reduced or abolished on 26 types of fertilizers and 52 types of cereals and products of the milling industry.⁵²

To help China's financial institutions (which are generally subject to BT rather than VAT) through the GFC, the securities exchange tax rate was reduced from 0.3 percent to 0.1 percent from 24 April 2008 and the tax was levied solely on the sellers of securities from 19 September 2008.⁵³ (In addition, interest derived by individual

⁴⁸ There were several reasons why China opted for an export refund VAT system. Briefly, in the first year of formally implementing VAT in China, due to rapid export growth, and fraudulent invoices and rebate claims, a large number of the rebates claimed had to be deferred. In the following two years, the government budget still could not satisfy the claims and as a result the rebate rates were reduced. See J. Whalley and Li Wang, "Evaluating the Impure Chinese VAT Relative to a Pure Form in a Simple Monetary Trade Model with an Endogenous Trade Surplus" *NBER Working Paper* No.13581, 2007.

⁴⁹ In China, VAT refunds for exported goods and the VAT exemption on importation of capital equipment were often subject to adjustment. Normally, taxpayers pay VAT first and then claim VAT refunds from the relevant tax authority based on the Exported Goods Declaration certified by Customs. The procedures and assessment of VAT refunds are very complicated and the Central Government has issued a number of circulars in relation thereto. *China Briefing* reported on 23 December 2009 that export VAT rebates would continue through 2010.

⁵⁰ See the MOF and SAT Notice on Further Increasing Export Refund Rates on Certain Commodities, No.88, 2009.

⁵¹ *Id.* Export tax refunds for some steel products involving high energy consumption were recently repealed, see the MOF and SAT Notice on Invalidating VAT Refund for Certain Products, No. 57, 2010. The repeal was effected mainly for the purposes of reducing pollution and saving energy, as well as for fostering industrial structural change.

⁵² See the Notice of the Customs Tariff Committee of the State Council on Revising the Export Customs Duty Rates, 13 November 2008.

⁵³ For details, see "Adjustment of Imposition Method on Securities Exchange Tax", available at http://www.gov.cn/jrzq/2008-09/18/content_1098950.htm (accessed 23 March 2010).

investors on the settlement of securities transactions was temporarily exempted from Individual Income Tax.⁵⁴) This reduction and change of the imposition method served as a fillip to China's securities market.

Finally, the Central Government is still considering plans to extend the tax base of VAT to cover BT in order to eliminate the double taxation on service providers produced by the separation of these two taxes. Currently BT is levied on gross turnover derived from provision of services, assignment and licence of intangible assets, and sale or rental of real estate, provided that such activities are rendered or carried on within China. There is no credit for BT paid along the supply chain as is the case with VAT. Separation of the tax base thus means that VAT taxpayers still do not get any relief for BT paid on the provision of services and other items that would be credited under a comprehensive VAT or goods and services tax (GST).

As we will see below, the timing of the VAT reforms could not have taken place at a better time. VAT reform has long been considered an important policy goal by the Central Government,⁵⁵ and experiments were carried out in some parts of the Northeast and Central regions of China as well as for certain industries including the oil, chemical, and automobile sectors with a view to eventually extending it nationally.⁵⁶ According to official reports, the move to a consumption-based VAT was effective from an economic perspective during the trial phase.⁵⁷ The major overhaul was, nonetheless, undertaken only after the GFC emerged, which shows the GFC prompted the government to apply the reforms to the whole country and to all industries in order to help increase investment in fixed assets and relieve the tax burden placed on many enterprises. The GFC had a negative impact on industrial production, with many enterprises suffering shortfalls of working capital. The inability to expand production and the consequent shrinkage of investment in fixed assets were, for many enterprises, serious problems. Allowing input VAT paid for the purchase of fixed assets to be credited against VAT payments clearly provided immediate cash flow benefits for enterprises in China during a time of financial turmoil, and in the long term facilitates development of capital-intensive industries and a platform for upgrading technology.

⁵⁴ See the MOF and SAT Circular on the Policy of Individual Income Tax on the Income Derived from Interests of Securities Trading Settlement by Individual Investors of Securities Market, No.140, 2008.

⁵⁵ See Gao Peiyong, "Implementation of a New Round of Tax Reform Under a Structural Tax Reduction" (2009) *Asia-Pacific Journal of Taxation* 62. Gao notes that the 2008 reforms can be traced back to the Third Plenary Session of the 16th Party Central Committee of the CPC held in October 2003. During this meeting proposed changes included the reform of the export tax refund system and a reform of VAT from a production-oriented to a consumption-oriented system.

⁵⁶ See the SAT, "VAT Transformation: Win-Win for Taxation System Reform and Economic Development", 6 February 2009, available at <http://www.chinatax.gov.cn/n8136506/n8136593/n8137537/n8138532/8814903.html> (accessed 5 February 2010). The Central Government began a pilot reform in Northeast China, which covered three provinces, namely, Heilongjiang, Liaoning, and Jilin in January 2004. The pilot reform covered eight industrial sectors including oil, chemical, and automobile production. The trial scheme was extended to 26 cities in the central region in July 2007 and to parts of the Inner Mongolia Autonomous Region and the areas hit hard by the Wenchuan earthquake in July 2008.

⁵⁷ See the SAT, "VAT Reform Trial in Northeast China Achieved Positive Effects", 21 December 2005, <http://www.chinatax.gov.cn/n480462/n480483/n480549/1009527.html>; and "SAT: VAT Reform Trial in Central China Had Evident Effects", 6 February 2008, <http://finance.people.com.cn/GB/6869248.html> (accessed 23 November 2010).

3.3 General Measures to Improve the Social Security System

The GFC clearly made it more urgent for China to change the focus of its domestic economic development from an export to a consumption model. Indeed, what China's economy faced during and after the GFC is not simply a short-term difficulty, but a fundamental challenge to its development model that originated from East Asia's economic success led by Japan.⁵⁸ The eruption of the GFC and its impacts on China betrayed a severe problem in the Chinese economy, namely, structural imbalance, which is reflected by not only the heavy reliance on export-oriented manufacturing and processing industries, but also the excessive expansion of industrial capacity at the cost of consumption.⁵⁹ Despite a steady increase in GDP, China's consumption rate as a percentage to GDP has kept falling (as noted in Table 5 above).

Compared with the low consumption rate however, the savings rate in China has remained high.⁶⁰ This is not necessarily because the Chinese people are economically prudent, but because the inadequate socio-economic welfare system makes them feel insecure about healthcare, children's education, unexpected rainy days and eventual retirement from the workforce. Taking the savings rate of urban households for example (as data for the savings rate of rural households is limited), the average savings rate relative to disposable income rose from 17 percent in 1995 to 24 percent in 2005, against a background of rapid income growth and an interest rate on bank deposits that was very low throughout the period.⁶¹ The unique pattern of savings behavior in China at present – relatively high savings rates at the early and late stages of the life cycle – is inconsistent with the standard life cycle model in which young workers save little in anticipation of rising income but then savings rates tend to peak when earnings potential is the highest in middle age and fall off as workers approach retirement.⁶² A detailed study by Chamon and Prasad on the increase in savings rates of urban households in China suggests that habit formation cannot provide sufficient evidence to explain the rise in saving rates; but rather that the declining public provision of education, health, and housing services seems to offer more convincing explanations, at least during a transitional period.⁶³ Interestingly, Chamon and Prasad contend that the build-up in savings would have been smaller if financial markets in China were more developed,⁶⁴ since this would allow households to borrow against future income, diversify their assets, and obtain better rates of return on their savings. Importantly, improvements in the social security system would pool the risks associated with unusual income shocks and health expenditures, reducing the need for

⁵⁸ See Huang Jing, "Social Security Crucial to Higher Consumption", *China Daily*, 15 January 2009, available at http://www.chinadaily.com.cn/bizchina/2009-01/15/content_7400619.htm (accessed 6 February 2010).

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ See Marcos Chamon and Eswar Prasad, "Why are Saving Rates of Urban Households in China Rising?" *NBER Working Paper* No. 14546, December 2008.

⁶² *Id.*

⁶³ *Id.*

⁶⁴ Chamon and Prasad found that most house purchases in China were financed from savings and that this was an important reason for increased household savings over the past decade. They conclude that although house purchases would continue on an upward trend as income levels rise and the capacity to buy better houses increases, nonetheless saving rates could stay high given that the mortgage market in China is still underdeveloped.

households to save for the purposes of self-insurance.⁶⁵ In the event, Chamon and Prasad's study illustrates that the long-term remedies for China's economic problems lie in increasing the consumption level while developing an adequate socio-economic welfare system. Simply put, these two aspects are essentially interrelated.⁶⁶

The Central Government has been well aware of these challenges and has taken serious steps to improve China's social safety net to achieve sustainable development in the economy and society. One key goal of this plan is, in the long run, to encourage people to save less and spend more.⁶⁷ One of essential aims of China's massive stimulus package for the GFC,⁶⁸ which was to be spent on improving the standard of living of rural households, infrastructure, raising the level of social security and public housing, improving public healthcare and education and so on, is to develop a strong and balanced internal market (so as to increase domestic demand and promote healthy economic development).⁶⁹ The GFC has shown that only a transformation in the growth model in China from heavy reliance on external demand to domestic-based demand will provide a basis for continued growth.⁷⁰ It has been argued that an improved social security system may be able to reduce savings and increase consumption, which, along with other measures, would effectively correct the saving-consumption imbalance in China.⁷¹

The sufficiency of the social security system is indeed hugely problematic in China.⁷² Throughout the economic reform period from the 1980s onwards, individual expenditure on medical-care, pension and education by ordinary individuals has

⁶⁵ *Id.*

⁶⁶ *Id.* See also Huang, *supra* note 58.

⁶⁷ Consumption can be seen as the part of disposable income that does not go into savings. Generally, as wealth rises, consumers will substitute less costly inferior goods and services and choose higher priced alternatives. Consumerism refers to economic policies placing emphasis on consumption. It has strong links with the western world – modern capitalism. However, unnecessary, irrational and excessive consumption is more likely to damage the environment and use up resources at a higher rate. Conspicuous consumption has been on the rise throughout the 20th century and beyond. A consumer can have the instant gratification of purchasing an expensive item that will help improve his or her social status. Many developed countries have a high-income and a high (indeed excessively high) consumption model, which has helped trigger the GFC. Thus, China needs to be clear about what kind of consumption it aims to promote for sustainable development. While the Central Government has encouraged domestic household consumption, it also stresses that it is necessary to pursue an environmental-friendly, rational and limited consumption model. See the 11th FYP, *supra* note 16.

⁶⁸ For details of the stimulus package, see the Appendix.

⁶⁹ See, e.g., Paul Maidment, "China Announces Massive Stimulus Package", *Forbes*, 9 November 2008, available at http://www.forbes.com/2008/11/09/china-stimulus-economy-biz-cx_pm_1109notes.html (accessed 6 February 2010); see also "China's Stimulus Package", *The Economist*, 12 November 2008, available at http://www.economist.com/blogs/theworldin2009/2008/11/chinas_stimulus_package (accessed 6 February 2010).

⁷⁰ See Wang and Fan, *supra* note 23; see also Huang Yiping and Tao Kunyu, "Causes and Remedies of China's External Imbalances", *China Center for Economic Research Working Paper Series No. E2010002*, 25 February, 2010, available at <http://www.ccer.edu.cn/download/10946-1.pdf> (accessed 21 April 2010).

⁷¹ *Id.*

⁷² See generally, "Social Security Reform in China: Issues and Options", 27 January 2005, available at http://www.oup.com/us/pdf/social_security_study_2005 (accessed 6 February 2010); see also Li Jieli, Yi Feng, and Ismene Gizelis, "China's New Social Security System in the Making: Problems and Prospects" (2008) *International Journal of Public Administration* 31, at pp. 5-23.

increased dramatically (as the national share in these areas has reduced).⁷³ The level of expenditure on consumption as a contribution towards economic growth has dropped from around 46 percent of GDP in 2000 to 36 percent of GDP in 2008.⁷⁴ The main problem is “high-income earners are unwilling to spend, and low-income people have no capacity to spend.”⁷⁵ Due to large differences in wealth distribution, consumption by low-income earners is limited to basic living items. According to the National Statistical Bureau sample survey in 2007, around 60 percent of the urban population (about 365 million people) had a monthly disposable income on average of only RMB 1,000 per person. And sadly, during this time the average monthly net income of 40 percent of the rural population (about 291 million people) did not exceed RMB 220 per person.⁷⁶

Having realized the problem, the Central Government began serious efforts to reform the medical system and to extend the pension scheme to Chinese rural residents. However, neither of these social security benefits has yet been comprehensively expanded to fully cover rural residents. Things have been changed since 2006 when a nationwide rural cooperative medical service was determined to be generally established in rural areas in 2008.⁷⁷ According to a recent policy statement,⁷⁸ a basic medical care system is expected to be established by 2011 to cover all Chinese urban and rural residents. A basic pension scheme benefiting rural residents has been incrementally implemented on a trial basis, and is expected to cover all rural residents by 2020.⁷⁹

Improvements in the social security system are clearly conducive to maintain socio-political stability. However, to operate a fair and efficient social security system it is also obvious that the government needs to raise sufficient funds. Although increasing the rates of direct taxation, such as Enterprise Income Tax and Individual Income Tax, may not be politically and economically desirable, raising money from broadly-based indirect taxation seems feasible. This could be achieved by broadening the VAT base, increasing tax rates on certain consumer goods such as luxury vehicles and expensive jewelry, and introducing a comprehensive environmental tax regime.

Reforms in VAT, BT, and CT occurred after the outbreak of the GFC. These reforms are partly—and importantly—driven by China’s domestic economic and taxation concerns. But they have also undoubtedly been accelerated by the GFC. The crisis has also revealed that the high input but low output and high pollution developmental model in China is reaching the end of its useful life. Greening the tax regime will also

⁷³ For example, Chamon and Prasad’s study found that health and education expenditures have increased from 2 percent of consumption expenditures among urban households in 1995 to 14 percent in 2005.

See Chamon and Prasad, *supra* note 61.

⁷⁴ See the NBS, *supra* note 22; see also Table 5.

⁷⁵ See Qing Zhu, “China’s Response to the International Financial Crisis, Fiscal Policy Research” in *SourceJuice*, available at <http://www.sourcejuice.com/1258106/2009/09/21/China-response-international-financial-crisis-fiscal-policy-research/> (accessed 22 October 2009).

⁷⁶ *Id.*

⁷⁷ See the Central Committee of CPC and State Council, *Some Opinions on Furthering Construction of New Socialist Countryside*, 31 December 2005.

⁷⁸ See the Central Committee of the CPC and State Council, *Opinion on Deepening the Medical and Health Care Reforms*, 17 March 2009.

⁷⁹ See the State Council, *Guideline on Implementing the Pilot Reform of New Pension Insurance System for Rural Residents*, No. 32 [2009].

help provide an opportunity for China's sustainable development. Introducing environmental taxes and reforming the indirect tax regime should result in a number of distortionary taxes being phased out. This will be of significant help to rationalize China's overall tax system. As will be shown in Part IV below, it will also help provide sustainable tax revenues for the provision of social security for the people.

4. EVALUATION OF THE RECENT TAX REFORMS

The series of structural tax cuts and reform measures described above, as explained by China's Vice Premier Li Keqiang, were intended to combat the challenges produced by the GFC.⁸⁰ Specifically, tax policy was used as a means to adjust and control the national economy, to improve people's livelihood, and to influence behavior. In this regard, the reforms were carried out to expand domestic demand, assist structural adjustment so as to promote economic growth both in terms of quality and overall productivity, and to promote sustainable development. This then gives rise to what we perceive to be the crucial question—were the tax cuts and reforms effective in achieving the desired goals?

4.1 Growth Effects of Tax Reforms (economic recovery)

If the tax cuts and reforms were effective, we should clearly be able to see increases in investment, employment, and consumption as targeted by the Central Government. In this regard, various statistics show that the reforms and changes to China's indirect taxation system have played their part in pushing the Chinese economy far away from the edge of the doldrums.

The quarterly figures for China's GDP growth rate in 2009 increased from a disappointing 6.2 percent for the first quarter to an admirable 10.7 percent for the fourth.⁸¹ This was achieved notwithstanding reduced external demand. In the event, the GDP growth rate for 2009 was 8.7 percent, which significantly surpassed the previous target of 8 percent. This was in sharp contrast to the significant economic downturn and soaring unemployment rates in other major economies.⁸² The promising prospect for China's economy that is apparent from these statistics is also reflected in the recent FDI environment—since August 2009, China has witnessed a steady

⁸⁰ See the SAT, "Li Keqiang: Give Full Play to the Role of Fiscal and Tax Policy for Advancing Development and Improving People's Livelihood", 12 November 2009, available at <http://202.108.90.130/n6669073/n6669118/9341095.html> (accessed 3 February 2010).

⁸¹ See Ma Jiantang, "National Economy Overall Rebounded in 2009" in the *Official Website of NBS*, 21 January 2010, available at http://www.stats.gov.cn/tjfx/jdfx/t20100121_402615506.htm (accessed 6 February 2010).

⁸² For instance, the US economy lost more jobs than expected in December 2009 while the unemployment rate held steady at 10 percent. The Euro zone jobless rate also rose to 10 percent in November 2009 for the first time since the single currency was introduced at the beginning of 1999. See the United States Department of Labor, "International Unemployment Rates and Employment Indexes, Seasonally Adjusted, 2008-2010" Table 1, available at http://www.bls.gov/fls/intl_unemployment_rates_monthly.htm#Rtable1 (accessed 25 March 2010); and The Associated Press (London), "Euro Zone Jobless Rate Hits 10%" in *The Globe and Mail*, 8 January 2010, available at <http://www.theglobeandmail.com/report-on-business/euro-zone-jobless-rate-hits-10/article1423501/> (accessed 7 February 2010).

upward trend of FDI for five consecutive months.⁸³ And, it has been estimated that FDI to China can rise a further 10 percent in 2010.⁸⁴ This strong increase clearly reveals foreign investors' confidence in the Chinese economy.

