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CONTENTS

- 4 Comparison of a lower corporate income tax rate for small and large businesses
John Freebairn
- 22 Wine options of Australian tax reform|
Paul Kenny, Michael Blissenden and Sylvia Villios
- 51 Tax compliance of ethnic minority immigrant entrepreneurs: A social capital perspective
Sue Yong and Fiona Martin
- 77 Tax compliance costs in developing countries: Evidence in Ethiopia
Wollela Abehodie Yesegat, Jacqueline Coolidge and Laurent Olivier Corthay
- 105 Retrospective tax law: Has Pandora's Box opened never to be shut again?
Rocco Loiacono and Colleen Mortimer
- 119 Risks of IFRS-based taxation: The application of section 24JB by authorized users to hedged relationships
Pieter van der Zwan



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Comparison of a lower corporate income tax rate for small and large businesses

John Freebairn¹

Abstract

The comparative effects of a lower corporate income tax rate on effective tax rates and investment decisions of small and large businesses are assessed, and some of the implications for the economy are explored. A lower corporate tax rate results in a larger reduction in the effective tax burden facing large businesses. This combined with the higher funds supply elasticity generates a larger investment response by large businesses, and flow on to GDP and labour incomes. Despite this, however, a larger share of the benefits of a lower corporate tax rate accrue to non-resident shareholders of large businesses.

Key words: corporate income tax, small business, large business, capital income taxation

¹ University of Melbourne. Email: j.freebairn@unimelb.edu.au. With the usual caveats, I gratefully acknowledge the informed comments of two referees.

1. INTRODUCTION

An analytical framework is developed to compare and contrast the different effects of a lower corporate income tax rate² for Australia on small versus large businesses. The current political debate on business tax reform and recent computable general equilibrium modelling of the effects of a lower corporate tax rate provide a context. Following the 2015 Commonwealth budget reduction in the corporate tax rate for small businesses with an annual turnover of up to \$2 million (Hockey & Cormann, 2015), the 2016 Commonwealth budget proposed to extend the small business threshold to \$10 million from July 2016, with further increases each year through to 2022–23, before a common reduction for all businesses (Morrison & Cormann, 2016).³ The Labor opposition supports a lower rate only for small businesses with a turnover of up to \$2 million a year (Australian Labor Party, 2016). The Henry Tax Review (Henry et al., 2009) for Australia and the Mirrlees Review (Mirrlees et al., 2011) for the UK rejected the idea of a lower corporate tax rate for small businesses, primarily because of the complexity, costs and doubtful efficiency benefits. Recent computable general equilibrium model studies of the effects of a lower corporate income tax rate for Australia by Rimmer et al. (2014), Cao et al. (2015), Kouparitsas et al. (2016), Dixon and Nassios (2016) and Murphy (2016) implicitly assume similar effects of a lower corporate tax rate across businesses of different sizes. For simplicity they use a representative firm for each industry. Also, the assumptions that all corporate income after tax is distributed as dividends and there is a constant equity to debt funding ratio are challenged, and plausible alternative assumptions are found to influence the effects of a lower corporate tax rate on businesses of different sizes.

Key different characteristics of small and large businesses which generate different effects of a lower corporate tax rate are: the relative importance of resident versus non-resident shareholders; and different capital income tax systems. Capital income tax refers to the tax wedge between the corporate investor pre-tax return and the saver after-tax return. The tax wedge is shown to vary between resident and non-resident shareholders, and then for each category of shareholder between income distributed as dividends or retained for additional investment. The imputation system reduces the effect of a lower corporate tax rate on the effective tax burden for resident shareholders. By contrast, under the current system of withholding taxes applying to non-resident funds invested in Australian companies, most of a lower corporate tax rate reduces the effective tax rate and it is passed on to non-resident shareholders. Large businesses with a higher share of non-resident shareholders face a more elastic supply of investment funds in the global capital market than small businesses primarily dependent on family savings and retained earnings. Differences in the shareholder mix and the tax system between small and large businesses are shown to result in important differences in the effects of a lower corporate tax rate on the effective tax burden, the magnitude of the investment response, and the distribution of the benefits of a lower rate.

² A lower effective corporate tax rate can be driven by a lower statutory tax rate, or by additional exemptions and deductions from a comprehensive tax base. For reasons of space and brevity, the paper proceeds with a lower statutory rate, while recognising that the arguments apply also to a reduced tax base.

³ Specifically, the budget proposed to lower the current 30 per cent rate to 27.5 per cent for businesses with a turnover of less than \$10 million a year from July 2016, and to increase the turnover threshold by annual increments to \$1 billion by 2022–23, before extending reductions for all businesses to 25 per cent by 2026–27. In addition, small businesses are able to expense capital items costing up to \$20,000.

The rest of the paper is as follows. Section 2 provides background data on: the mix of businesses by alternative measures of size and their relative contributions to the economy; and differences between small and large businesses in the sources of, and the elasticity of supply of, investment funds. The different tax treatments of capital income earned by corporate and other businesses, and for corporations between resident and non-resident shareholders, and then between debt, dividends and retained earnings, are discussed in Section 3. Drawing on the background of Sections 2 and 3, Section 4 assesses the comparative effects of a lower corporate tax rate in reducing the effective tax burden on marginal investment by small and large businesses. A partial equilibrium model of investment demand and supply is used to assess the effects of the lower effective tax on investment levels, distribution of the lower corporate tax rate, and other business decisions. A final Section provides a summary and conclusions.

2. SMALL AND LARGE BUSINESSES IN THE AUSTRALIAN ECONOMY

There are numerous definitions and measures of a small business. One set of definitions focus on institutional structure. This paper primarily considers corporate businesses. A snapshot or static picture of business size measures size by turnover as under the current policy discussion, but also alternatively by employment, payroll, assets and income. Then, there are different magnitudes for each measure, such as less than 5, 20, or X employees, and inevitably the specified magnitudes are arbitrary. Another set of business size characteristics take a dynamic picture of contributions to employment growth, technological change and firm survival. The Australian Bureau of Statistics (ABS), Australian Taxation Office (ATO) and Household Income and Labour Dynamics in Australia (HILDA) provide data on many of the different business size measures.⁴

The institutional mix of private businesses at the end of 2014–15 is shown in Table 1. Of the 2.1 million businesses, companies represent 36 per cent. However, companies account for a much larger share of economic output, income, employment and investment. Over the last decade the share of companies has increased. Most large businesses are corporates, but there are also many small businesses that are corporates.

Table 1: Australian Private Business by Type, 2014–15, and Some Measures of Transition Rates

Type of business	Number of businesses	Share of businesses (%)	Survival rate, 2011–15 (%)	Entry rate, 2014–15 (%)	Exit rate, 2014–15 (%)
Sole proprietor	555,294	26	50	16	16
Partnership	299,540	14	64	7	11
Trust	497,226	24	70	12	9
Company	747,586	36	66	15	12
Total	2,100,162		62	14	13

Source: ABS Catalogue No 8165.0, Table 10, except for column 4 which comes from Table 11 (ABS, 2016d).

⁴ A 2015 Reserve Bank of Australia (RBA) conference volume on small businesses provides an excellent review of the many dimensions of small businesses (Moore & Simon, 2015).

Table 2 reports ATO data on the mix of companies classified as private and public companies, and the taxable income within each category.⁵ Over 99 per cent of the companies are private companies, and most of these are small, and family-controlled and managed. Public companies with an annual taxable income of more than \$5 million represent just 0.3 per cent of taxable companies, but they account for over 61 per cent of taxable corporate income. Many of these large companies are multinationals with a significant share of non-resident shareholders.