Turning now to the plight of rural migrant workers, the severe unemployment problem has been somewhat mitigated. Stimulated by the more favorable arrangement of VAT refunds on exports as well as certain direct subsidies from the Central and local governments, the export-oriented SMEs in the Pearl River Delta have rebounded.⁸⁵ Indeed, at the end of 2009, it has been reported that some SMEs found it difficult to recruit new workers given the fact that the improving job market has already pushed wage levels higher.⁸⁶

Though the Central Government has called for a shift of focus in China's development model to promoting domestic consumption, export growth still matters to China's economy, particularly during this transitional period. Export figures reveal that only a moderate decline has occurred for the major labor-intensive products for which VAT refund rates have been raised. For example, in the first three quarters of 2009, the year-on-year decrease for China's exports for major labor-intensive products was lower than the overall decrease for exports of 21.3 percent for the same period.⁸⁷ The highest export rebate industries generally performed better than less favoured sectors during the GFC. The example in Part III B above illustrates this conclusion—in 2009 the highest rebate industries producing mechanical and electrical goods only suffered a year-on-year decrease in exports of 11 percent, while the lower rebate steel industry suffered a year-on-year decrease in exports of 67 percent.⁸⁸ Since June 2009, the decline in China's export sector began to stabilize, and it then quickly regained upward momentum. China's imports and exports surged 32.7 percent year-on-year in December 2009.⁸⁹ The level of exports of US\$130.7 billion even reached a historical high, which has helped China replace Germany as the world's number one exporting country.⁹⁰ The Central Government continued providing VAT rebates on exports through 2010 after China's foreign trade performance for November 2009 showed the

⁸³ See the MOC, "Statistics on the FDI", available at <http://www.mofcom.gov.cn/static/v/tongjiziliao/v.html/1> (accessed 6 February 2010); see also the MOC, "Press Conference (15 January 2010)" (in Chinese), available at <http://www.mofcom.gov.cn/aarticle/ae/ah/201001/20100106748039.html> (accessed 6 February 2010).

⁸⁴ See Liu Lulu and Sun Shaohua, "Economic Forecast: 10% Expected Growth of FDI to China in 2010" (in Chinese), *Xinhua News Online*, 25 December 2009, available at http://big5.xinhuanet.com/gate/big5/news.xinhuanet.com/fortune/2009-12/25/content_12701757.htm (accessed 6 February 2010).

⁸⁵ See Qiu Quanlin, "Worker Shortage Grips Export Hub", *China Daily Online*, 23 January 2010, available at http://www.chinadaily.com.cn/china/2010-01/23/content_9366179.htm (accessed 6 February 2010).

⁸⁶ *Id.*

⁸⁷ See the SAT, "Export Tax Rates in September Recorded a New High", 12 November 2009, available at <http://202.108.90.130/n6669073/n6669118/9341082.html> (accessed 4 February 2010).

⁸⁸ These statistics were obtained from the CEIC Database, "Foreign Trade China".

⁸⁹ See the MOC, "Briefing of China's Imports and Exports in December 2009", available at <http://zhhs.mofcom.gov.cn/aarticle/Nocategory/201001/20100106747574.html> (accessed 6 February 2010).

⁹⁰ See "China Overtakes Germany as World's Largest Exporter", *BBC News Online*, 10 January 2010, available at <http://news.bbc.co.uk/2/hi/8450434.stm> (accessed 21 April 2010).

healthiest increase in over a year, rising 9.8 percent year-on-year.⁹¹ This was the first increase after 12 consecutive months of decline. The actual decline in exports narrowed to 1.2 percent in November while imports climbed 26.7 percent.⁹² Correspondingly, VAT collections at the import stage reversed the downward direction that has been apparent since October 2008.⁹³ VAT refunds for exports also increased from October 2008, by a rate of 10.6 percent.⁹⁴ The reasons for the rapid increase in VAT refunds for exports, as analysed by the Central Government, mainly lie in the rise in VAT refund rates for exported products as well as the overall improvement in China's export performance.⁹⁵

It has also been reported that:

“China's SAT on November 12 [2009] announced that general taxpayers claimed RMB 74.1 billion in credits for input VAT paid on purchases of fixed assets during the first half of 2009, and estimated that the new VAT regime ... will ultimately lessen the VAT burden on taxpayers by more than RMB 140 billion this year. The new [VAT] reform is the biggest tax relief measure in the history of China's single-tax reforms and will help to promote technology, optimize industry structure, upgrade economic growth, and enhance Chinese enterprises' ability to compete in the global market, observers say. In the first three quarters of this year, nationwide investments in fixed assets increased by 33.4 percent over the same period in 2008, according to China's National Bureau of Statistics.”⁹⁶

Turning to consumption, recent data shows that household consumption in 2009 increased 15.5 percent year-on-year and this accounted for 37 percent of GDP in that year,⁹⁷ a slight rise compared with previous years (as shown in Table 5) when China's GDP experienced two-digit growth rates. This was achieved against the backdrop of GDP growth rate of 8.7 percent in 2009, a rate lower than that for previous years. It has also been reported that the rate cuts for vehicle acquisition tax and for CT applying to cars with lower emission capacity provided a strong incentive for the increase in vehicle production and sales. Specifically, there was a 46.2 percent increase in sales volume (and a 48.3 percent increase in production volume) of domestic passenger vehicles in 2009. Sales of vehicles with a capacity of less than 1.6 liters contributed a remarkable 63.5 percent share of total sales in 2009.⁹⁸ These

⁹¹ See “China to Maintain Export Tax Rebates in 2010”, *China Briefing*, 23 December 2009, <http://www.china-briefing.com/news/2009/12/23/china-to-maintain-export-tax-rebates-in-2010.html> (accessed 23 November 2010).

⁹² See the MOC, “Briefing of China's Imports and Exports in November 2009”, available at <http://zhhs.mofcom.gov.cn/aarticle/Nocategory/200912/20091206666658.html> (accessed 21 April 2010).

⁹³ See 2009 Tax Analysis, *supra* note 21; see also the Tax Executive Division of the SAT, “Analysis on the Increase in Tax Revenues in 2008” (in Chinese), published by the MOF, available at http://szs.mof.gov.cn/zhengwuxinxi/gongzuodongtai/200903/t20090304_118900.html# (accessed 24 March 2010) [hereinafter 2008 Tax Analysis].

⁹⁴ *Id.*

⁹⁵ See 2009 Tax Analysis, *supra* note 21.

⁹⁶ J. Wei, “VAT Reform Expected to Greatly Reduce Taxpayer Burden” *Tax Notes International*, 23 November 2009; see also the SAT, “Overall Transformation of VAT May Bring About Tax Abatement in Excess of RMB 120bln”, 16 December 2009, available at <http://202.108.90.130/n6669073/n6669118/9397383.html> (accessed 6 February 2010).

⁹⁷ See the NBS, 2009 NESD Report, *supra* note 11.

⁹⁸ See “Automobile Industry Association: China's Automobile Production Volume Became the No. 1 in the World in 2009” (in Chinese), published by the State Council, available at

achievements are in sharp contrast with the position in 2008 when both automobile production and sales experienced significant decreases due to the shrinkage of individual incomes and the lack of confidence in the economy caused by the GFC.⁹⁹ The tax cut policy which came into force from the very beginning of 2009 has directly and efficiently contributed to China's automobile industry maintaining growth amid conditions of downturn in the global automobile market. All in all, it seems a reasonable conclusion that, given the gradual recovery of China's economy in 2009, many Chinese citizens regained confidence and were willing to consume in order to seize the tax rate reduction opportunity before it disappeared.

As to whether the growth in investment, employment and consumption discussed above was attributable to increased private consumption, the indirect tax reforms as analyzed in Part III, or, more broadly, the Government driven stimulus package, is a question which requires comprehensive research involving the use of economic methodology which is beyond the scope of this article (such as engaging with multiple regression theory and undertaking a detailed study of whether other exogenous factors exist and, if so, what their impact may have been). It is fair to argue, however, that the growth effect in China is attributable to both factors. The growth may in large part be led by the Central Government's efforts in investing in infrastructure-building and social welfare development. But it also appears to have been driven by domestic consumption that was incentivized by the policy of cutting indirect taxes, which steadily increased throughout 2009, and should continue to increase as many ordinary Chinese people have begun to move to more advanced consumption from the purchase of basic necessities.

4.2 Budget Effects of Tax Reforms (tax revenue increase since the tax reforms launched)

The structural tax reduction in China has apparently been effective not only in stimulating economic development but also in generating tax revenue. According to the SAT, the total cost of the tax reductions for 2009 was expected to exceed RMB 140 billion, surpassing the amount of RMB 120 billion forecast in 2008.¹⁰⁰ But the costs have paid off. Data from the SAT shows that its total tax collections for 2009 amounted to RMB 5.95 trillion with a year-on-year growth rate of 9.8 percent,¹⁰¹ which created another historical high. Total collections from VAT, BT and CT were RMB 3.23 trillion, rising by 2.7 percent, 18.2 percent, and 85.3 percent, respectively.¹⁰² This accounted for 54 percent in total tax revenues (excluding revenue derived from Customs' collection of VAT, CT on imported goods and VAT export refunds). The revenue from vehicle acquisition tax also increased remarkably by 17.5 percent, amounting to RMB 116.3 billion, notwithstanding the tax rate cut.¹⁰³ The effect of the reduction in indirect taxes seems clear: it was quick to implement and had immediate benefit.

http://big5.gov.cn/gate/big5/www.gov.cn/jrzg/2010-01/11/content_1507693.htm (accessed 25 March 2010).

⁹⁹ See 2008 Tax Analysis, *supra* note 93.

¹⁰⁰ See the SAT, "Looking into the RMB 550bln Structural Tax Deduction Program", 17 December 2009, available at <http://202.108.90.130/n6669073/n6669118/9397442.html> (accessed 6 February 2010).

¹⁰¹ See 2009 Tax Analysis, *supra* note 21.

¹⁰² *Id.*

¹⁰³ *Id.*

In so far as VAT is concerned, allowing input VAT paid on purchases of fixed assets to be credited against VAT payable appears to have had a positive effect on investment in fixed assets. During the first three quarters of 2009, the total investment in fixed assets by registered VAT payers reached more than RMB 15 trillion, a rise of 33.4 percent as compared to 2008.¹⁰⁴ The contribution of the rate of investment in fixed assets to GDP growth amounted to 7.3 percent.¹⁰⁵ The VAT transformation towards a consumption-based system and the successive increases in export rebate rates may decrease the total VAT collections in the short term; but, on the other hand, these measures will help reduce costs of enterprises for the expansion of production and export, thereby contributing to the long-term strength of this critical source of tax revenue. Despite the widespread concern that Central Government played a dominant role in allocating investments in fixed assets, statistical data shows that investment by private enterprises has increased significantly in tandem with the stimulus provided by China's vigorous public investment programme.¹⁰⁶

In addition, the VAT transformation and increase in export rebate rates have paid off in an indirect manner. The relief of the VAT burden reduced the costs of production for many enterprises, and would surely have assisted them in times of financial distress. From the second half of 2009, the business environment for many enterprises began to pick up when the decline in exports narrowed month by month and some started to gain a firm foothold in the domestic market.¹⁰⁷ Industrial enterprises were thus able to earn greater profits, and these increased by 7.8 percent during the period from January to November 2009 compared with the negative rate of 22.9 percent from January to May.¹⁰⁸ The improvement in enterprise profitability eventually led to an increase of 3.2 percent in Enterprise Income Tax collections in the difficult year of 2009.

However, the situation for the SMEs (who generally suffered much more than large state-owned enterprises (SOEs) during the GFC) may still be difficult. As noted above, SMEs have played a significant role in promoting China's economic development and boosting market prosperity. They have also played an increasingly important role in easing employment pressure and maintaining social stability. The GFC had a significant impact on SMEs in China, ranging from limiting access to credit and decreasing orders from overseas, to rising costs due to the increasing pressure brought about by the appreciation of the RMB. To help SMEs deal with these difficulties, the Central Government decided that in 2010 small and low-profit enterprises whose annual taxable income is less than RMB 30,000 should be assessed on 50 percent of their income and then pay Enterprise Income Tax at a reduced rate of 20 percent (as compared to the normal rate of 25 percent).¹⁰⁹

The most astonishing aspect of China's tax collections in 2009 was that CT collections increased more than that for any other tax. Specifically, the increase in CT collections

¹⁰⁴ See the SAT, "Overall Transformation of VAT May Bring About Tax Abatement in Excess of RMB 120bln", *supra* note 96.

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ See 2009 Tax Analysis, *supra* note 21.

¹⁰⁸ *Id.*

¹⁰⁹ See the Circular of the Policy on Small and Low-profit Enterprises' Enterprise Income Tax, MOF and SAT No. 133, 2009.

for the year contributed an impressive 41.4 percent of the total increase.¹¹⁰ This was different from the position in 2008 and previous years when the largest tax collection increase was referable to VAT.¹¹¹ The 2009 statistics can be mainly attributable to the VAT and CT reforms that took effect from 1 January 2009. Four taxable items, namely, fuel, cigarettes, wine, and motor vehicles, accounted for 98.5 percent of the total CT revenue. Of these items, the CT revenue from fuel increased nearly 4.5 percent.

BT collections also began to rise from March 2009. Of those taxpayers subject to BT, the operations of construction and real estate enterprises expanded rapidly due to the increase in government investment in infrastructure projects. Other businesses such as telecommunications, services, finance and insurance also performed well. Notwithstanding these results however, many businesses in China have called for a further reform in BT. The transformation of VAT has impacted on the service industries that are subject to BT and therefore cannot offset input tax on fixed asset purchases. Replacing BT with VAT may help China's service industry develop, facilitating an effective adjustment of China's industrial structure for the future.

Finally, it should be noted that when the reforms in VAT, BT and CT were implemented, the Central Government was also aware of the potential for revenue loss. Collection and administration procedures were therefore strengthened. This may help explain the increase in tax revenues in 2009, although the precise extent of the role which such strengthening has played in collecting taxes remains unclear due to limited data.

The above analysis shows generally that revenues from enterprise taxes (corporate tax) may take a longer time to recover from the GFC and there will be an increased reliance in China on other forms of taxes, in particular indirect taxes—with VAT remaining as the centerpiece. There is a global tendency that growth-oriented tax reforms have involved shifting revenues from corporate and personal income taxation, or social security contributions (which is not the case in China) to consumption and property taxes. It is now recognized that strengthening and relying upon VAT (or some other form of broadly-based GST) is likely to be of crucial importance to maintaining government finances (this statement is particularly true in China), and could become even more significant as the world emerges from recession and countries seek to deal with their public debt imbalances. When seeking to bolster taxation revenue, countries may have two choices to consider—broadening the existing tax base or increasing standard VAT rates. In the case of China, however, the VAT system *can* be further modified to incorporate VAT and BT into a single advanced VAT system. Indeed, modernizing China's VAT system to keep pace with changes in the technological and economic environment would be beneficial to its long-term interests.

5. CONCLUSIONS

China's fiscal responses to the GFC have involved a combination of continuing structural reforms accompanied by a very specific focus—through reforms to its

¹¹⁰ See 2009 Tax Analysis, *supra* note 21.

¹¹¹ See 2008 Tax Analysis, *supra* note 93.

indirect tax system—to facilitate the development of capital-intensive industry, upgrade technology, and enhance consumer spending to promote growth and shape economic development. The tax cut measures adopted by the Central Government include the reduction of certain indirect tax rates such as vehicle acquisition tax, and relieving tax burdens through increasing export refund rates, allowing deduction of input VAT on purchases of fixed assets, and so on.

China has thus far consolidated its economic recovery, but it is vulnerable to major adverse shocks generated domestically or internationally. From a macro-economic perspective, further adjustments are needed to develop an economy demanding both new investment and increased domestic consumption. It is also true that some crisis-fighting measures, such as the granting of certain tax exemptions on real property transactions,¹¹² only have a one-off effect and may fuel a renewed risk of creating asset bubbles.

Most importantly, the stimulus package and related fiscal and tax measures can be credited with limiting the potential economic difficulties associated with the GFC and assisting China's recovery therefrom. From any perspective, such an achievement is more laudable than China's accession to the throne of the world's biggest exporter. Although it would be overreaching to claim that the taxation reforms were simply a product of economic crisis, at the very least it seems clear that by late 2008 the GFC had directly influenced the Central Government to implement reforms to China's indirect tax system and, most importantly, apply the VAT reforms to the whole country and to all industries. In terms of increasing investment in capital assets, stimulating domestic consumption and increasing tax collections, Part IV above has shown that the reforms have apparently been successful and that their timing could not have been more opportune.

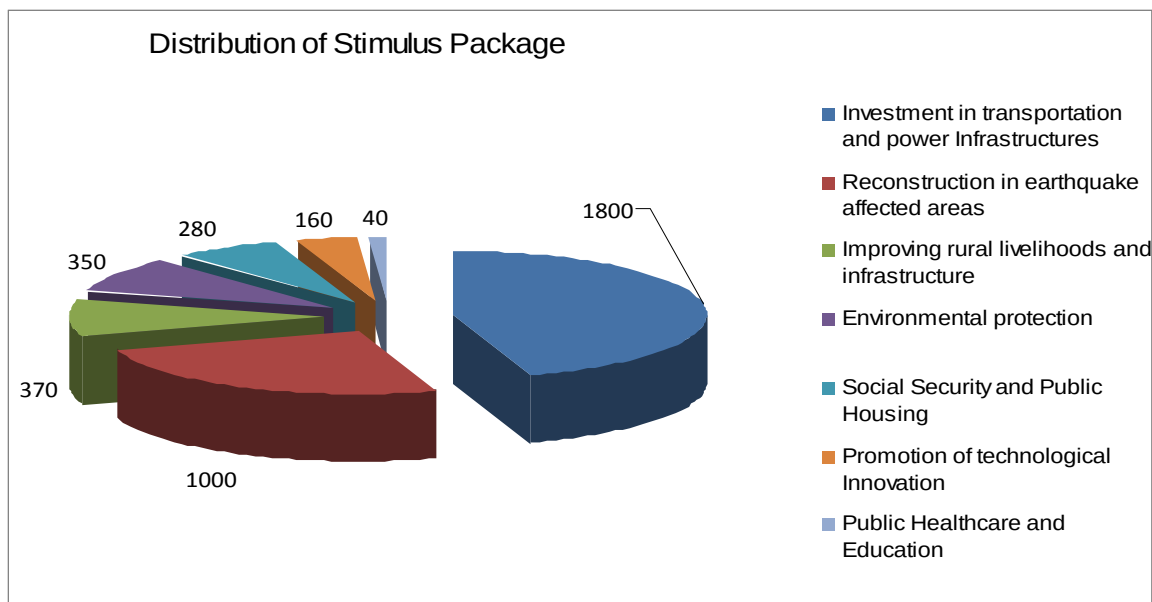
The success in adopting taxation reform, particularly in relation to indirect taxes, to deal with the economic difficulties associated with the GFC should encourage the continuation of China's ongoing tax reform programme, particularly in light of the revenue demands that will arise from increased expenditure upon social security. Both now and in the future, China will need to find sustainable ways to finance the cost of exiting the GFC and, in the long term, improve the efficiency of its taxation system.