Table 2: Taxable Resident Companies Classified as Private/Public and by Taxable Income, 2013–14

Status and taxable income	Companies		Taxable income	
	Number	Share of total (%)	\$ m	Share of total (%)
Private companies:				
<\$100k	216,545	65.9	5,817	2.2
\$100–500k	76,432	23.3	17,271	6.5
\$500k–1m	16,280	5.0	11,379	4.3
\$1–5m	13,280	4.2	27,592	10.4
>\$5m	2,442	0.7	39,093	14.8
Total private	325,592	99.1	101,152	38.2
Public companies:				
<\$100k	778	0.2	-42	
\$100–500k	501	0.2	125	
\$500k–1m	222	0.1	166	
\$1–5m	568	0.2	1,478	0.6
>\$5m	954	0.3	161,823	61.1
Total public	3,023	0.9	163,550	61.8
Total resident taxable	328,615		264,702	

Source: ATO, Taxation Statistics, 2013–14.

For businesses of different sizes according to the number of employees, Table 3 shows contributions to the economy as shares of national employment and value added. For the ABS definition of ‘small business’ as being less than 20 employees (ABS, 2004), small businesses account for 97 per cent of all businesses by number, but only 43 per cent of employment and 33 per cent of value added. Very large businesses with 200 or more employees represent just 0.2 per cent of businesses, however they account for 32 per cent of employment and 44 per cent of value added. The relatively higher value added contribution versus employment for large businesses reflects more capital per employee and a larger share of higher skilled employees.

⁵ Some caution is required with annual taxable income for a particular year as a general measure of average taxable income over time. In any year a specific company’s taxable income can be below or above average because of a combination of: losses carried forward; large depreciation and other expenses incurred prior to the production boost; cyclical and other short-term adverse effects on sales; and bad luck and/or poor management.

The relative importance of small businesses varies across the different industries, with, for example, larger than average employment and value added shares in agriculture and construction, and smaller shares in mining and manufacturing.⁶

Table 3: Contributions of Business by Employment Size to the Economy, 2013

Number of employees per business	Number of businesses		Employment* % of total	Value added* % of total
	'000	% of total		
0	1,264	61		
1–4	563	27		
5–19	197	10		
<20	2,025	97	43	33
20–199	51	2	25	23
≥200	4	0.2	32	44
Total	2,078			

*share of private non-financial sector

Source: Nicholls and Orsmond (2015) drawing on ABS Catalogues 8165.0, 8166.0 and 8167.0.

Data on firm survival, entry and exit rates in Table 1, and other ABS (2016c) data on involvement in research and development (R&D) and innovation, reveal considerable dynamics across businesses of different sizes and also considerable heterogeneity within the different size categories.⁷ From Table 1, about 62 per cent of all businesses in July 2011 survived to June 2015, with sole proprietors slightly below the average and companies slightly above the average. Across the different business types, the average entry and exit rates over 2014–15 were around 13 per cent, with greater movements for sole proprietors and below average movements for partnerships. ABS (2016c) reports that some businesses across the different measures of size are involved in R&D and innovative activity to develop better and new products and to reduce costs of production. However, a much bigger share of large businesses report innovative activity, and large businesses account for over 80 per cent of the national investment in R&D. Innovative small businesses predominately are new or start-ups rather than established small businesses, and are only a subset of small business. More generally, drawing on data collected by the RBA from its business liaison program, Nicholls and Orsmond (2015, p. 5) conclude that ‘the drivers of small firms’ current price, employment and investment decisions are generally not statistically different from larger firms, though this may in part reflect the large degree of heterogeneity in the small business sector’. This picture of heterogeneity of business dynamics across businesses of different sizes supports the arguments of the Henry Review (Henry et al., 2009) and Crawford and Freedman (2010) for neutral taxation of businesses of different sizes for efficiency reasons.

⁶ For additional statistical details see Wilkins (2016).

⁷ Clearly, there are many anecdotes of small businesses which are innovative and with expanding employment, but at the same time there are anecdotes of dynamic and successful large businesses, and there are anecdotes of both small and large businesses which fail.

Corporations depend on a mixture of debt and equity funds to finance their investments. Given the different characteristics of debt and equity, including a guaranteed but in general lower income and expense for debt, together with portfolio diversification preferences, debt and equity are imperfect substitutes for both savers and investors. While there is much heterogeneity across businesses in sources of investment funds and income distribution, and also across time for each business, there are some general patterns which have important implications for the effects of a lower corporate tax rate. On average, between 30 and 40 per cent of investment is financed by debt, and the majority of equity finance is from retained earnings rather than the issue of new equity (Fang et al., 2015). Supporting the latter is the observation that on average, two-thirds of the after-corporate income tax return on shareholder equity is distributed as dividends, and one-third retained, with a slightly higher payout rate for non-ASX and smaller corporates (Bergmann, 2016).

Since colonisation, Australia has been a net capital importer, and non-resident shareholders hold a large share of the equity used to fund investment by the larger companies. Across the business sector, average foreign ownership is around 33 per cent (ABS, 2016a). For most of the multinationals, non-resident shareholders represent 50 per cent or more, including around 80 per cent for mining companies (Connolly & Orsmond, 2011).

Most small businesses, both unincorporated businesses and family-controlled companies, are highly dependent for business equity on family savings and reinvested, or non-distributed, business income. Matic et al. (2012) estimate that less than 20 per cent of small businesses draw on outside debt or equity. Family-funded small businesses have to compete for limited household saving against alternative investments in owner-occupied housing,⁸ other property, public shares, superannuation and financial deposits, and for some investment overseas.⁹ The low elasticity of supply for aggregate household saving combined with portfolio diversification considerations means the supply of household saving for small business investment in most cases will be inelastic. While small businesses have access to debt finance from the banks and other financial intermediaries, most have limited access to equity from general Australian investors and especially from non-resident investors. Lack of information, asymmetric information and high transaction costs are more marked for private small businesses.

By comparison, large public companies, and especially multinational companies, have access to non-resident equity and debt funds. With Australia being a small player in a large global capital market, the supply of non-resident funds available to public listed corporations is highly elastic, and in some studies it is assumed to have an infinite elasticity (Cao et al., 2015; Murphy, 2016).

⁸ For some family small businesses there is a significant complementarity between household saving allocated to the home and the business with property used as collateral for business borrowing (Connolly et al., 2015).

⁹ ABS (2015) shows that across all households in 2011–12, for average household wealth of \$728,139, 3.3 per cent was in own incorporated business, 2.4 per cent in own unincorporated business and 2.8 per cent in trusts. The more important by value household wealth is owner-occupied homes at 43.1 per cent, other property at 15 per cent, superannuation at 15.4 per cent, and 7.9 per cent in other financial assets.

3. EFFECTIVE TAX RATES

This section describes the effective tax rates for different saving and investment options to highlight the different taxation of business investment income between: resident and non-resident shareholders; individuals and superannuation funds; income on shares distributed as dividends and retained earnings; and, debt and equity. The effective tax rate is the tax wedge between the pre-tax rate of return earned by the investor and the after-tax income rate of return received by the saver. A combination of differences of the tax system, measurement of the tax base, including exemptions, and the statutory tax rate(s) determine the effective tax rate on the different options. Table 4 provides a summary of the wide range of different effective tax rates.

Corporate income tax acts as a withholding tax, and it is a component of the tax wedge between the required pre-tax return earned by the company on its investment and the after-tax return received by the shareholder or saver.

Measurement of the capital income return to corporate equity uses an Australian production or source base measure of nominal income. Effectively, the corporate tax base is a measure of the residual return to equity, or of the consumer surplus to the investor. The return includes the normal return to compensate saving and risk taking, and above normal returns involving rents for limited in supply inputs, monopoly power and short-term quasi-rents on innovation and managerial expertise.