When viewed in the context of promoting structural reform, reducing the tax burden to promote capital investment and consumption in times of economic turmoil, though not necessarily a panacea for curing all manner of ills, is not necessarily ill-conceived. Applied to indirect taxation, the reductions can be implemented swiftly and, as has been shown in the case of China, appear to have had immediate and positive benefits.¹¹³

¹¹² In 2009, the five-year limit for tax exemption from BT on transfers of residential property was reduced to two years. This preferential tax policy was abolished from the beginning of 2010 in order to curb speculation.

¹¹³ See further, D. Williams, "Direct Taxes or Indirect Taxes? Considering the Merits of the Two Approaches" *Tax Planning International: Indirect Taxes* 4, June 2009, at p. 8. Williams concludes at p. 11 that: "Indirect taxation probably has the advantage for governments in terms of revenue-raising, flexibility and administrative convenience. It also enables the achievement of more precisely targeted behavioural effects than direct taxation." In short, it seems clear—and the economic statistics referred to

APPENDIX 1: DISTRIBUTION OF 4 TRILLION RMB STIMULUS PACKAGE BY THE CHINESE GOVERNMENT



in Parts III and IV of this article bear this out—that tax reductions that are peculiar to particular goods and services will encourage consumption thereof.

Tax Devolution and Intergovernmental Transfer Policy Options in a Budgetary Crisis: UK Lessons from Australia

Neil Warren*

Abstract

The new UK Conservative-Liberal Democrat Coalition Government has committed itself to 'radical devolution' in a period of unprecedented and protracted budgetary crisis. Commitments include implementing the recommendations of the Scottish Calman Commission, supporting a referendum on further devolution in Wales, promoting further devolution to local government and community groups, and reviewing local government financing. The focus of this paper is on what lessons the UK can learn from Australia's approach to tax assignment and general grant distribution as it strives for greater devolution in an environment characterised by substantial public sector deficits and debt. On tax assignment, Australian experience is that base sharing of broad based taxes is clearly preferable to revenue sharing arrangements because the latter has proven to be not durable. On grant distribution arrangements (on which UK devolved administrations are almost totally dependent), the UK can benefit considerably from Australia's experience in allocating general and specific grants to devolved governments. However, the paper recommends that despite support in recent UK reviews for the Australian approach, it should not be implemented without also introducing its accompanying institutional framework. Required is a consultative framework (similar in concept to the Australian COAG) and an independent authority to advise on an alternative grant distribution framework to the Barnett Formula (similar to the Australian Commonwealth Grants Commission). Given Australia's experience, with these two institutions in place an environment exists in which the nations in the UK union will be able to work cooperatively and responsibly to address the twin objectives of further devolution and the resolution of the current budgetary crisis.

1. DEVOLUTION FUNDING CHALLENGE

In the *Conservative-Liberal Democrat Coalition Agreement* reached on 11 May 2010¹, it was stated that:

We will promote the radical devolution of power and greater financial autonomy to local government and community groups. This will include a review of local government finance. (p11)

We will establish a commission to consider the 'West Lothian question'. (p27)

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¹ Source of quotations is the *The Coalition: our programme for Government* (HM Government; Cabinet Office, May 2010) at <http://www.cabinetoffice.gov.uk/media/409088/pfg_coalition.pdf>. This document is based on the actual signed agreement - the *Conservative Party-Liberal Democrat Agreement* - which is available at <<http://www.conservatives.com/~media/Files/Downloadable%20Files/agreement.ashx?dl=true>>

We will implement the proposals of the Calman Commission and introduce a referendum on further Welsh devolution. (p28)

We recognise the concerns expressed by the Holtham Commission on the system of devolution funding. However, at this time, the priority must be to reduce the deficit and therefore any change to the system must await the stabilisation of the public finances. (p28)

A central theme in this *Agreement* is maintaining the strength of the union during a period of financial crisis. A key element of their strategy is that 'The constituent parts of the union must have arrangements appropriate to their needs'². Also important is ensuring elected representatives from the nations in the UK are accountable to their constituents for the decisions they make. Put differently, that which elected representatives vote for is that for which they are responsible. This latter issue lies at the heart of the West Lothian Question³ which is focussed on 'ensuring that legislation on devolved issues that only affect England, or England and Wales, can only be passed with the consent of MPs from England, and where applicable Wales'⁴.

For the new UK Government, the challenge is how to match the rhetoric on devolution in the *Agreement* with the substance of governing in an environment characterised by a sizeable national budget shortfall and large public sector debts. When times are bountiful, all can benefit and any perceived unfairness in the distribution of gains is relative. However, when times are tight, many will lose both absolutely and relatively so any deficiencies in established arrangements become heightened and potentially divisive. For the UK Government, its current extremely difficult fiscal situation poses a number of critical threats to the very future of devolution in the UK, let alone to any further moves to greater devolution.

Not surprisingly, the issue of a greater financial contribution from the nations in the UK was not a topic of great focus by any party during the 2010 UK Election. Nor was the impact of cuts in grants or how the Devolved Administrations of Scotland, Wales and Northern Ireland (DA)⁵, and local government (LG) in England (or any new devolved government in England) could assume greater funding responsibility. Even the important 22 June 2010 emergency *UK Budget* did not begin to directly address this issue. However, what it did do was move to constrain funding available to finance current expenditure by DAs and LG (with further real cuts imminent). With a diminishing DA funding pool, the risks to the stability of the union are real. Not surprisingly, in the recently released *Final Report* of the Holtham Commission (2010), division in the union was evident with the Commission's observation that the funding

² See

<http://www.conservatives.com/news/news_stories/2008/07/we_must_act_on_west_lothian_question.aspx?conservativestvtabview=conservatives.tv&ConservativesTvTabView=Conservatives.TV>

³ The West Lothian question centres on the commonly perceived paradox that Scotland, Wales and Northern Ireland have their own governments while England is represented only in the UK Parliament. As a result, the UK Parliament can decide on all issues relating to England, but only on some issues relating to Scotland, Wales and Northern Ireland. Should England then have its own government or should politicians from the regions where DAs exist, be excluded from voting on issues which only relate to England?

⁴ See <http://www.conservatives.com/policy/where_we_stand/cleaning_up_politics.aspx>

⁵ For a brief overview of Devolved Government in the UK see
<<http://www.nidirect.gov.uk/index/government-citizens-and-rights/government-1/devolved-government.htm>>

allocation model under funds Wales (by £400 million) and substantially over-funds Scotland (around £4 billion)⁶.

The purpose of this paper is to draw on the Australian experience with funding its devolved (State) governments and what lessons the UK can learn from this experience as it moves towards greater devolution during a period of financial crisis. As background to this discussion, Section 2 provides an overview of the budgetary challenge currently confronting the UK and some of the funding options which might impact on and cause problems for DAs (and England) and the union.

Two options available to the UK Government to shift some of the financial burden of central government to regional governments are then examined. Section 3 reviews the tax-based funding options that could be made available to DAs and the lessons for the UK from the experience in the Australian Federation. Section 4 examines possible changes to the grant design and distribution arrangements focussed on forcing DAs to fund more of their own expenditure commitments. Particular attention is given to grant distribution arrangements and what lessons can be learnt by the UK from Australia's long experience with ensuring the grant distribution framework is a cohesive force in the federation, not a source of division.

Section 5 concludes by noting that based on Australian experience, further devolution in the UK involving the DAs assuming greater expenditure responsibility must be accompanied by them having access to:

1. tax base sharing arrangements based on broad based own-taxes, and
2. grants distribution arrangements which are equitable, transparent and contemporaneous but still flexible enough not to prevent efficiency-improving DA policy reforms.

Unless these two key requirements are met, devolution of greater expenditure and funding responsibility in the UK will fail and be potentially divisive for the union. These conclusions have important implications for the findings of the Scottish Calman Commission (2009), the Welsh Holtham Commission (2010) and the House of Lords Select Committee on the Barnett Formula (July 2009).

⁶ In 2008-09, if the *Total identifiable expenditure* per capita in the UK was 100, in England it was 97, Wales 112, Scotland 115, and Northern Ireland 123 or 100:115:119:127 for England, Wales, Scotland and Northern Ireland <http://www.hmtreasury.gov.uk/d/pesa2010_chapter9_tables.xls>. Ian McLean has estimated that using the Holtham revision to the Barnett Formula, the ratios are 100:115:105:121 respectively <[http://www.nuffield.ox.ac.uk/politics/papers/2010/Calman_and_Holtham_\(2\).pdf](http://www.nuffield.ox.ac.uk/politics/papers/2010/Calman_and_Holtham_(2).pdf)> See also the discussion on this issue in 'Funding the United Kingdom's Devolved Administrations', 2010, Research and Library Service, Briefing Paper 82/10, 30 June 2010 NIAR 206-09 <<http://www.niassembly.gov.uk/researchandlibrary/2010/8210.pdf>>

2. HOW BIG IS THE UK BUDGET CRISIS?

The contagion accompanying the 2007-08 US subprime crisis has few parallels in history – except potentially the financial markets collapse preceding the Great Depression. For the UK, the importance of the City of London as a global financial centre fundamentally linked into the US financial markets and the commoditisation of US debt meant the UK's fortunes were closely linked to those of the US economy. While the subprime crisis had its beginnings in 2007 and had already impacted with the collapse of Northern Rock, what Table 1 illustrates is that in the 12 March 2008 UK Budget, there was still no recognition that this held potentially dire implications for the UK economy. It was not until the collapse of Lehman Brothers in September 2008 that the full extent of the implications of the contagion associated with the US subprime crisis – now universally referred to as the Global Financial Crisis (GFC) – was fully acknowledged. The impact on the UK was swift and profound as is clear from Table 2. Economic growth forecasts for 2009 fell from 2.5% in March 2008 to -3.5% in April 2009 to -4.75% in December 2009, with a final outcome of -4.9%. The collapse in GDP forecast over the 2008 and 2009 Budget period was therefore some 7%.

TABLE 1: SUMMARY OF UK BUDGETS OUTCOME FORECASTS

Forecast	Date of release	Mar-08 2006-07 Outturn	Mar-08 2007-08 Estimate	Apr-09 2007-08 Outturn	Mar-08 2008-09 Projections	Apr-09 2008-09 Estimate	Dec-09 2008-09 Outturn
Public sector net borrowing (PSNB)		2.3	2.6	2.4	2.9	6.3	6.6
Surplus on current budget		-0.3	-0.6	-0.4	-0.7	-3.6	-3.5
Public sector net debt (PSND)		36.6	37.1	36.5	38.5	43.0	44.0
Budget - June 2010		2009-10 Estimate	2010-11 Projections	2011-12	2012-13	2013-14	2014-15 2015-16
Public sector net borrowing (PSNB)		11.0	10.1	7.5	5.5	3.5	2.1 1.1
Surplus on current budget		-7.5	-7.5	-5.7	-4.0	-2.3	-0.9 0
Public sector net debt (PSND)		53.5	61.9	67.2	69.8	70.3	69.4 67.4
Budget - March 2010		2009-10 Estimate	2010-11 Projections	2011-12	2012-13	2013-14	2014-15
Public sector net borrowing (PSNB)		11.8	11.1	8.5	6.8	5.2	4.0
Surplus on current budget		-8.3	-8.4	-6.6	-5.2	-3.9	-2.8
Public sector net debt (PSND)		54.1	63.6	69.5	73.0	74.5	74.9
Pre-Budget Report - Dec 2009		2009-10 Estimate	2010-11 Projections	2011-12	2012-13	2013-14	2014-15
Public sector net borrowing (PSNB)		12.6	12.0	9.1	7.1	5.5	4.4
Surplus on current budget		-9.1	-9.3	-7.2	-5.6	-4.3	-3.2
Public sector net debt (PSND)		55.6	65.4	71.7	75.4	77.1	77.7
Budget - March 2008		2009-10 Projections	2010-11	2011-12	2012-13		
Public sector net borrowing (PSNB)		2.5	2.0	1.6	1.3		
Surplus on current budget		-0.2	0.3	0.6	1.0		
Public sector net debt (PSND)		39.4	39.8	39.7	39.3		

Source: UK Budget 2008, Table 2.2 (March 2008), UK Budget 2009, Table 2.1 (April 2009), UK Pre-Budget report 2009, Table 2.2 (Dec 2009), Table 1.1 (March 2010), Table C1 (June 2010) <<http://www.hm-treasury.gov.uk/budget2010.htm>>

With a collapsing economy and rising unemployment, the impact on the UK Government budget was rapid and dramatic. From a deficit equal to 0.4% of GDP in 2007-08, it was estimated in the June 2010 Budget to rise to 7.5% of GDP and not decline from this level until 2011-12 (Table 1). In 2009-10, this budget deficit is equivalent to twice the revenue from the VAT or almost as much as current personal income taxes. Put more simply, by the end of 2009-10, the UK was estimated to raise 25% less revenue than it needs to fund its spending. A direct result of these ongoing high budget deficits is a doubling in public sector net debt (PSND) from 36.5% of GDP in 2007-08 to an estimated 53.5% in 2009-10. Prior to the June 2010 Budget, PSND was forecast to be 74.5% of GDP by 2013-14. Even after the changes introduced in the June 2010 Budget, it was still forecast to be 70.3% (Table 1).

In responding to this budgetary crisis and the deteriorating economic position, the UK Government has been canvassing all possibilities. What Table 1 shows is that the actions taken by the new coalition Government in the emergency 2010 UK Budget (June 22) might have reduced government expenditure and increased taxes (such as raising the VAT rate from 17.5% to 20%), but that the Budget will not be balanced until 2015-16 and by then, PSND will be 67.4%, up from 35.5% in 2007-08.

TABLE 2: SUMMARY OF UK FISCAL PROJECTIONS: PSNB, BUDGET SURPLUS AND PUBLIC SECTOR NET DEBT (% OF GDP)

	2007	2008	2009	2010	2011	2012
Budget 2010 (June 2010)						
GDP growth (per cent)			-4.9	1.2	2.3	2.8
CPI inflation			2.1	2.7	2.4	1.9
Budget 2010 (March 2010)						
GDP growth (per cent)		½	-5	1 to 1½	3 to 3½	3¼ to 3¾
CPI inflation		4	2	2	1½	2
Pre-Budget 2009 (Dec 2009)						
GDP growth (per cent)		½	-4¾	1¼	3½	3½
CPI inflation		4	2	1¾	1½	2
RPI inflation		2¾	½	2½	3½	3½
Budget 2009 (April 2009)						
GDP growth (per cent)	3	¾	-3½	1¼	3½	
CPI inflation	2	4	1	1	2¼	
RPI inflation	4¼	2¾	-1¼	2½	4	
Budget 2008 (Mar 2008)						
GDP growth (per cent)	3	1¾ to 2¼	2¼ to 2¾	2½ to 3		
CPI inflation	1	2½	2	2		
Source: UK Budget 2008, Table 2.2 (March 2008), UK Budget 2009, Table 2.1 (April 2009), UK Pre-Budget report 2009, Table 2.2 (Dec 2009), UK Budget 2010, p5 < http://www.hm-treasury.gov.uk/budget2010.htm >						

Reducing PSND will require sustained budget surpluses. While a strong and sustained economic recovery could play a large part in bringing about such surpluses, Table 2 indicates that only modest growth is forecast over the coming years. Any near-term turnaround in PSND must therefore come from a combination of reduced government expenditure and increased taxes. The UK Government has itself acknowledged that further action will be needed to reduce PSND. With a devolved system of government and significant transfers from the central to the sub-central and local governments, attention must inevitably shift in the UK to the scope for transferring a larger share of the responsibility for reducing PSND to DA and local governments.

3. TAX ASSIGNMENT

Seven basic options are available to the UK Government in their dealings with Devolved Administrations (and England) if they are intent on exacting from them a greater contribution to reducing PSND:

1. change expenditure assignment;
2. change tax assignment;
3. encourage (or force) own-tax increases;
4. reduce general grants;
5. transition from general to specific grants;
6. change the method of distributing general grants; and
7. change the method of managing specific grants.

Since Federation in 1901 Australian States have experienced all seven options as a result of their changing and evolving relationship with the Australian Government. In fact, in the past two years alone, all options have found application and debate. On 1 January 2009, the Australian Government and States agreed on a new approach to allocating specific grants which involved introducing fewer specific grants (from over 90 to just 5 payments) accompanied by a greater focus on performance monitoring and the availability of reward payments for the achievement of agreed objectives (option 7). On 28 February 2010, the Commonwealth Grants Commission (CGC) introduced, following a five year review, a new system used when advising the Australian Government on how to allocate general grants (option 6). At the 19 April 2010 meeting of the Council of Australian Governments (COAG), the Commonwealth moved to assume effective control of health funding from the States (option 1) accompanied by substantial cuts in intergovernmental transfers (options 4 and 5). And on 2 May 2010 the Henry Review (*Australia's Future Tax System, 2010*) proposed a number of major changes to State and local taxation (affecting options 2 and 3 above)⁷.