With a few exemptions, the Australian corporate income tax base is a comprehensive one. Special exemptions include immediate expensing of investments of less than \$20,000 for small businesses with an annual turnover up to \$2 million, accelerated depreciation on most transport equipment and some oil and gas, and R&D preferences (Australian Treasury, 2016). Current corporate income tax rates are 28.5 per cent for small corporations with a turnover of less than \$2 million a year, and a flat 30 per cent for all other corporations.

The system of taxation of the capital income earned by shareholders of Australian companies varies between resident and non-resident shareholders, and then for income distributed as dividends and retained by the company for additional investment. With the imputation system, equity returns distributed to resident shareholders face the personal rate for households, which is a progressive rate schedule, and for superannuation funds a flat rate of 15 per cent for accumulation funds and zero for most in the retirement phase.¹⁰ For franked dividends, a dollar for dollar credit is given for the corporate tax. The imputation system for resident shareholders and for company income distributed as dividends means a reduction (increase) in corporate tax paid is offset by an additional (lower) dollar of personal tax, and a smaller (larger) credit for superannuation funds.

For non-resident shareholders, dividends bear the 30 per cent corporate tax if franked and no withholding tax.¹¹ Unfranked dividends, meaning no corporate tax because of, for example, exemptions from the tax base and losses carried forward, are subject to a withholding tax. The withholding tax rate varies by tax treaty and is in most cases a

¹⁰ From July 2017, for post-accumulation funds the superannuation income tax rate is zero for assets up to \$1.6 million, and then 15 per cent for income earned on assets above \$1.6 million.

¹¹ Dixon and Nassios (2016) estimate that franked dividends represent about 90 per cent of dividends.

flat rate of no more than 10 per cent (Australian Treasury, 2015).¹² For franked dividends paid on existing shares and corporate investment, a lower corporate tax rate is a dollar for dollar transfer to non-resident shareholders.

Returns to equity reinvested by the company face a different tax treatment to retained earnings. Realised capital gains generated by the additional investment face a second set of taxation for resident investors, namely the corporate tax rate plus a capital gains tax on realised gains at a half of the progressive personal rate for individuals, and for superannuation funds of 10 per cent during the accumulation phase and zero for retirement accounts. For non-resident investors, the retained earnings are subject to company income tax up to the statutory rate, but a lower effective rate if the tax base is less than comprehensive, and capital gains are exempt from further Australian tax, except for special cases involving land assets.

Different taxation systems apply to debt interest than for equity returns. For all business types, corporate and non-corporate, debt interest is a deductible business expense. On interest income received by residents, households pay the progressive personal rate and superannuation funds pay a flat 15 per cent rate during the accumulation phase and zero during the retirement phase. Then, for residents the effective tax burdens for debt and for equity income distributed as dividends are equal, but a different effective tax rate applies to retained earnings. Non-resident providers of debt funds to Australian companies pay a low withholding tax rate on debt interest income. The withholding tax rate on interest varies by country and tax treaty (with an estimated average tax rate of less than 3 per cent (Smails, 2015)), and it is much lower than the 30 per cent rate on franked dividends.

Returns to equity investments in non-corporate businesses, including sole proprietors, partnerships and trusts, are taxed as personal income. The measured tax base for the residual return to equity investment involves a number of concessions, including immediate expensing for small businesses for capital items costing less than \$20,000, some exemptions from capital gains taxation, and generous allowances for actual and quasi-household expenses not available to wage earners. In general, for distributed income the progressive personal income tax rate is applied, with an 8 per cent discount for small business income of up to \$1,000 a year per individual introduced in July 2016 to match the benefits of the lower corporate tax rate on small corporations (Morrison & Cormann, 2016). Retained income reinvested in the business initially becomes a deduction as depreciation and other expenses, and the future returns are distributed as personal income or realised as a capital gain. The realised capital gain component is taxed at half of the personal income tax rate.¹³

The consumption tax treatment of income earned on household saving investment in own homes clearly is much lower than that of other household investment options, including in companies. In general, the taxation of income earned on investment in other property is lower than shares.

¹² Non-residents of some countries, and specifically the US, may receive credit for Australian tax paid on debt and equity returns in assessing the home country tax contribution. Rimmer et al. (2014) indicate that Australian tax is the final tax for about 90 per cent of non-resident investment income earned in Australia.

¹³ Taxation of realised capital gains, as opposed to an accrued system, in most cases provides further concessions through the delay, and is often to a lower marginal tax rate. For some however, the lumpy nature of the realised capital gain may shift the taxpayer into a higher marginal rate.

Table 4: Effective Tax Rates for Different Funding and Investment Options

Investment and funding option	Effective tax rate
Company:	
Debt funds	
–resident household	Personal progressive, T_p
–resident super fund	Super flat, T_s
–non-resident	Withholding, average < 3%
Equity, dividend	
–resident household	Personal progressive, T_p
–resident super fund	Super flat, T_s
–non-resident, franked	Corporate, T_c
–non-resident, unfranked	Withholding, < 10% for most
Equity, retained and capital gain	
–resident household	Up to T_c plus $0.5T_p$
–resident super fund	Up to T_c plus $0.67T_s$
–non-resident	Up to T_c
Unincorporated business:	
Debt finance	Personal progressive, T_p
Equity, distributed income	Personal progressive, T_p
Equity, retained income and capital gain	Progressive, $0.5T_p$
Alternative household options:	
Own home	Zero
Other property	Personal, $aT_p = (1 - a) 0.5 T_p$
Financial deposits	Personal progressive, T_p

1. T_p is the progressive personal tax rate, with marginal rate from 0 per cent up to 49 per cent;
2. T_s is the flat superannuation fund rate of 15 per cent during accumulation and 0 per cent during retirement phases;
3. T_c is the corporate income tax rate, currently 28.5 per cent for businesses with turnover of up to \$2 million a year, and 30 per cent for all others; and
4. a is the share of rent less expenses accrued income (or loss) in accrued income plus capital gain income.

The effective tax rates of Table 4 and the predominance of resident investors in small companies compared to the dominance of non-residents in most large companies reveal different effective tax rates on debt and equity investments between small and large businesses. The imputation system for resident shareholders results in different effective tax rates to those of the withholding tax system for non-resident shareholders. Also, income distributed as dividends and income retained for further business investment have different effective tax rates. Importantly, a lower corporate tax rate will have a different magnitude of changes to the effective tax rate for resident and non-resident shareholders and for dividends and retained earnings.

4. EFFECTS OF A LOWER CORPORATE INCOME TAX RATE

The effects of a lower corporate income tax rate are assessed in three steps, with a comparison of the effects on small and large corporations. First, drawing on Section 3, the effects of a lower corporate tax rate on the effective tax burden on a marginal investment are measured, with large differences for a resident relative to a non-resident shareholder. Second, a partial equilibrium comparative static model of the demand for investment and supply of funds is used to assess the investment response to the lower effective tax burden. Drawing on Section 2, the supply of funds for additional investment is more elastic for large businesses with a large share of non-resident shareholders than for small businesses largely dependent on family funds. Third, some general equilibrium flow-on effects of the additional investment on the wider economy, including the labour market and government revenue are assessed.

4.1 Changes to effective tax rates

The magnitude of effect of a lower corporate tax rate on the effective tax burden for a marginal investment will vary with the relative importance of equity and debt finance, and for equity finance between resident and non-resident shareholders, and then between returns distributed as dividends and reinvested. For investment funded by debt funds, there are no changes for both resident and non-resident sourced funds.

Resident equity investors face the same effective tax rate for dividends under the imputation system, and for retained earnings a portion of the lower corporate tax rate is recaptured through the concessional taxation of capital gains generated by the additional investment. By contrast, non-resident equity investors receive almost a dollar for dollar transfer from the Australian Treasury for the lower corporate income tax; the exception is the small share of unfranked dividends which face no corporate income tax and the same withholding tax rate.