While changes to expenditure assignment between tiers of government in the UK is an option available to the UK Government as it addresses its budget crisis, such changes will not be the focus of this paper. However, Table 3 highlights the already important role devolved governments have in the UK. Factoring in the critical role of DAs in funding Local Government (LG), then DAs have a greater role in the UK than States and local government in the Australian Federation. However, this paper will not consider expenditure reassignment but focus only on what lessons the UK can learn from Australia's approach to tax assignment and intergovernmental transfers as it attempts to address its budget crisis.

⁷ These recommendations are outlined in Warren (2010a).

TABLE 3: SUMMARY OF EXPENDITURE ASSIGNMENT IN THE UK AND AUSTRALIA: 2008-09

	Population	Local Government excluding Social Protection (a)	Devolved Administration	UK Government including All Social Protection (a)	Total
2007-08	Share				Expenditure
Scotland	8.4%	20.1%	40.7%	39.2%	100.0%
Wales	4.9%	20.4%	35.0%	44.7%	100.0%
Ireland	2.9%	3.6%	89.8%	6.6%	100.0%
England	83.9%	22.1%	0.0%	77.9%	100.0%
<i>Total</i>					
<i>Expenditure</i>	<i>100.0%</i>	<i>21.2%</i>	<i>9.2%</i>	<i>69.7%</i>	<i>100.0%</i>
2008-09		Local	States and Territories	Commonwealth	Total
Australia		5.9%	39.3%	54.8%	Expenditure 100.0%

(a) Local Expenditure on "Social Protection" is added back to "UK Government" as it largely determined by the UK Government

Source:
UK National Statistical Office, Public Expenditure Statistical Analyses (PESA) 2009, Table
Australian Bureau of Statistics, Cat No 5512, Government Financial Statistics 2009-10

TABLE 4: SUMMARY OF SUB-CENTRAL TAX ASSIGNMENT IN THE UK AND AUSTRALIA

Australian States and Territories	United Kingdom
Current State Own-Source Revenue Employers payroll taxes Land Taxes Developer and other property levies Stamp duties on property conveyances Gambling taxes Insurance taxes Motor vehicle taxes	Collected by Local Government (and retained) Council Tax Collected from Local Government (Pooled by Devolved Administration and redistributed) Non Domestic Rate Income (NDRI) (or National Non-Domestic Rate (NNDR)) Collected and distributed by Central Government to Devolved Administrations Scotland: <i>Current (February 2010)</i> <i>After UK Government response to Calman Commission</i> 3p to personal income tax basic rate (but while available, it was not enacted) 10p of Income tax basic and higher rates assigned to Scotland with scope for Scotland to increase or decrease this rate - Stamp Duty Land Tax - Aggregates Levy - Landfill Tax - Air Passenger Duty
Australia: Local Government	
Municipal Rates	

How the UK and Australia go about funding their devolved governments is very different. Table 4 details tax assignment in the UK and Australia. In 2008-09, this saw the central government in Australia raise 82% of tax revenue, States 14.8% and local government 3.2%. In the UK, the comparable figures for 2007 were 94.8%, 0% and 4.7% respectively, with supra-national government levies (for EU) being 0.5%⁸. UK DAs therefore have an almost total dependence on the central government for their funding. The option available to Scotland (Table 4) of imposing an additional 3p on the basic rate has not been exploited despite being available since the sitting of the first Scottish Parliament on 1 July 1999.

While Australian States have borrowing and bond issuing powers, this borrowing is regulated through the Loan Council which was formed early in the Federation to prevent States competing for scarce funds in the then limited capital market. Today, the Loans Council exists in name only and is a formality in annual Commonwealth-State negotiations over funding arrangements. In contrast, DAs in the UK have no substantive borrowing or bond issuing capacity – which is not unreasonable as they have no revenue capacity with which to fund any repayments. Where borrowing is permitted but tightly regulated is to fund expenditure made ahead of its funding. The UK DAs therefore have what Bird and Smart (2002, 2010) term ‘hard budget constraints’ while Australian States have ‘soft budget constraints’. The combination of a soft budget constraint and high levels of intergovernmental transfers poses a real challenge to the efficient and equitable operation of the Australian federation.

As Freebairn (2010, p59) has argued, with high vertical fiscal gap (VFG⁹) and no hard budget constraints, there will be:

1. Lack of accountability for funding own expenditure from own sources because of a dependence on intergovernmental transfers;
2. Shifting of responsibility for policy failure to other governments (on same or different tier) based on claims of overall under funding;
3. Additional administrative costs arising from States managing a process of blame shifting in relation to policy failure; and
4. Externalities arising from States shifting the cost of their deficit inducing policies to non-residents, and the costs arising from funding based on average rather than State specific marginal costs.

Evidence exists in the Australian federation of all four occurrences amongst States. The generally accepted solution (Bird and Smart 2010 and Freebairn 2010) is for Australian States to have access to revenue from taxes levied on broad tax bases and for transfers to be inframarginal with the latter focussed on addressing fiscal equalisation issues. In this way, not only would States be responsible for the funding of the majority of expenditure, any increased funding would be a State responsibility. The additional benefit would be that States would have a greater benefit to build their

⁸ See Tables B (p19) and E (p28) of *OECD Revenue Statistics 1965-2008* (2009).

⁹ The gap (or revenue deficiency) between a State's own-revenue means and their expenditure needs is the vertical fiscal gap (or VFG). The differing capacities of individual States to raise revenue from own-sources (such as lower average wages of employees) or disabilities which impact on their ability to make expenditure (such as higher wage costs) is referred to as horizontal fiscal gap (HFG). The challenge for any federation is how then to address VFG through a framework which acknowledges HFG. This is the objective of the horizontal fiscal equalisation (HFE) principle found applied when allocating central government transfers between sub-central governments.

own economies because they have direct access to revenue from taxes levied on broad bases. What is critical though, is that States have some discretion over the taxation of their own base.

In the UK, the lack of any substantive tax assignment to DAs must be changed if there is to be any genuine move to further devolve government. The recent recommendation by the Calman Commission (2009, p111) to assign greater revenue raising powers to the Scottish Government through assigning 10p of the basic and upper personal income tax rates (with scope for additional imposts), is a positive move in this direction. So too is the Holtham Commission (2010, p72) recommendation for the revenue from 10p, 20p and 25p of the basic and higher rate bands (Table 5) to be assigned to the Welsh Government. However, there are important lessons to be learnt from the Australian experience with tax assignment to States, including the assigning and reassigning of numerous taxes during the period since Federation in 1901.

The current tax assignment to States in the Australian federation, as shown in Table 6, is the product of two forces driven by sections of the Australian Constitution. Firstly, s90¹⁰ of the Constitution prohibits States from imposing duties of customs and excise. The High Court has interpreted this section as excluding States from imposing all forms of sales tax. Secondly, s96¹¹ of the Constitution has been interpreted by the Commonwealth (supported by High Court judgements) as enabling it to allocate grants to States at its discretion. As a result, the Commonwealth has been able to deny States the right to impose taxes within their powers by threatening to reduce their grants equal to any revenue they might raise from such taxes¹².

TABLE 5: SCOTTISH AND WELSH OWN INCOME TAX RATES

2010-11 Income Ranges	Description	Current Rates	Calman Commission: Scottish Income Tax Rates	Holtham Commission: Welsh Income Tax Rates*
£0-£37,400	Basic rate	20%	10%	10%
£37,401-£150,000	Higher rate	40%	10%	20%
£150,001 and over	Additional rate	50%	10%	25%

* The rate for each band would be able to be changed by Wales but any variance from rates in England would be limited to 3p.
Source: Calman Commission (2009), Holtham Commission (2010), HMRC
<<http://www.hmrc.gov.uk/rates/it.htm>>

¹⁰ s90 of the Australian Constitution states that: 'On the imposition of uniform duties of customs the power of the Parliament to impose duties of customs and of excise, and to grant bounties on the production or export of goods, shall become exclusive.'

¹¹ s96 of the Australian Constitution states that 'During a period of ten years after the establishment of the Commonwealth and thereafter until the Parliament otherwise provides, the Parliament may grant financial assistance to any State on such terms and conditions as the Parliament thinks fit.'

¹² For an outline of the design of each Commonwealth tax, see *Pocket Guide to the Australian Commonwealth Tax System* <<http://www.treasury.gov.au/contentitem.asp?NavId=&ContentID=866>>. A description of the taxes imposed by States is available in the NSW Treasury Publication, *Interstate Comparison of Taxes 2009-10* <http://www.treasury.nsw.gov.au/_data/assets/pdf_file/0005/17780/TRP10-01_dnd.pdf>

TABLE 6: TOTAL TAXATION REVENUE 2008-09

	Commonwealth		States		Local		Total	
	\$m	%	\$m	%	\$m	%	\$m	%
Taxes on income								
Income taxes levied on individuals								
Personal income tax	124,029	44.6%					124,029	36.6%
Fringe benefits tax	3,581	1.3%					3,581	1.1%
Total	127,610	45.9%					127,610	37.7%
Income taxes levied on enterprises								
Company income tax	62,784	22.6%					62,784	18.5%
Income tax paid by superannuation funds	9,201	3.3%					9,201	2.7%
Total	71,986	25.9%					71,986	21.2%
Income levied on non-residents								
Dividend withholding tax	303	0.1%					303	0.1%
Interest withholding tax	1,035	0.4%					1,035	0.3%
Other income taxes levied on non-residents	436	0.2%					436	0.1%
Total	1,774	0.6%					1,774	0.5%
Total	201,369	72.4%					201,369	59.4%
Taxes on employers payroll and labour force								
Employers payroll taxes			16,402	32.7%			16,402	4.8%
Other employers labour force taxes								
Superannuation guarantee charge	377	0.1%					377	0.1%
Total	377	0.1%	16,402	32.7%			16,779	5.0%
Taxes on property								
Taxes on immovable property								
Land taxes			5,565	11.1%			5,565	1.6%
Municipal rates			179	0.4%	10,758	100.0%	10,946	3.2%
Other			1,017	2.0%			1,017	0.3%
Total			6,761	13.5%	10,758	100.0%	17,519	5.2%
Taxes on financial and capital transactions								
Financial institutions transactions taxes								
Government borrowing guarantee levies	16	0.0%	386	0.8%			402	0.1%
Stamp duties on conveyances			9,534	19.0%			9,534	2.8%
Other stamp duties			304	0.6%			305	0.1%
Total			10,225	20.4%			10,225	3.0%
Total	16	0.0%	16,986	33.9%	10,832	100.7%	27,834	8.2%
Taxes on the provision of goods and services								
General taxes (sales taxes)	1,090	0.4%					1,090	0.3%
Goods and services tax (GST)	42,626	15.3%					42,626	12.6%
Excises and levies								
Crude oil and LPG	15,592	5.6%					15,592	4.6%
Other excises	8,727	3.1%					8,727	2.6%
Agricultural production taxes	608	0.2%					608	0.2%
Levies on statutory corporations	210	0.1%	69	0.1%			279	0.1%
Total	25,137	9.0%	69	0.1%			25,206	7.4%
Taxes on gambling								
Taxes on government lotteries			746	1.5%			746	0.2%
Taxes on private lotteries			438	0.9%			438	0.1%
Taxes on gambling machines			3,034	6.1%			3,034	0.9%
Casino taxes			413	0.8%			413	0.1%
Race betting taxes			381	0.8%			381	0.1%
Taxes on gambling n.e.c.			15	0.0%			15	0.0%
Total			5,028	10.0%			5,028	1.5%
Taxes on insurance								
Insurance companies contributions to fire brigades			1,028	2.1%			1,028	0.3%
Third party insurance taxes			371	0.7%			371	0.1%
Taxes on insurance n.e.c.			3,106	6.2%			3,106	0.9%
Total			4,505	9.0%			4,505	1.3%
Taxes on international trade	6,289	2.3%					6,289	1.9%
Total	75,141	27.0%	9,602	19.2%			84,743	25.0%
Taxes on the use of goods and performance of activities								
Motor vehicle taxes							0	
Stamp duty on vehicle registration			2,026	4.0%			2,026	0.6%
Other			4,432	8.8%			4,432	1.3%
Total			6,458	12.9%			6,458	1.9%
Franchise taxes								
Gas taxes			2	0.0%			2	0.0%
Petroleum products taxes								
Tobacco taxes								
Liquor taxes			1	0.0%			1	0.0%
Total			4	0.0%			4	0.0%
Other	1,098	0.4%	596	1.2%			1,694	0.5%
Total	1,098	0.4%	7,058	14.1%			8,156	2.4%
Total	278,002	100.0%	50,118	100.0%	10,758	100.0%	338,878	100.0%
Taxes received from public corporations	420	0.2%	1,985	4.0%	121	1.1%	2,526	0.7%
Taxes received from other levels of government	4	0.0%	753	1.5%	-136	-1.3%	621	0.2%

Source: ABS 55060do001_200809.xls

TABLE 7: TAXES CEDED BY AUSTRALIAN GOVERNMENT TO STATES AND STATES TO THE AUSTRALIAN GOVERNMENT

State 'piggyback' Base Sharing with Australian Government	
1978-1989	States were permitted to impose a flat % surcharge on Australian Government collections from the personal income tax. This was repealed in 1989 when several States took interest in this tax, primarily with the intention to provide an income tax rebate.
State Base Sharing with Australian Government	
1901-1952	Land tax (Australian Government abandoned in 1952)
<1976	Entertainments tax, a minor tax which was initially shared, then solely applied by the Australian Government, and subsequently solely applied by the States who abandoned it in 1976.
<1981	Death duties, abandoned by all jurisdictions by 1981
1915 – 1942	Income tax was initially imposed prior to Federation in 2001. It remained solely a State tax until 1915 and was then jointly levied by both the Australian Government and States between 1915 and 1942. It was then taken over by the Australian Government in 1942.
1997	Taxes on fuel, liquor and tobacco, which were levied by both the Australian Government (as excise duty) and States (as Franchise Fees) until the State taxes were successfully challenged in the High Court as contravening s90 of the Constitution which prevented States from levying duties of customs and excise.
Australian Government Revenue Sharing with States	
1976 – 1985	Personal Income Tax: <i>New Federalism</i> was introduced in 1976 and saw States received a fixed share of Australian Government personal income taxes during its first 5 years (until 1981-82). However, by the early 1980s, the Australian Government was confronting substantial Budget deficit and since income taxes were a major growth tax, the <i>New Federalism</i> arrangements were changed. After a transitional year (1981-82), they opted (from 1982-83) for the less generous arrangement, giving States a fixed share of Australian Government total taxation. In 1985-86, this revenue sharing arrangement was permanently abandoned as the Australian Government felt even these arrangements were too generous to States.
1997-2000	Franchise Fees: The State Franchise Fees which were declared unconstitutional in 1997 were replaced with a revenue sharing arrangement where the Australian Government increased its own taxes on fuel, alcohol and tobacco and passed on the proceeds to the States. While States originally imposed different Franchise Fees, the Constitution prevented the Australian Government imposing taxes which discriminated between States. Consequently, the new tax surcharges were uniform across all States and States were then free to use this revenue to finance differential subsidies so as to leave consumers in each State approximately in the same position they were before the Franchise Fees were declared unconstitutional.
2000+	GST: Since the introduction of the GST in June 2000, its revenue has been allocated to States as a block grant and distributed on fiscal equalisation principles by the Australian Government on the basis of advice from the Commonwealth Grants Commission.

Source: Langoulant(1999), Warren(2004)

What the current distribution of taxing powers (Tables 4 and 6) does not reveal is a history of taxes at one level of government in Australia being ceded to another, either cooperatively or through coercion. Table 7 outlines the major changes to tax assignment and to base and revenue sharing arrangements since Federation. Cooperation is what characterised the Commonwealth ceding the Payroll Tax to States in 1971 and the Commonwealth collecting the (unconstitutional) State Franchise Tax between 1997 and 2000.

Cooperation is also what led to the Commonwealth assigning revenue from its taxes to States as the basis for determining general grants. In 1976, income tax sharing arrangements were introduced but following a budget crisis the Commonwealth replaced this arrangement with a less generous sharing of 'total' tax revenue, before abandoning even this arrangement in 1985. In 2000, the Commonwealth assigned 100% of the revenue from the newly introduced GST to States as a general grant, in part response to States agreeing to repeal various taxes. However, from 2011-12, this arrangement will also change, with States set to receive only two thirds of the GST

revenue following their agreement to cede to the Australian Government responsibility for funding 60% of all health expenditure¹³.

Cooperation has also extended to the Commonwealth facilitating the introduction of own-State taxes collected by the Commonwealth on behalf of States. Between 1978 and 1989, the Commonwealth offered States the opportunity to share the base of the personal income tax by providing enabling legislation where States could impose a 'piggyback' State personal income tax (in the form of a surcharge, administered by the Australian Tax Office). With the Australian Government making no room, no State moved to introduce such a tax and in 1989, the Commonwealth repealed the relevant provisions.

In practice, coercion rather than cooperation characterises the relationship between the Commonwealth and the States. This was the case when the Commonwealth assumed exclusive responsibility for imposing income taxes in 1942, threatening States with a loss of grant funding equivalent to any revenue they might raise from their own taxes on this base. Sometimes this coercion arises from budgetary crisis, which saw income tax sharing arrangements between the Commonwealth and States replaced with 'total' tax sharing arrangements in the early 1980s, and at other times, to encourage State tax reform (as with the GST revenue sharing arrangements in 2000).

On 2 May 2010, the Australian Government released the Final Report of a review into *Australia's Future Tax System* (Henry Review) along with its response¹⁴. The Henry Review continues a long tradition of governments, both Federal and State, reviewing State taxes¹⁵. However, major tax reform has been slow to come to the States. The benefit of the Henry Review has been that its recommendations have served to bring together a disparate debate on the future of State taxation and proffer a 10 to 20 year strategy for its reform. Table 8 summarises its proposed State tax reforms which centre on three major changes to State taxation. The first is a State Cash Flow Tax (CFT) whose base is a business's cash flow where wages and salaries are not a deductible outflow but where exports are a deduction. In the case of imports, they would be taxable as they enter the country. In effect, the CFT is just another form of GST – this time administered not on the subtractive-indirect (or invoice) method as with the GST but on the subtractive-direct method. The advantage of the CFT over the GST is that it has no exemptions and therefore has a broad base. However, the CFT would need to be centrally administered if only because States are not permitted under the Constitution¹⁶ to impose taxes on interstate flows and it would not be possible for States to choose their own CFT rate.