Formally, the change in the effective tax burden on additional investment by a corporation, ΔTE , with a lower corporate income tax rate, ΔT_c , can be represented as:

$$\Delta TE = RS ES RIS (1 - 0.5T_p) \Delta T_c + (1 - RS) ES (1 - FS) \Delta T_c \quad (1)$$

where RS is the share of equity funds provided by residents, ES is the share of equity funds in the new investment, RIS is the share of equity returns retained and reinvested, T_p is the resident income tax rate for individuals and superannuation, and FS is the share of dividends franked.¹⁴ The first right-hand term of (1) is the effective tax rate change for resident shareholders, and the second right-hand side term is the effective tax rate change for the non-resident shareholders.

Clearly, values for the parameters of (1) driving the effect of a lower corporate tax rate on the effective tax rate on additional investment vary across business, including by size, and over time for each business. However, there are significant differences on average between small and large businesses. Equity funding for small businesses primarily is by residents and then for most from family funds. That is, RS is close to unity and only the first right-hand term is applicable. To illustrate, suppose equity contributes 60 per cent of funds and ES is 0.6, a third of the equity income is reinvested in the business and RIS is 0.33, and there is an effective capital gains tax

¹⁴ For simplicity, an implicit assumption in (1) is that ES and RIS are independent of the corporate tax rate. In a fully general equilibrium model, both would be functions of T_c .

rate of 15 per cent (equal to half of a middle income personal rate of 0.3). Then, a 5 percentage point reduction in the corporate rate becomes a 0.765 percentage point reduction in the effective tax rate on additional investment by a small business.

By comparison, using (1) for a large business, a lower corporate income tax results in a much larger reduction in the effective tax rate. At one extreme case, if non-resident equity is used to fund marginal investment, almost all of the reduction of the statutory corporate tax rate flows to a lower hurdle rate of return on additional investment, that is $\Delta TE = \Delta Tc$. Or, taking the mining industry example with 80 per cent non-resident shareholders, and an equity share of 0.6, over a half of a lower corporate tax rate reduction is passed through to a lower effective tax rate, or at least three times the reduction for a small resident-owned business.

4.2 Investment increase effects

Employing a conventional partial equilibrium model of the demand for and supply of business investment, the magnitude of the investment response, ΔI , to the lower effective tax rate, ΔTE of (1), is given by:

$$\Delta I = [(E_s E_d) / (E_s + E_d)] \Delta TE \quad (2)$$

where E_s and E_d are the (absolute value) elasticities of the supply of and demand for investment funds. This investment response is illustrated in Figure 1 below as the increase from K to K' . The investment response will be larger the larger the reduction of the effective tax rate, the more elastic the investment demand function, and the more elastic the supply of funds function.

Using (2) as a framework, a lower corporate tax rate will lead to a much larger investment response, ΔI , by large as compared with small business. First, as noted in the above discussion of (1), the effective tax reduction ΔTE is larger for a large business. Second, the elasticity of supply of funds for additional investment, E_s , is larger for most large businesses. Most small companies depend on resident shareholders, and then most on family saving, for funds for investment. A combination of a low household saving elasticity and the competition in drawing business funds away from alternative household investments in owner-occupied housing, other property, and so forth results in a low elasticity of supply of funds, E_s , to the family-owned and operated company. By contrast, large companies with a high share of non-resident shareholders have access to the international capital market for additional funds. Many take the view that the elasticity of supply of international funds to Australian multinational companies is close to infinite, and this is the assumption made in many of the computable general equilibrium model studies of a lower Australian corporate tax rate (including Cao et al., 2015; Kouparitsas et al., 2016; Murphy, 2016).