The second major State tax reform recommended by the Henry Review was a significant expanding of the land tax base to include the owner-occupied residence

¹³ At the time of writing this paper (November 2010), a formal agreement has not been finalized with States. Moreover, Western Australia has indicated that it will not be party to any such agreement and other States are showing reluctance to act on their initial agreement to cooperate with the Commonwealth.

¹⁴ See <http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/pubs_reports.htm>. The Government's response is available from <<http://www.futuretax.gov.au/pages/default.aspx>>

¹⁵ The most recent example of a State sponsored review is the NSW Review of State Taxation in 2007-08 undertaken by Independent Pricing and Regulatory Authority (IPART, 2008).

¹⁶ s92 of the Australian Constitution states that 'On the imposition of uniform duties of customs, trade, commerce, and intercourse among the States, whether by means of internal carriage or ocean navigation, shall be absolutely free.'

(akin to the base of the local government rates). In fact, the proposal does consider the scope for the State land tax to be administered by local government as part of their local government rates. The third major reform was to the taxation of transport related services and in particular, a move toward congestion charges and market based road pricing. At the same time, State Payroll Tax, property conveyancing duties and insurance and other stamp duties would be repealed, while gambling taxes would be reformed to ensure they are more uniform and capture rents.

While there is broad acceptance that the current tax assignment in the Australian federation is less than ideal (Freebairn 2010, Warren 2010a, Henry Review 2010), there is less agreement on the direction of necessary reform. What is agreed however is that States must have access to their own broad-based tax bases and discretion over the rates applied.

When devolution was introduced in the UK in the late 1990s, it was essentially a delegation of expenditure responsibility from the UK Parliament to Scotland, Wales and Northern Ireland – rather than of taxing powers. The basic objective was to enable DAs to use their pool of funding to fund programs which better reflected local preferences. Funding for DAs came primarily through grants and for local government through a combination of grants, (domestic) Council Tax¹⁷, and a National Non Domestic Rate (NNDR)¹⁸. In the case of NNDR, the revenue collected is contributed to a central pool which is then redistributed amongst authorities on the basis of population¹⁹ and equalisation principles. With the Council Tax, each DA can set rate-capping conditions on local councils which gives them effective control over the collections from this tax.

¹⁷ 'Most dwellings are subject to the Council Tax. There is one bill per dwelling, whether it is a house, bungalow, flat, maisonette, mobile home, or houseboat, and whether it is owned or rented. The value of your home has been assessed by the Listing Officer of the Valuation Office Agency (part of HM Revenue & Customs). Each dwelling has been allocated to one of eight bands based on its estimated open market capital value at 1 April 1991. The band for your dwelling is shown on your bill and you will be in one of eight bands. You should bear in mind that all Council Tax valuations are based on the price a property would have fetched if it had been sold on 1 April 1991. Any increase or fall in a dwelling's value which results from general changes in the housing market since then will not affect its valuation. Such movements in general prices will not be a reason for changing your Council Tax band.' Source <http://www.bedford.gov.uk/advice_and_benefits/council_tax/explanatory_notes.aspx>.

'Local authorities are responsible for setting their budgets for the year and determining how much will be met through council tax. In each area, one local authority ('the billing authority') sends out council tax bills which include council tax charges ('precepts') set by other authorities in the area. For example, a council tax bill issued by a district council could include precepts for the county council, the parish council, the police authority and, in some cases, the fire authority. However, the Devolved Governments have powers to cap excessive increases.' Source: <<http://www.communities.gov.uk/localgovernment/localgovernmentfinance/counciltax/counciltaxfacts/>>

¹⁸ 'The local authority works out the Business Rates (National Non-Domestic Rate or NNDR) bill by multiplying the rateable value of the property by the appropriate multiplier. There are two multipliers; the standard non-domestic rating multiplier and the small business non-domestic rating multiplier. The former is higher to pay for small business rate relief. The various Governments set the multipliers for each financial year for the whole of the country (ie England, Scotland Wales and Northern Ireland). The multipliers change each year in line with inflation and to take account of the cost of small business rate relief. In the year of a revaluation the multipliers are set at a level which will keep the total amount raised in rates after the revaluation the same as before, plus inflation for that year. The current multipliers are shown on the front of the rate bill.'

Source:<http://www.bedford.gov.uk/business/business_rates/nnnr_explanatory_notes.aspx>

¹⁹ See <<http://www.scotland.gov.uk/Publications/2008/01/23112333/20>>

In the case of Scotland, there currently exists an option for it to add an additional 3p to the basic rate of personal income tax paid by its residents. The recent Calman Commission (2009) proposal for the introduction of a Scottish Variable Rate (SVR) of income tax administered by HMRC has received UK Government support as a replacement for the current 3p option. With the Scottish Variable Rate of income tax, the default arrangement would be that 10p of the basic and higher rates of personal income tax paid by Scottish residents (Table 5) would be assigned directly to the Scottish Government and offset against its general (or block) grant.

The Scottish Parliament would then be able to set the SVR above or below 10p with their grant from the UK Government being reduced by an amount always equivalent to revenue collected from a rate of 10p. This Scottish base-sharing arrangement has its parallels in Australia as shown in Table 7. Australian States had the option between 1976 and 1989 to impose their own tax on personal taxable income (through a State ‘piggyback’ arrangement with the Australian Government) but as with the current Scottish 3p, the Australian States never took up the option. The argument (*Henry Review* 2010, Volume 2 p682) has always been that this did not occur because the Australian Government did not make room for the States to impose their own levy. This will not be an issue with the proposed Scottish income tax option since the UK Government would ‘make room’ by cutting the Scottish general grant by an amount equivalent to the revenue collected from the 10p tax, resulting in no change in the overall income tax rates.

Scotland will also have an incentive to increase its rate of tax with the proposed arrangements. This is because if Scotland imposes a rate greater than 10p, the UK Government will not reduce its grant allocation by the new greater amount of revenue, giving Scotland an incentive to impose a rate greater than 10p. If Scotland opts to reduce the rate below 10p, then it will have to find equivalent expenditure reductions or funding from other sources.

The Holtham Commission (2010) income tax proposal is conceptually similar to that of the Calman Commission (2009) but different in two important respects: that the proportion of the rate in each rate band assigned to Wales is variable while constant in Scotland; and that any variance from the UK rates in Wales would be limited to 3p while being uncapped in Scotland. In both the Scottish and Welsh proposals, it is assumed that the UK Government makes room for the tax.

An obvious issue is just how durable such an arrangement would be since it would be dependent for its success on UK Government cooperation. What is apparent from the above discussion is that while arrangements have existed in the Australian federation for States to share both the revenue and base of Commonwealth taxes (Table 7), such arrangements have not been durable. A key factor driving changed central government attitudes to such arrangements has been budgetary considerations, especially where these arrangements are perceived as too generous to States or where the States’ policies run counter to central government objectives²⁰. The response in Australia has been for the central government to either abandon (often without consultation) any cooperative arrangement (as with income tax surcharge and revenue

²⁰ For example, what ultimately led the Commonwealth to repealing the provision enabling States to impose their own income tax surcharge was not a move by States to impose a ‘positive’ surcharge but a move by them to use this mechanism to introduce income tax rebates for residents. Such a rebate had the potential to run counter to Australian government objectives of equity.

sharing options) or to reduce grants equivalent to any revenue raised from actions not sanctioned (as with the State own-tax on income in 1942).

TABLE 8: HENRY REVIEW RECOMMENDATIONS FOR REFORMING STATE TAXATION

<i>Tax</i>	<i>Short term</i>	<i>Medium term</i>	<i>Long term</i>
Payroll Tax	Base broadened through reducing/removing threshold.	Rate increased	Repealed
State Cash Flow Tax (or Business Activity Tax)			Introduction of Cash Flow Tax accompanies repeal of Payroll Tax and most stamp duties (other than conveyancing)
Insurance Duty	Repeal Fire Service Levy component	Repeal other insurance duties	
Other Stamp Duties	Progressive repeal (funded through changes to payroll taxation)		All repealed
Land Tax	Base broadened through reducing threshold;	Base broadened through removing exemptions; increase rate and reduce conveyancing duty	Rate increased and conveyancing duty repealed Local government administer land tax with Local Rates and Fire Service Levy
Property Conveyancing Duty		Reduce duty	Repealed
Gambling taxes	Set rates to recoup rents. Abolish concessions, an industry support through direct expenditures		
Road transport taxes (Progressive implementation)	Introduce congestion taxes and market based road pricing. Motor vehicle ownership and use set related to road provision. Government administration funded through user charges.		

Source: Henry Review (2010), Volumes 1 and 2, Warren (2010a)

While ever a DA does not impose its own-tax legislation and have its own tax administration, the risk will always be there that the UK Government may not be cooperative and could act to be unresponsive or positively antagonistic towards any proposed DA tax changes. This would be expected if such changes were seen as counter to central government objectives or predatory in relation to other DAs. The Holtham Commission recognised this issue in relation to a Welsh income tax when recommending that any variation from the UK Government rate should be limited to 3p.

Where arrangements have been more durable in Australia is where the Commonwealth has completely vacated an area of taxation to States. This was the case with the reassignment of the Australian Government Payroll Tax to States in 1971. The UK Government acceptance of the Calman Commission proposal to reassign four UK taxes imposed in Scotland (Stamp Duty Land Tax, Aggregates Levy, Landfill Tax and Air Passenger Duty) to the Scottish Government therefore has its parallels in Australia and is likely to be a durable arrangement. However, based on Australian experience, such reassignment will not result in a substantial increase in own-source funding for States, largely because such reassigned taxes do not have the potential to contribute significantly to State funding. Also, there is a real risk that the design of these taxes will be compromised as a result of tax competition.

In summary, there are three basic options available to sub-national governments intent on increasing their access to taxes and tax bases administered by a central government:

1. Share tax revenue;
2. Share tax bases;
 - a. with harmonised base, own rate but central (or shared) administration of the State tax (eg ‘Piggyback’ Scottish Variable Rate personal income tax)
 - b. with harmonised base, and own tax and administration of the State tax (eg reforms to local property tax base managed at national level but tax imposed at local level)
 - c. with own tax base, rate and administration of the State tax (eg land tax at State and local level)
3. Reassign taxes
 - a. central taxes assigned to sub-central governments (eg Payroll Tax in Australia assigned to States in 1971)
 - b. sub-central taxes assigned to central government (eg the introduction of the Council Tax in 1991 effectively assigned the determination of the local property tax base to the UK central government and rate setting to DAs in consultation with the UK government)

What the Australian experience has shown is that revenue sharing (1 above) without a legally binding agreement between the levels of government sharing the tax is prone to failure. With no formal binding agreement, the government collecting the revenue can arbitrarily rescind the arrangement, impose reforms to this tax which directly impact the level of revenue being shared, or more fundamentally, arbitrarily change the proportion of the revenue being shared.

Reassigning minor tax bases to sub-central governments (3 above) is also not a long term solution and potentially the source of economic inefficiencies (as the Henry Review (2010) concluded in relation to the current Australian State Payroll Tax). However, such minor taxes (and own-income taxes) might have a role in ensuring accountability by DAs who confront ‘hard budget constraints’ (as in Scotland and Wales) such that a direct link can be drawn between increased expenditure and increased funding. In Australia, soft budget constraints and substantial VFG has done little to encourage accountability by States. For DAs, access to own-taxes on broad bases is essential. While the Calman and Holtham Commissions proposed these taxes being linked directly to the UK income tax, there is a strong case for the DAs imposing their own legislation related to such a tax.

None of the discussion in this section has considered the important issue of how any new taxes in DAs will impact on their grant allocation in the longer term. While both the Calman and Holtham Commissions supported a full offset against grants to DAs for the basic rate structure in Table 5 and some tax reassignment, the important question is how might the UK government then respond in an attempt to shift some of the burden of addressing its current budgetary crisis to DAs through changes to grants. To this end, we need to review how current intergovernmental transfer arrangements might change following any tax reassignment and how this might impact on both the quantum and distribution of grants amongst DAs and England.

4. INTERGOVERNMENTAL TRANSFER ARRANGEMENTS

In theory, there is no reason why the financial obligations accompanying any expenditure assignment should ultimately equate to the revenue arising from any tax assignment. For reasons of equity, efficiency and simplicity, some level of intergovernmental fiscal transfers is justified. Principal amongst these reasons are:

1. the achievement of national priorities (and so the need to override local preferences);
2. positive externalities (or spillovers) associated with State expenditure (and the resulting risk of under-expenditure by States);
3. negative externalities associated with State expenditure (such as congestion);
4. States have varying access to tax bases;
5. States confront differing disabilities (eg cost structures) in the delivery of services; and
6. economies of scale in delivery of services and the administration of taxes.

Even if these issues were not important, a *fiscal gap* may arise for a sub-central government because either the central government has greater revenue raising capacity (vertical fiscal gap or VFG)) or because comparable sub-central governments have a greater capacity to raise own-source revenue than similar governments (horizontal fiscal gap or HFG). In practice, these issues are resolved primarily through intergovernmental fiscal transfers between levels of government and through transfers being distributed to reflect tax capacity and expenditure disabilities.

Four elements typically characterised most intergovernmental transfer arrangements:

1. A grants management process which focuses on the form of the consultative and performance assessment framework;
2. Grant design issues including the mix of general and specific grants;
3. Grant value determination which could be based on some fixed formula (eg tax share) or variable arrangement (such as based on needs and priorities); and
4. General grant distribution arrangements which are based typically on fiscal equalisation principles.

Any push for further devolution in the UK inevitably raises the issue of the appropriateness of current intergovernmental transfer arrangements and how they, or any changes to them, might interact with changed tax and expenditure assignment. The Calman and Holtham Commissions recognised this issue but did not fully acknowledge its implications, in fact confusing two important issues in making their recommendations. On the one hand, they recommended a move away from current grant allocation arrangements towards applying fiscal equalisation principles; while on the other, recommending DAs have imputed to them a grant equivalent to the revenue collected from the income tax rates in Table 5 – even where these rates are different in practice. However, these tax assignment proposals are not compatible with rigorously applying fiscal equalisation principles when allocating grants amongst DAs.

The risk for the Calman and Holtham Commission proposals on intergovernmental transfer allocation is that they lack a systematic approach to the problem and that this may ultimately work against the scope for introducing their otherwise worthy reforms. For example, Warren (2010a) models the interaction between grant entitlements and

tax design in Australia and shows just how significant but little understood is the potential disincentive this interaction might be to any State either reforming current taxes or introducing new ones – an issue not even addressed in the recent Henry Review (2010) recommendations on State tax reform.

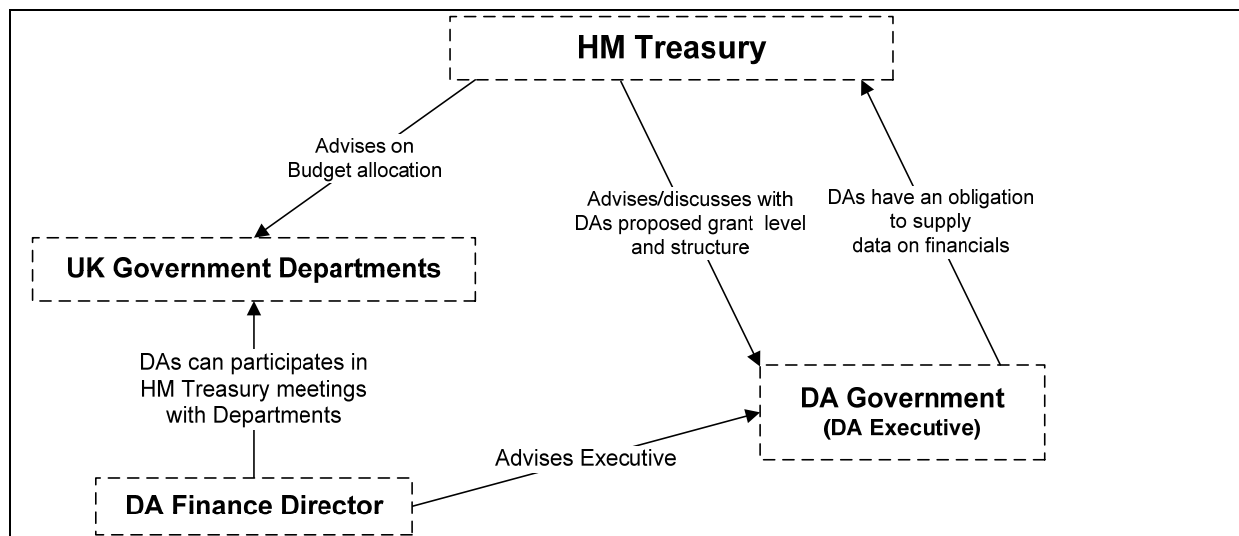
If the UK government moves to have DAs bear a greater share of the burden of addressing public sector net debt through reduced and redistributed grants (with or without tax and expenditure reassignment), it cannot achieve this simply with a focus on introducing fiscal equalisation principles (4 above). Rather, based on Australian experience, elements (1) through (4) must be addressed sequentially to ensure the approach taken avoids division and derision.

In the remainder of this section, attention will be given to the basic approach taken in Australia when responding to the four key elements identified above as being involved in determining intergovernmental transfer arrangements, and how this knowledge can inform the UK debate on a pathway to the reform of its current intergovernmental arrangements.

4.1 Grant management process

Too often, policy makers focus on outcomes rather than process. In the UK debate, while there is seeming agreement about the need for change in current grant allocation arrangements, there is a critical lack of accompanying discussion over the consultative framework for negotiating such transfers. This oversight is important as ‘process’ is everything when negotiating changes to intergovernmental agreements, especially on the sensitive issue of funding. Without due process, ownership and commitment from the parties involved will be missing. In the UK, grant levels are determined as part of the annual UK Government budget process and their level is not the subject of substantive consultation with DAs or England. Instead, the ‘top-down’ approach outlined in Figure 1 is applied with HM Treasury working with the UK Government to determine total expenditure by Department which directly impacts grant allocations to DAs and to England.

In the HM Treasury Statement of Funding Policy, HM Treasury sets out the arrangements which apply in setting devolved budgets. In addition, there is a Concordat between each DA and HM Treasury which sets out the relationship between HM Treasury and a DA Executive to ensure that both are aware of the requirements of the other and that both are consequently able to fulfil their responsibilities fully. This concordat is made in addition to any statutory arrangements for the provision of information to HM Treasury under the Acts which brought about the DA or as outlined in the Statement of Funding Policy. What results is at least twice-yearly, formal liaison meetings between HM Treasury and the DA Executive to ensure that there is co-operation between the two administrations and that the business of both operates effectively. This consultation is complemented by the Finance Director of the DA Executive being invited to attend HM Treasury’s regular meetings of Finance Directors of UK Government departments.

FIGURE 1: INTERGOVERNMENTAL CONSULTATIVE FRAMEWORK IN THE UK

Source:

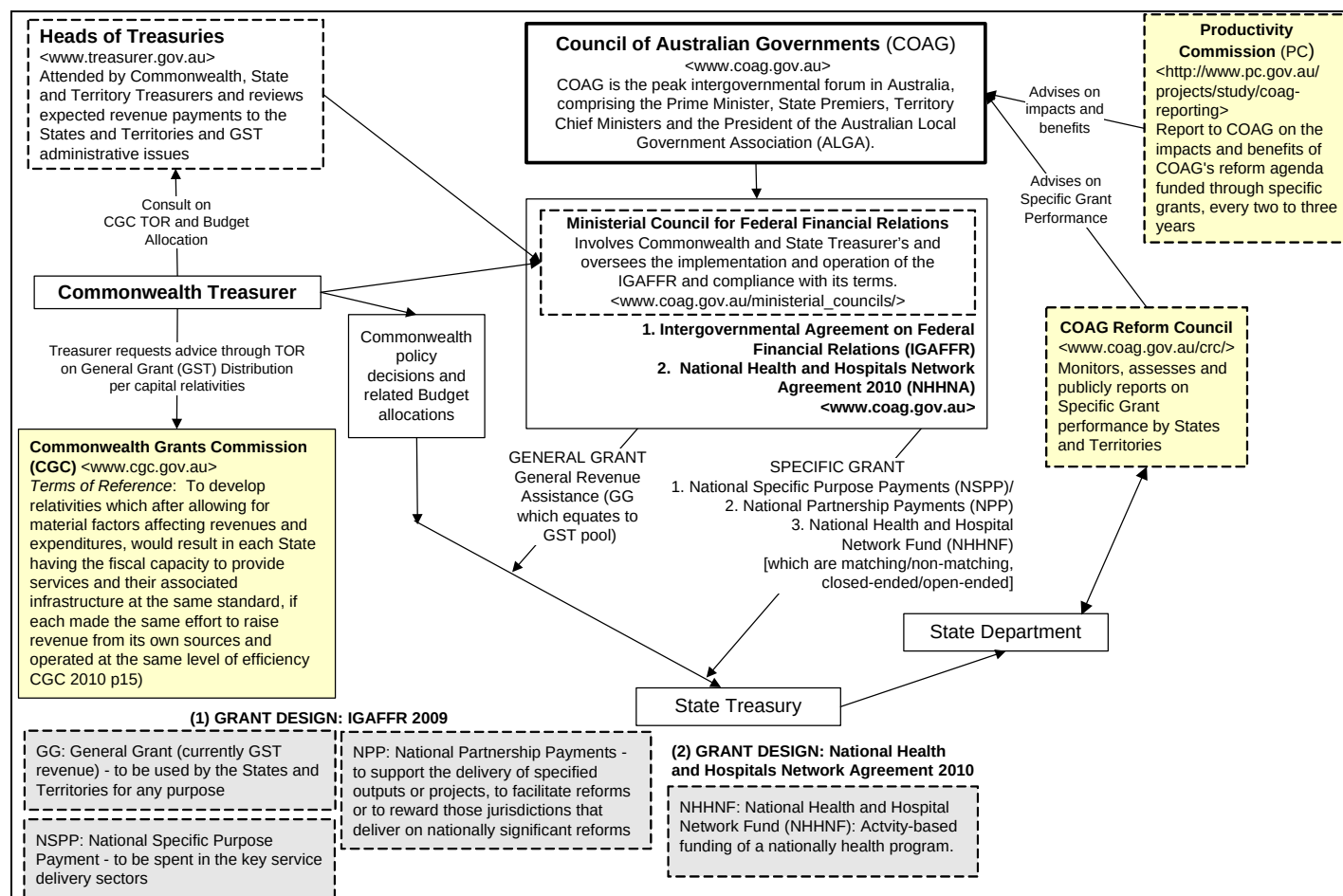
HM Treasury (2007), *Funding the Scottish Parliament, National Assembly for Wales and Northern Ireland Assembly: Statement of Funding Policy*, October, (PU401) <http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/d/pbr_csr07_funding591.pdf>

Concordat Between HM Treasury and the Scottish Executive (2005) <http://www.hm-treasury.gov.uk/d/scottish_executive_concordat.pdf p2> and <http://www.hm-treasury.gov.uk/psr_devolved_assemblies.htm>

This approach is a legacy of devolution in the UK which involves only a devolving of expenditure responsibility and a central role for HM Treasury. While it has the advantage of being administratively simple for HM Treasury and the UK Government, any push for greater devolution with the assignment of increased taxing powers and needs-based funding cannot be undertaken without a more open, transparent and consultative approach. Moreover, it will need to move from consultation between HM Treasury and the DAs to between the UK Government and the DA Executive.

In contrast to the UK, Australia has a long tradition of high level engagement between the Australian Government and State governments. This approach has its foundations in the Australian Constitution which made provision for transfers during the post-federation transitional period, following the loss by States of taxes to the Australian Government. In contrast, the unitary system of government in the UK has not required such a level of formal engagement with DAs.

Figure 2 outlines the consultative, advisory and performance assessment framework which accompanies the current intergovernmental transfer arrangements in Australia. Central in this process is the consultative forum, the Council of Australian Governments (COAG) which is the forum for the Prime Minister and State Premiers to come together to consider issues. It is here that intergovernmental agreements are negotiated, one of which relates to intergovernmental transfers. On intergovernmental fiscal relations, COAG is in turn advised by a Ministerial Council for Federal Financial Relations which involves the Heads of all Federal and State Treasuries who oversee the implementation of any intergovernmental agreements relating to financial issues. In relation to fiscal transfers, this might involve a number of different agreements relating to different grants, whether general or specific.

FIGURE 2: INTERGOVERNMENTAL CONSULTATIVE AND ADVISORY FRAMEWORK IN AUSTRALIA

Source: Warren (2006, 2008)

In relation to specific grants, a grants management and performance framework often accompanies these transfers and in recent years, oversight has been through the COAG Reform Council (COAGRC²¹) or through advice from the Productivity Commission²² to COAG on the impacts and benefits of COAG's reform agenda. In the case of general (or block) grants, the Commonwealth Treasurer requests through a Terms of Reference (TOR) to the Commonwealth Grants Commission (CGC) advice on their distribution between States²³. The CGC is an independent statutory authority which, having received its TOR from the Commonwealth Treasurer, consults openly and frankly with all State and Commonwealth Treasuries on its methodology and any issue which might be of concern to any government. All documents related to all consultations around each response to the TOR are published by the CGC²⁴. Ultimately, the response to the TOR is a set of eight per capita relativities which when

²¹ See <<http://www.coag.gov.au/crc/index.cfm>>

²² See <<http://www.pc.gov.au/projects/study/coag-reporting>>

²³ See Collins and Warren (2006), Warren (2006, 2008 and 2010a).

²⁴ For the 2010 CGC Review, see

<http://www.cgc.gov.au/method_review2/2010_review_documents2/2010_review_final_report>

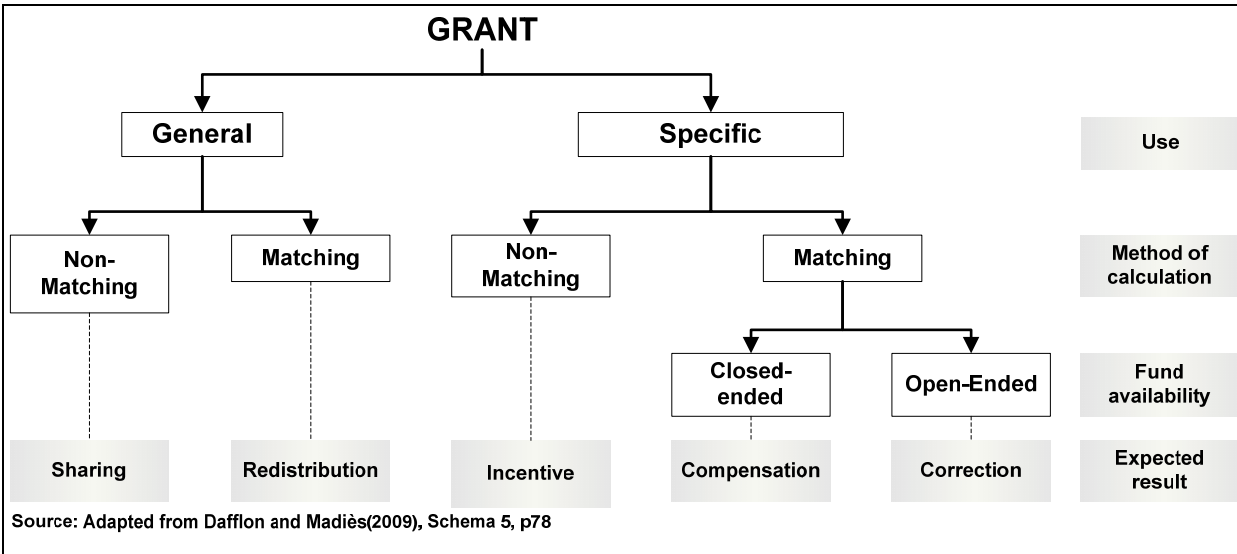
applied to each State’s population provides advice to the Australian Treasurer on how to distribute general grants between States.

The great strength of the Australian approach to determining intergovernmental transfers is the open and consultative forum it provides for States with widely divergent populations and interests (Warren 2010b), to have equal voice. What results is a federation with a heightened sense of fairness for all residents, which has had a cohesive influence on the federation.

4.2 Grant design

Figure 3 outlines the basic design options for intergovernmental grants. In the UK, grant funding for the devolved administrations is through the Departmental Expenditure Limit (DEL)²⁵ which is a general grant for 3 year funding by expenditure category from the UK Government. The Annually Managed Expenditure²⁶ (AME) grant includes funding for those expenditures that cannot be predicted with relative certainty (eg NHS). Other funding in DAs is from the Council Tax and National Non Domestic Rates (NNDR) which are imposed at the local level with the latter distributed by the DA. From these transfers, the DAs also fund LG. In the case of England, the UK Government is the direct funding source for LG.

FIGURE 3: GRANT DESIGN



²⁵ The Departmental Expenditure Limit forms the majority of the Scottish Government’s budget and is made up of operating and capital expenditure. DEL is set for three years during the Spending Review process, and the annual DEL spend is subject to End Year Flexibility (Source: *Scottish Budget Draft 2010-11* <<http://www.scotland.gov.uk/Resource/Doc/284860/0086518.pdf>>)

²⁶ Annually Managed Expenditure is set each year and contains those elements of expenditure that are not readily predictable. For example, NHS and Teachers Pensions (*Scottish Budget Draft 2010-11* <<http://www.scotland.gov.uk/Resource/Doc/284860/0086518.pdf>>)

In Australia, while States in 2008-09 raised \$50,118m or 14.8% of all tax revenue, their expenditure was \$173,876m or 42% of all government expenditure. This was only possible because States were the recipient of some \$84,006m in total grants (Table 9), 49% (or \$41,189m) from a GST based general grant distributed on fiscal equalisation principles. Some 51% of grants were specific grants and comprised National Specific Purpose Payments (NSPP) which are assigned to healthcare, schools, skills and workforce development, disability services and affordable housing; National Partnership Payments (NPP) which are designed to deliver on nationally significant reforms; and National Health and Hospitals Network Funding (NHHNF) which are health activity-based grants. While 100% of the GST is currently is assigned to the general grant, from 2011-12, the introduction of NHHNF will result in this share declining to 67%.

TABLE 1: TOTAL PAYMENTS TO STATES: AUSTRALIAN GOVERNMENT

	Previous payments for specific purposes	National Partnership payments	National SPPs(a)	Health and Hospital Network funding (b)(c)(d)	GST	Other general revenue assistance	Total	Growth	Per cent of GDP
\$million									
2000-01	19,207	-	-	-	24,355	3,715	47,277	-	6.7
2001-02	21,458	-	-	-	26,632	4,841	52,931	12.0	7.0
2002-03	21,781	-	-	-	30,479	1,734	53,994	2.0	6.7
2003-04	22,940	-	-	-	33,219	647	56,806	5.2	6.6
2004-05	24,795	-	-	-	35,323	944	61,062	7.5	6.6
2005-06	26,904	-	-	-	37,182	1,039	65,125	6.7	6.5
2006-07	28,549	-	-	-	39,552	-	68,101	4.6	6.2
2007-08	31,994	-	-	-	42,630	-	74,624	9.6	6.3
2008-09	16,874	18,664	6,116	-	41,189	1,162	84,006	12.6	6.7
2009-10	-	28,892	24,409	-	44,529	717	98,547	17.3	7.6
2010-11	-	19,347	26,098	-	47,930	707	94,082	4.5	6.7
2011-12	-	14,419	15,033	26,575	37,497	647	94,172	0.1	6.3
2012-13	-	15,026	16,000	28,695	39,439	650	99,811	6.0	6.4
2013-14	-	12,602	17,060	30,959	41,259	604	102,483	2.7	6.2

Source: Australian Government, 2010-11 Budget, Budget Paper No 3, Table 1.2, p20

4.3 Grant value

The Australian mix of general (GST) and specific grants is detailed in Table 9. General grant value to States in Australia is equivalent to the agreed share of the GST, currently 100% (agreed in 1999) declining to 67% from 2011-12. Specific grants (NSPP/NPP/NHHNF) are the subject of a number of intergovernmental agreements negotiated between States and the Australian Government. In the case of both general and specific grants, such agreements are not binding and any party can move to change or withdraw its involvement. Historically, the initiative for new or changes to established agreements has come from the Australian Government primarily, as it is the funding source. Specific grants are largely driven by national priorities and as evident in Table 9, there has been a trend from general to specific grants in Australia.

In the UK, general and specific grants are provided to DAs and LG. The quantum of such grants is determined very differently from similar grants in Australia. While specific grants can be changed at the margin for specific purposes, the UK system has a rigid formulaic approach to determining the quantum of general and specific grants.

With England having no representative assembly (a major focus of the ‘West Lothian Question’) unlike the DAs of Scotland, Wales and Northern Ireland, funding for public service delivery in England is determined by the UK Parliament and is assigned either directly to English LG or to the UK Departments providing these services. Based on the change in the various levels of UK Government expenditure in England, grants to DAs are adjusted using the Barnett Formula²⁷ as shown in Figure 4.

FIGURE 4: BARNETT FORMULA

‘Consequential’ change (or additional spending made available) in the allocation to a Devolved Administration	=	Change expenditure on service in England*	X	Relevant ‘comparability proportions’ to England’ by Devolved Administration	X	Relevant population proportion to England’ by Devolved Administration
* The base can in practice be England, England and Wales or Great Britain, depending on the coverage of the expenditure considered.						

The strength (and weakness) of the Barnett Formula is that it is simple in its application – and for the UK Government (and HM Treasury) something over which they have direct control. Under Barnett, the grant to a DA in any year is the previous year’s grant plus a ‘consequential change’ as calculated in Figure 4.

If, for example, expenditure on an English service increases by £100 million and the service is 100% comparable in Scotland and Scotland’s population relative to England is 8.4%, then Scotland’s consequential is £100m x 1.0 x 0.084 = £8.4 million. The actual expenditure on any service at any point in time in a DA is therefore an historical construct; the combination of the allocation made available to service agencies in DAs prior to the introduction of the Barnett Formula – over 30 years ago – and the many ‘consequential’ changes made since then which impact only at the margin. The current total grant allocation to a DA is therefore not reflective of current needs but needs evident in the pre-Barnett grant allocation adjusted for government expenditure growth in England and population changes in the DAs relative to England. An obvious long-term consequence of this (mathematical) approach is the convergence of the DAs share to the average English level of funding per capita as the cumulative ‘consequential change’ becomes increasingly important as a share of the total grant (Holtham Commission 2010, p5, para1.12).

It is not surprising that there has been a broad based call for a systematic revision of the allocation of grants in the UK designed to fund expenditure on services in devolved administrations, both across DAs and within administrations across service areas²⁸. The Holtham Commission(2010, p140 paraA4.23) estimated that if the per capita funding index for England was 100, current Welsh funding is 112 when it should be 115 per capita – the equivalent of underfunding Wales by £400m per annum²⁹. In the Holtham Commission, the focus on perceived grant distribution inequities (and therefore Barnett) is an avenue for strengthening its case for a greater share of the general grant pool available to DAs.

²⁷ For example, the Barnett Formula allocates Scotland a population share of changes in comparable spending programmes in England. For comparable expenditure, Scotland gets exactly the same £s per head increase as in England. (See discussion in *Scottish Budget 2010-11* <<http://www.scotland.gov.uk/Resource/Doc/284860/0086518.pdf>>)

²⁸ See <<http://www.niassembly.gov.uk/finance/2007mandate/research/090320d.pdf>>

²⁹ See footnote 6.

In the recent past, this legitimate concern by Wales about being underfunded relative to Scotland when needs-based criteria are applied to grant allocation has been addressed through a Barnett Formula bypass. This was most evident when Wales secured Barnett Formula bypass from the UK government to enable the Welsh Assembly Government to access available European Union Structural Funds. Such an approach is a temporary solution to a known problem which can only worsen with the passage of time. Central to the problem for Wales is that the Barnett Formula is essentially an uplift regime for a needs-based grants distribution between the nations in the UK as determined in 1978. While the Barnett Formula can adjust for population changes between regions, it does not accommodate the changing needs of the different regions in the UK.

Recommended responses have taken two forms: firstly, directly addressing the underfunding of selected DAs (such as Wales) through increased specific grants; and secondly, revising the distribution of grants between DAs (and England) to reflect current needs. The UK Government response to both issues has been arbitrary rather than systematic and considered. While Wales has been the recipient of ad hoc grants which assist with addressing the issue on underfunding, this only addresses the 'symptom and not the disease' – the disease being the failure of Barnett to reflect current funding needs in Wales.

With the pressure on the UK government in the current budgetary crisis to reduce the level of funding to DAs, this will inevitably place far greater attention on the distribution of the shrinking grant 'pool'. Avoiding potentially deleterious effects on the union of dissent over the distribution of the shrinking grant 'pool' must inevitably mean attention on reforming grant distribution arrangements.

4.4 General grant distribution

The distribution of general grants in the UK is based on a 1978 *Needs Assessment Study* by HM Treasury³⁰. The findings of this study (which was not officially released) formed the basis for allocating grants to Scotland in 1978 and two years later in Northern Ireland and Wales³¹. As HM Treasury stated at the time 'It is a long-established principle that all areas of the UK are entitled to broadly the same level of public services and that the expenditure on them should be allocated according to their relative needs'³².

³⁰ The original fiscal equalisation methodology was detailed in HM Treasury *Needs Assessment Study-Report* (London: The Treasury, December 1979) (unpublished). See also

<<http://www.publications.parliament.uk/pa/cm199798/cmselect/cmtreasy/341ii/ts0204.htm>>

<<http://wales.gov.uk/docs/icffw/report/090708barnettfullen.pdf>>.

<<http://www.publications.parliament.uk/pa/ld200809/ldselect/ldbarnett/139/13907.htm>>

³¹ For a brief history of Barnett Formula see

<[http://www.devolution.ac.uk/pdfdata/Impact%20 of Barnett Formula on Scottish Economy.pdf](http://www.devolution.ac.uk/pdfdata/Impact%20of%20Barnett%20Formula%20on%20Scottish%20Economy.pdf)>

and <<http://www.assemblywales.org/09-012.pdf>>

³² See p6 in <<http://www.niassembly.gov.uk/io/research/8102.pdf>>

FIGURE 5: HOLTHAM COMMISSION PROPOSAL TO REVISE THE BARNETT FORMULA

'Consequential' change (or additional spending made available) in the allocation to a Devolved Administration	=	Change expenditure on service in England*	X	Relevant 'comparability proportions' to England* by Devolved Administration	X	Relevant population proportion to England* by Devolved Administration	X	Needs adjustment term	X	Transition mechanism to account for any discrepancy between the needs-based assessment and the last block grant
* The base can in practice be England, England and Wales or Great Britain, depending on the coverage of the expenditure considered										

Source: Holtham Commission(2010, p27)

It is this 1978 needs-based grant distribution that the Barnett Formula (Figure 4) is designed to update 'as if' the needs in 1978 applied today in each DA. Not surprisingly, with the passage of time, the Barnett Formula has proven increasingly controversial. In its Final Report, the Holtham Commission (2010)³³ strongly supported the introduction of needs-based funding of DAs and recommended the changes to the Barnett Formula shown in Figure 5. By introducing a 'needs adjustment term' which reflects per capita relativities in a DA relative to England (where this factor for England=100), changes in needs over time are introduced (but only at the margin). The Final Report of the Commission on Scottish Devolution (Calman Commission in June 2009)³⁴ and the Final Report of the House of Lords Select Committee on the Barnett Formula (July 2009)³⁵ also supported applying the principle of fiscal equalisation to grant distribution to DAs. In each Report, there was particularly strong support for the adoption of an approach similar to the independent advice provided by the Australian Commonwealth Grants Commission (CGC) to the Australian Treasurer on the allocation of general grants amongst States.

In the case of the Holtham Commission proposal in Figure 5, it would be the role of an independent statutory organisation (similar to the CGC) to advise the UK Government on the 'needs adjustment term'. Alternatively, if the Australian CGC approach was adopted, it would provide a 'needs adjustment term' for all regions of the UK, not just DAs. The response of the UK Government in December 2009³⁶ to the House of Lords Select Committee recommendation on the Barnett Formula (2009) was emphatic:

2.10 Recommendation: The role of the Commonwealth Grants Commission (CGC) in Australia offers a useful institutional model of an independent body that has responsibility for making recommendations about the allocation of finance. An independent body, similar to the CGC should be established in the UK. It should be the role of such a body to recommend the allocation of public monies based on population and through a needs based formula. Within the new framework the Treasury will need to retain its authority over the overall level of the block grant but not the proportionate allocation of the grant between the devolved administrations. This independent body might perhaps be called the UK Funding Commission. This Commission would carry out an assessment of relative need, undertake periodic reviews, and collect and publish information on an annual basis about the allocation of finance to the devolved administrations.

³³ See <<http://wales.gov.uk/docs/icffw/report/090708barnettfullen.pdf>> and <<http://wales.gov.uk/icffw/home/report/?lang=en>>

³⁴ See <<http://www.commissiononscottishdevolution.org.uk/>>

³⁵ See <<http://www.parliament.uk/business/committees/committees-archive/hlbarnettformula/hlbarnettformula/>>

<<http://www.publications.parliament.uk/pa/ld/ldbarnett.htm>>

³⁶ See <<http://www.official-documents.gov.uk/document/cm77/7772/7772.pdf>>

The Commission should be advisory in nature rather than have the power to make substantive allocation of funds on its own account. Its advice should, however, be published.

The remit of the Commission should be to determine the relative needs of each devolved administration on a regular basis, perhaps every five years. The Commission should also advise on the relative proportions of public spending for the devolved administrations, compared with spending within England, during a transitional period and recommend annual increments based on the latest population figures.

The Commission should be appointed by the UK Government as a non-departmental public body. It should be politically neutral and independent. It should be composed of a small number of members with sufficient expertise to ensure the dispassionate and authoritative nature of its work.

2.11 Response: The Government notes the Committee's views on the role of the Australian Grants Commission. Under the devolution settlements for Scotland, Wales and Northern Ireland the UK public expenditure framework and allocation methodology is reserved to the Treasury. We note the Committee's views on the desirability of establishing an independent UK Funding Commission, notwithstanding the potentially substantial costs of establishing and running such a system, but currently have no plans to set up such a body.

In the recent pronouncements by the new Conservative-Liberal Democrat government, it too has indicated that while it is in support of devolution including addressing the 'West Lothian Question' and addressing concerns by Wales about being relatively disadvantaged under Barnett, it has not given any priority to replacing the Barnett Formula as the basis for allocating transfers to DAs. In fact, in an outline of their future program, they stated that³⁷:

We recognise the concerns expressed by the Holtham Commission on the system of devolution funding. However, at this time, the priority must be to reduce the deficit and therefore any change to the system must await the stabilisation of the public finances. Depending on the outcome of the forthcoming referendum, we will establish a process similar to the Calman Commission for the Welsh Assembly.

This is despite the Liberal Democrats Manifesto stating that it would 'Replace the current Barnett formula for allocating funding to the Scottish, Welsh and Northern Irish governments with a new needs based formula, to be agreed by a Finance Commission of the Nations.'³⁸

The hesitancy of the previous Labour Government and now the new Conservative Liberal Democrat Coalition to embrace the introduction of a needs-based formula appears to have a number of sources.

1. Changing the Barnett Formula is potentially controversial and politically divisive;
2. Reviewing the Barnett Formula will raise issues which are complex and not easily resolved;
3. Potential cost of ensuring there are no losers in the long term (and therefore the difficult issue of how to manage the transition to any new arrangement); and

³⁷ See p4 in *The Coalition: our programme for government*, HM Government, <www.cabinetoffice.gov.uk/media/409088/pfg_coalition.pdf>

³⁸ See p92 of <http://network.libdems.org.uk/manifesto2010/libdem_manifesto_2010.pdf>

4. Potential costs of establishing and running such a system (including an independent advisory organisation (eg CGC) and the consultative framework (such as COAG).

These concerns are unreasonable and taken to their extreme, the basis for never changing current arrangements, no matter how unjustifiable in theory and practice. In relation to (1), this is true of most change but the solution lies in how the process is managed. On (2), this is contradicted by the seemingly uncontroversial and politically accepted operation of an already complex fiscal equalisation arrangement for the allocation of grants to local government. In the case of England's local government, since 2006-07 the UK Government has administered the Four Block System of allocating Grant Revenue to local authorities (LA) where, under this system, the distribution of the formula grant is determined by four factors: Relative Needs Formulae, the Relative Resource Amount, the Central Allocation and the Floor Damping Scheme³⁹. In the case of the DAs of Scotland and Wales, conceptually similar but operationally different and equally complex grant allocation arrangements exist structured around needs-based formulae⁴⁰.

On the cost of the transition (3 above), this is more an issue of 'when' rather than 'if' as the failings of Barnett will only increase as will the need for a systematic rather than ad hoc response. The Holtham Commission proposed transitional arrangements in their revision to the Barnett Formula (Figure 5), and acknowledges this as a real issue. Whether the Holtham approach is accepted or an Australian CGC-type approach implemented across all regions in the UK, the greater the delay, the greater will be the challenge in resolving the transitional problems encountered in returning to a needs-based distribution of grants from the Barnett Formula which is inextricably leading all DAs to converge to the England average per capita grant.

On the issue of the cost of funding a CGC-type organisation in the UK (4 above), any such costs will be miniscule in relative terms and has the far greater benefit of increasing transparency and engagement of the nations in the union in the discussion about the distribution of funding.

Such transparency and engagement is not always welcomed by all governments. States in the Australian federation have been quick to blame other States and the Australian Government for their policy failures. The Australian Government has always been able to ignore the CGC advice and address issues of concern to States about grant allocation – but has opted not to take such an action. In the UK, HM Treasury has shown no interest in open engagement with DAs. Most telling of their position are the comments of Treasury officials appearing before the House of Lords Select Committee on the Barnett Formula⁴¹. Here they present a clear exposition of

³⁹ See <<http://www.sigoma.gov.uk/sigoma/WhatWeDo/LocalGovernmentFinanceAndLocalTax.aspx>>

⁴⁰ For Scotland, see <<http://www.scotland.gov.uk/Topics/Government/local-government/17999/Glossaryofterms>> and in particular, <<http://www.scotland.gov.uk/Topics/Government/local-government/17999/Glossaryofterms>>. For Wales see <http://www.assemblywales.org/qg_08-0084.pdf> and Northern Ireland <<http://www.nidirect.gov.uk/index/government>-citizens-and-rights/government-1/local-government.htm>>

⁴¹ See transcript in the First Report at <<http://www.parliament.uk/business/committees/committees-archive/hlbarnettformula/>>

the basis for the UK Government's continued support for the Barnett Formula despite the general chorus call for change. In particular, that:

1. Barnett Formula is simple and with Barnett Plus, flexible, whereas a needs-based arrangement would be complex and far less simple;
2. Barnett Formula places greater control of both the quantum and distribution with the central government (and HM Treasury);
3. Central government concern that sub-central governments might not be accountable given they do not have substantial revenue ('hard budget constraint' issue) or expend untied general grants according to national principles ('National Priorities').
4. That while ever England is not a DA, the allocation to the current three DAs could not take place without effectively modelling England as if it was a DA. This has the potential to duplicate (and possibly conflict with) the needs-based approach to allocating grants to English LG.
5. That despite the House of Lords Final Report asserting that the new system should not duplicate what DAs currently do for LG when determining their grant entitlement, this is a real possibility when the LG has essentially an agency relationship with the DA⁴². In effect, moving to needs based grant allocation at the DA level and the DA's grant allocation framework for LG funding would need to be consistent. Since DAs 'pass-through' a substantial proportion of their DA funding from the UK Government to LG, anything else would lead to inconsistencies.
6. Identification of needs is often unavoidably linked to funding levels whereas with Barnett, needs are not really determined, only the level of available funding which is in the control of HM Treasury.

For a Government (and a bureaucracy), these concerns are more about control than about good governance. The issues raised warrant a direct response as they have the potential to be major impediments to moving away from Barnett at any time in the near future.

1. *Barnett is simple and flexible*: Simplicity and flexibility are worthy attributes but the key purpose of grants is to achieve distribution objectives reflective of revenue raising capacity and expenditure disabilities.
2. *Barnett is operated at minimal cost*: Cost is not the issue. There is no substance to the argument that replacing Barnett with the equivalent of the Australian CGC fiscal equalisation grant allocation framework would be complex and therefore expensive and poorly understood. The CGC is not expensive and no more complex than the needs-based framework used in allocating UK LG grants. Moreover, complexity can be addressed in the design of the grant assessment framework.. Australia in 2010 introduced a more simplified system, addressing criticisms that the previous framework was overly complex.

⁴² The House of Lords *Select Committee on the Barnett Formula 1st Report of Session 2008–09* stated that 'The new system should respect territorial autonomy. The new system must leave the devolved administrations free to decide what to do with their block grant. There should be no ring-fencing. Neither should the new system attempt to duplicate the detailed assessments of local needs that the devolved administrations must themselves necessarily make.' (p 38) at <http://www.publications.parliament.uk/pa/ld200809/ldselect/ldbarnett/139/139.pdf>>

3. *Barnett is not divisive*: In fact, the lack of transparency around Barnett and perceptions of unfairness, is divisive. In contrast, the CGC approach in Australia since 1933 has been a cohesive force within the federation.
4. *Barnett facilitates greater central control*: Any needs-based approach to grants would force greater transparency and engagement between the central and sub-central governments than has historically occurred, the result being less UK Government control and a greater need to engage nations in the union;
5. *DA accountability and achieving national priorities*: Accountability can be achieved through tax assignment and grant design, ensuring 'hard budget constraints' are imposed. National priorities can be achieved transparently through specific grants and associated performance agreements.
6. *Needs-based grant allocation would require an all of UK approach*: This is not a criticism but a strength of any needs-based approach, ensuring that the 4 nations in the Union are treated equitably.
7. *An all of UK needs-based framework would conflict with a LG needs-based framework*: The factors determining the allocation of LG grants by DAs should be consistent with the framework determining the DAs' share of any national grant pool. Anything else could lead to funding level and distribution issues. If a region should choose to fund LG differently from some national needs-based criteria, then it should be funded from own-sources and if the national government sought regional priorities, then this can be achieved transparently through specific grants.
8. *Needs-based framework would raise issues about the level of funding, not just about distribution*: This is not a criticism of the needs-based framework but of the level of funding. In practice, funding and distribution are two separate issues which involve different considerations and are readily separable.

Central to the above concerns about applying fiscal equalisation principles to general grant allocation in the UK is its operation in practice and whether its advantages outweigh any disadvantages. In the remainder of this section, attention is therefore given to the Australian approach to fiscal equalisation and whether the support for such an approach by the Calman Commission, Holtham Commission and the House of Lords Committee on Barnett Formula, is justified.

TABLE 2: CGC ESTIMATION OF POPULATION RELATIVITIES: PRE AND POST 2010 CGC REVIEW

Revenue	Expenditure(b)
1 Payroll tax	1 Schools education
2 Land tax	2 Post-secondary education
3 Stamp duty on conveyances	3 Admitted patients
4 Insurance taxes	4 Community and other health services
5 Motor taxes	5 Welfare and housing services
6 Mining revenue	6 Services to communities
7 Other revenue(a)	7 Justice services
	8 Roads
	9 Transport services
	10 Services to industry
	Depreciation
	Investment(b)
	Net lending
	All other State expenditure(d)
Revenue from Australian Government payments	
(a) Includes gambling taxes, emergency levies, user charges and any other revenue in GFS.	
(b) Includes expenditure funded by State revenue, the GST and Australian Government payments.	
(c) Investment on new infrastructure and equipment only. Replacement of existing assets is assumed to be funded by depreciation expenses.	
(d) Includes State legislatures, central administrative agencies, national parks and cultural services and a balancing item to ensure the expenses equal those in GFS	

Source: CGC 2010 Review CGC 10) Vol 1 p 43

The Australian approach to distributing grants between State governments is internationally recognised as one of the most comprehensive in acknowledging differences in each State government's capacity to raise revenue and to provide services. Each year, the Australian Government Treasurer issues a Terms of Reference to the Commonwealth Grants Commission (CGC) requesting advice on per capita relativities to use in the distribution of general grants to States. While the basic approach taken by the CGC has changed over the years⁴³, its overriding focus has been on applying the principle of fiscal equalisation. In its most recent review of its methodology completed on 26 February 2010, it sought to 'place the Commission's methodology on a sounder and more sustainable basis'⁴⁴. Table 10 details the categories of revenue and expenditure identified in any CGC estimates of per capita relativities.

The definition of fiscal equalisation applied by the CGC (CGC 2010 Review p34) is that:

State governments should receive funding from the pool of goods and services tax revenue such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.

As noted by the CGC 2010 Review (p34-35):

- the aim is to equalise the fiscal capacity of the States to deliver services and to acquire the infrastructure used in their provision. Equalisation does not aim to equalise actual service

⁴³ For a history of the CGC, see <http://www.cgc.gov.au/about_cgc>

⁴⁴ See Cover Letter to CGC from the Australian Treasurer in his Terms of Reference for the Review available at <http://www.cgc.gov.au/data/assets/pdf_file/0005/18086/2010_Review_ToR_final_Pt_I.pdf>

levels. Since States have the right to spend the GST revenue according to their policy priorities, the GST distribution cannot equalise the actual level of services provided unless States choose to do so; and

- the equalising GST distribution is determined on the basis that all States make the same effort to raise their own revenue and operate with equal efficiency. States are not obliged to follow any particular service delivery or revenue raising policies. However, if any State adopts revenue raising or service delivery policies that differ from the others, the GST distribution would not compensate it for any lost revenue or extra expenses; nor would it offset any extra revenues or cost savings.

The CGC approach is subsequently based on ‘five pillars’ (Warren, 2010a):

- Pillar 1 a State’s **financial capacities**, not its performance or outcomes;
- Pillar 2 **what States collectively do** (on average);
- Pillar 3 **policy neutral** or a State’s own policies or choices should not directly influence its grant;
- Pillar 4 **practical**; and
- Pillar 5 **contemporaneity**, delivering relativities most appropriate to the application year.

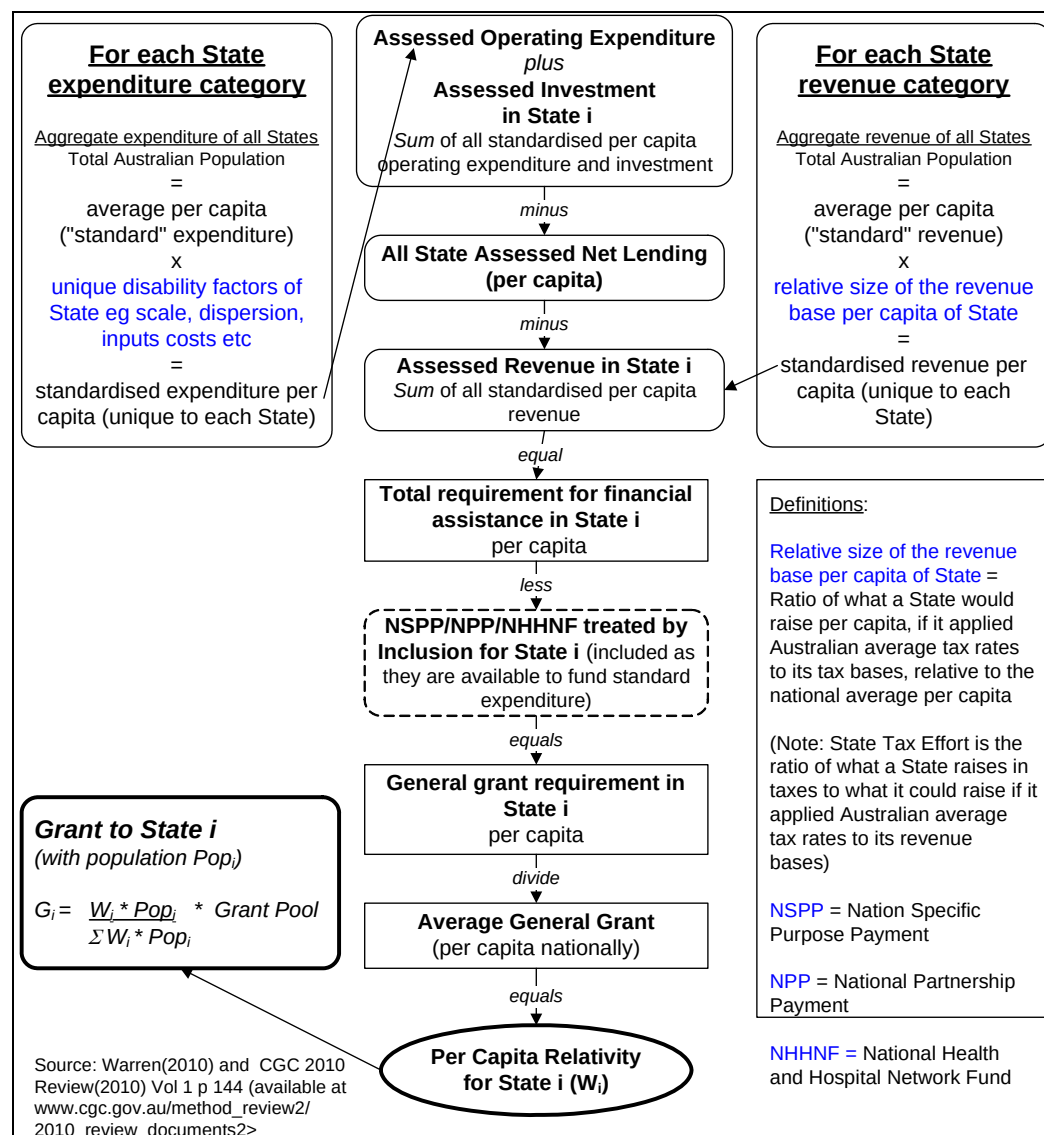
In being based on what states do, the CGC methodology is in no way judgemental about what States should or could do. However, in practice, ‘what individual States do’ is widely divergent (Warren 2010a) as they choose very different approaches to spending their general grant, reflecting divergent local preferences. It is in part this divergence which has led to the growth of NSPP, NPP and NHHNF, all of which have performance conditions and in some cases, reward payments (as with NPPs). Figures 6 and 7 outline the approach to estimating per capita relativities in Australia. ‘Assessed’ refers to ‘what States do’. For example, in the case of taxation, ‘Assessed State (own-source) Revenue’ is the *All States* average tax rate (schedule) applied to the tax base in each State. In this case, differences in per capita assessed revenue reflect differences in the distribution of the tax base.

FIGURE 6: CGC ESTIMATION OF GST REVENUE SHARING PER CAPITA RELATIVITIES: CGC 2010 REVIEW

(1)	Assessed Net Lending (per capita)
(2)	Assessed Operating Expenses(a) (per capita)
	Assessed Investment (per capita)
(3)	Assessed State (own-source) Revenue (per capita)
(4)=(2)-(1)-(3)	Total Requirement for Financial Assistance (per capita)
(5)	Revenue assistance from Australian Government Payments (treated by Inclusion (ie NPP/NSPP)) (per capita)
(6)=(4)-(5)	GST Requirement (from GST Pool) (per capita)
(7)=(6) per capita for State i/ ((6) National average per capita)	State per capita relativities

Source: CGC 2010 Review(2010) Vol 1 p 144

FIGURE 7: GENERAL GRANT ASSESSMENT FRAMEWORK IN AUSTRALIA



The 'Total Requirement for Financial Assistance' is therefore a measure of the total funding required by States who make an 'average' effort to raise own-source revenue and have acknowledged any disabilities impacting service delivery and infrastructure provision. In offsetting against this funding 'Requirement' the 'Revenue assistance from Australian Government Payments' (or NSPP, NPP and NHHNF), the CGC methodology effectively undoes the distribution amongst States of any special negotiations between the Commonwealth and the States in terms of the allocation of specific grants. However, the Commonwealth Treasurer in his TOR to the CGC has the option to demand a different approach which is currently the case with performance based reward payments to States which are required to be quarantined from the CGC analysis. This CGC approach to specific grants when advising on the distribution of general grants does make it difficult for any real meaning to be attached to the initial distribution of specific grants as they are, in effect, added to the general grant pool.

The Australian Government appears aware of this limitation and this is what drove it to introduce the NHHNF grants from 2010-11. As noted in the 2010-11 *Australian Government Budget Paper No. 3*. (p7):

Horizontal fiscal equalisation does not guarantee that the States will provide a uniform standard of service – its aim is to equalise the capacity of each State to do so, while leaving each State free to determine the standard of service provision.....Under the *National Health and Hospitals Network*, Australian Government funding for public hospitals will be based on the efficient price of public hospital services, determined by an independent pricing authority.'

Under the NHHNF, States will be compensated in a way which provides a uniform standard of service after taking into account local factors which might impact on the cost of service delivery. In effect, the Australian Government is expressing a level of impatience with States and frustration with the operation of fiscal equalisation in Australia – without directly stating as much.

A key question for fiscal equalisation as applied by the CGC for the future in Australia is whether the approach to fiscal equalisation in Australia is out of step with Australian Government objectives and Commonwealth-State developments such as in IGAFFR 2008 and NNHNF (as noted above). Moreover, in the recently released *Henry Review* (2010, Volume 2 p627), it made:

Recommendation 108: The Productivity Commission should examine the principles of public service delivery and the mechanisms that are available to governments to deliver public services and their implications for financial arrangements in the federation. The findings of this study should be considered by COAG.

Of direct relevance to the UK debate over the merits of a CGC-like organisation advising the UK Government on the distribution of general grants on fiscal equalisation principles is the Australian debate about the merits of its approach. The more telling criticisms of the Australian approach are not about complexity or the cost of such a system but how the grant allocation framework balances the competing goals of equity and economic efficiency. In the Australian CGC framework, fiscal equalisation is focused on achieving an outcome which is fair in that it reflects the fiscal capacity (or revenue raising ability) and expenditure (cost) disabilities of regions in a steady-state environment. This focus on fairness has been criticised for failing to adequately acknowledge the implications for economic efficiency of such an approach (Warren 2006, 2008). In particular, the application of full fiscal equalisation principles by the CGC in its advice to the Australian Government can therefore (Warren 2010a):

1. frustrate a central government intent on achieving national standards in areas where States deliver public services (as noted above in relation to health in Australia)
2. create disincentives for individual States to undertake major efficiency-improving reform⁴⁵;

⁴⁵ Warren (2010a) also argues the CGC methodology is best suited to a steady-state evaluation and not well suited to periods of major reform because the fiscal equalisation mechanism can work against change and only with direct Commonwealth involvement (through changing the CGC TOR and supplemental funding for States) can these limitations of fiscal equalisation be overcome.

3. not reflect State preferences (as ‘what States do’ can vary widely); and
4. with the methodology based on ‘what States do’, is not independent of actual State policies and can act as a disincentive to major tax reform.

Such criticisms are not fundamental and do not challenge the merits of applying fiscal equalisation principles to the allocation of general grants. Rather, they highlight the need for flexibility in applying these principles to ensure both equitable and efficient outcomes are derived. In resolving any fiscal equalisation ‘trip’ to the introduction of economic efficiency improving State (tax and expenditure) reforms, Warren (2010a) proposes that strategies in the case of major State tax reform might include:

1. Quarantining (or excluding) some part of the additional revenue raised by States undertaking major tax reforms;
2. Quarantining any Australian Government tax reform incentive grants (such as a share of increased revenue from a growth tax imposed by the central government in the region);
3. Limiting the scope for fiscal equalisation methodology to redistribute State-specific fiscal dividends arising from reforms to other regions not undertaking reform;
4. The central government institutionalising (or formally constituting) arrangements for compensating those regions which undertake reform; and
5. Considering introducing a ‘Flexible Pillar 3’ which enables a partial move to ‘what States should do’ rather than ‘what States do’ to ensure the achievement of national priorities through specific grants.

The above discussion is not a criticism of fiscal equalisation principles as applied in Australia but enhancements which are designed to improve its operation in practice. The real question though is whether there are demonstrable benefits for the UK from moving from the Barnett Formula to a framework similar to that in Australia. The answer must have two parts: is the current arrangement sustainable and is the Australian approach a superior alternative to other options.

In relation to the sustainability of current arrangements, three observations can be made. Firstly, the Barnett Formula is not sustainable because of its convergence characteristic – and patching it is a temporary, not a permanent solution. Secondly, if further devolution is imminent, including tax reassignment and expenditure reassignment, there will ultimately be no alternative but to move away from Barnett. Thirdly, if the ‘West Lothian Question’⁴⁶ is resolved through regional government in England, Barnett is no longer appropriate.

On the issue of the UK adopting an approach to allocating general grants similar to that in Australia, the discussion above has highlighted that there are considerable strengths in the Australian approach but it too requires constant review and enhancement. However, the Australian approach is more than just the application of fiscal equalisation principles to grant allocation – it is about a process of engagement within the federation which is open and consultative and has served the federation well during periods of crisis. COAG (Figure 2) has in recent years been a critical

⁴⁶ *ibid* p27

element in bringing about positive reforms and from which the UK can learn much in terms of how to manage the process of change during a period of budgetary crisis.

If the UK Government moves to reduce funding to DAs or force tax reassignment without addressing inequities in the distribution of current grants, it can only expect division and dissent and a risk to the stability of the union. The new UK Government's stated commitment to a commission in Wales along similar lines to the Calman Commission in Scotland will undoubtedly reach similar conclusions to the Calman Commission (and the Holtham Commission) on Barnett and tax assignment. The commitment to a review of local government financing will also inevitably raise issues about tax assignment and the Barnett Formula based funding to DAs since DAs are a primary funder of LG in their regions. Inevitably, any push for tax reassignment or further expenditure devolution in the UK must bring into question the future of the Barnett Formula and to its replacement.

5. OVERVIEW OF LESSONS FROM AUSTRALIA ON THE WAY FORWARD ON TAX AND IGT IN A FISCAL CRISIS

For the UK, its current difficult budgetary circumstances pose a number of critical questions about the future of devolution in the UK, let alone any push for further devolution as sought by the new UK Government. Of particular concern is that any push for further devolution will be resisted if this involves DAs assuming greater expenditure responsibility in an environment of unfair grant distribution and inadequate access to broad own-tax bases.

In its 2010 Manifesto, the UK Conservative Government proposed that over the next four years⁴⁷:

We will make politics more local, more transparent and more accountable. We intend to build a new political system that serves people rather than politicians. Together, we can change our politics for the better.

Rhetoric in recent months has given way to reality and this has major implications for any broad push for greater devolution in the UK. In particular, key elements warranting reform such as the Barnett Formula have been delayed. The risk to DAs is that if there is no upside to any push for devolution, their resistance or unwillingness to cooperate will be met with coercion. However, such an approach will do nothing to further devolution in the UK. Rather, what is needed is a more open and consultative approach to government where issues such as tax and expenditure reassignment and intergovernmental transfers are a focus of public debate and openness by institutions such as HM Treasury.

While Australia has a history of openness and consultation around intergovernmental arrangements, the UK has no such background. The promised reviews into Wales (similar to the Calman Commission), into local government financing and into the 'West Lothian Question' would all greatly benefit from a decision to develop a framework for facilitating improved intergovernmental consultations across the

⁴⁷ See p63 of <<http://www.conservatives.com/Policy/Manifesto.aspx>> or in particular, <http://media.conservatives.s3.amazonaws.com/manifesto/cpmanifesto2010_lowres.pdf> . The UK Conservative –Liberal Coalition agreement which outlines the shared agreed position on devolution is accessible from <<http://www.conservatives.com/~media/Files/Downloadable%20Files/agreement.ashx?dl=true>>

nations in the UK. The above discussion has shown that the UK could benefit greatly from Australia's experience with its COAG consultative framework and the important role the CGC has fulfilled in advising the Australian Treasurer on general grant allocation amongst States.

The risk for the UK Government is that in pushing for further devolution in an environment of reduced DA funding, that the union will be left to fracture along regional lines – a fact already evident in the Holtham Commission implied reference to the Barnett Formula disadvantaging Wales against Scotland⁴⁸.

In summary, Australia's experience would suggest the following four step approach to furthering devolution in the UK during a period of budgetary crisis:

- (S1) Develop a *COAG-type* consultative and performance monitoring framework for DAs and England (Figure 2);
- (S2) Develop a *CGC-type* independent statutory authority to advise the UK Chancellor of the Exchequer on per capita relativities to apply when allocating grants between DAs and England (Figures 6 and 7);
- (S3) Undertake a review of tax and expenditure assignment by level of government underpinned by a recognition that the role and functions of DAs and LG are inextricably linked; and
- (S4) Make provision for the regular review of the arrangements in (S1), (S2) and (S3).

The consultative framework (S1) is critical to the success of devolution and requires from the UK Government (and HM Treasury), a far more open and consultative approach than is currently evident. Here, issues such as whether DAs should confront hard or soft budget constraints, the design of general and specific grants along with all related intergovernmental agreements would all be determined along with advance knowledge of the level of annual grant funding. The framework does not need to be formal. In Australia's case, the COAG framework is not constituted as a result of legislation but has proven flexible enough to be able to respond to the widely varying and ever changing demands placed on the federation.

Through (S2) DA and LG would have a direct input into how fiscal equalisation principles are applied in practice in the UK and be able to air any concerns they might have about the equity or efficiency impact of grant arrangements. By only having an advisory role, the UK government can still act to ensure any allocation accords with its priorities and principles or outcomes agreed separately through (S1). Where advice is overridden on relativities, the reasons why would need to be made open and explicit.

With (S3), a successful outcome here is conditional on successfully implementing (S1) and (S2). Ultimately, process is everything in implementing and managing change and without the necessary framework capable of managing the process of change (resulting from (S1)), the ideas and recommendations in (S3) will be of little consequence.

⁴⁸ See footnote 6.

Since no system can be designed without the need for constant refinement, (S4) highlights the importance of constant review. In the case of (S1), a flexible arrangement permits its constant review and updating. In relation to (S2), the Holtham Commission (2010) proposed that the revised Barnett Formula (Figure 5) be reviewed each decade. Australia reviews its CGC arrangements every 5 to 10 years. In the case of tax and expenditure reform, Australia has routinely reviewed key aspects of its tax system every 7-10 years.

Over the coming decade, the nations in the UK union will confront a continuing budgetary crisis. In such an environment, any deficiencies in current arrangements will become potentially the source of failure and division within the union. The danger for the UK Government is that as it moves to greater devolution accompanied by tax reassignment and expenditure devolution (S3) during a period of budgetary crisis, that the weaknesses in the current intergovernmental arrangements (S2) will become exacerbated. Open and transparent government based on an informed and consultative decision making approach (S1) will do much to reduce policy-on-the-run and lack of broad support so often a characteristic of crisis policy making.

What the discussion in this paper has highlighted is that any move to further devolution and tax assignment in the UK, especially in an environment characterised by substantial budget deficits, will invariably force necessary institutional change. However, institutional change is typically slow to occur especially where change brings with it reduced influence by key participants (such as the UK Government and especially HM Treasury). What is different though about 2010 is that the UK government has committed to addressing its budgetary crisis and furthering devolution while the devolved governments are demanding a restoration of needs-based grant funding and the assignment of taxing powers. Resolving these potentially conflicting demands would be greatly facilitated through an open and consultative process on engagement by nations in the UK union. Here, the UK has much to benefit from building on the approach taken in the Australian federation (S1, S2, S3 and S4) to managing competing interests and demands across federation members during periods of major change. Change without attention to process and pathway risks divisiveness (and failure) at worst and delayed implementation at best. The UK does not have the luxury of time and the current crisis is the perfect environment in which to implement reforms which require major institutional change.

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