Third, while there is debate and uncertainty about the magnitude of the investment demand elasticity, E_d in (2), and then the magnitude of the investment stimulus, there is no doubt that there will be an increase in investment response. The investment demand elasticity in computable general equilibrium models depend primarily on the assumed elasticity of substitution between capital and labour in the production function. For example, Dixon and Nassios (2016) prefer a low elasticity value of 0.4 compared with 0.8 preferred by the Treasury (Cao et al., 2015; Kouparitsas et al., 2016) and Murphy (2016); and all report sensitivity studies to values 50 per cent

above and below the preferred elasticity value. Meta studies of the responses of investment to interest rates and taxation, such as Feld and Heckemeyer (2011), report a wide range of elasticity estimates. Of interest is the results of a study of actual business investment decisions as a component of the RBA's business liaison group. The study found firms used much higher hurdle rates of return than the cost of funds, often preference for the payback period criterion, and for many stability over time in the choice of investment hurdles to changes in interest rates and taxation (Lane & Rosewall, 2015). Investment lags of many years reflect adjustment costs and the timing of replacement of existing investments with larger scale and more advanced technology items. The larger the investment demand elasticity, E_d , the larger the investment response to a lower effective tax rate.

There is no compelling evidence that the demand elasticity is larger for small businesses compared with large businesses. While some small companies are innovative and growth-oriented, and will apply the extra available cash provided by the tax reduction to investment, many other small companies with lifestyle and other low-growth objectives are more likely to use the cash gain for other household purposes. Shareholder pressures for larger profits and dividends are dominant drivers of management decisions in large public companies. These a priori considerations suggest a lower value for the investment demand elasticity, E_d in (2), for small versus large businesses.

In addition to the lower tax-induced increase in aggregate investment, a lower corporate tax rate brings greater neutrality of the tax burden on some business decisions with associated gains in efficiency, but with different effects on small and large businesses. For non-resident investors in large businesses, a lower corporate tax rate reduces the effective tax burden on equity relative to the very low and unchanged rate on debt, and so reduces distortions to the equity to debt mix. Also, the lower corporate rate reduces the effective tax wedge between franked and unfranked dividends. For small businesses, to the extent a lower corporate tax rate reduces the effective tax burden involved in the corporate plus capital gains tax burden on retained earnings, tax distortions to the mix of dividends versus retained earnings are reduced, as are the magnitudes of distortions to the allocation of household saving to the tax exempt owner-occupied dwellings.

4.3 Second round economy and income distribution effects

Additional investment stimulated by a lower corporate tax rate in time boosts the national stock of capital. The larger capital inflow also brings additional foreign technology and management skills, and greater access to global supply chains. A larger ratio of capital and technology to labour shifts outwards the demand for labour. With labour demand more elastic than labour supply, most of the labour demand shift flows to higher wages with a relatively smaller increase in employment. In this way, in the longer term many of the benefits of a lower corporate tax rate flow through to labour and the general population.

Increased investment and labour productivity increase gross domestic product (GDP). The larger the investment response, the larger the increase in GDP, and as argued in Section 4.2 above, the investment response to a lower corporate tax rate will be larger for large versus small businesses. The greater the share of the additional investment sourced in Australia rather than from imports, the larger the additional flow-through effect to GDP. There is no comprehensive data to support a significant difference on

the import share of investment for small versus large businesses. The lower corporate tax rate induced expansion in the demand for labour, and increased labour incomes will be larger the greater the elasticity of substitution of labour for capital and the greater the share of geographic mobile investment (as illustrated in the sensitivity results from the computable equilibrium model studies of Cao et al. (2015) and Dixon and Nassios (2016)).

The increase in gross national income (GNI) will be less than the increase in GDP for large companies. Non-resident shareholders who are more important in large rather than small businesses receive much of the first round benefits of the lower corporate tax rate on existing investments, and they receive most of the after-corporate tax income earned on the additional investment (with a more detailed explanation in Figure 1 below). By contrast, for small businesses, and for those primarily with resident investors, most of the additional GDP stimulated by a lower corporate tax rate flows as higher after-tax incomes to resident shareholders and to employees. Bearing in mind that the available computable general equilibrium models employ a typical firm by industry and do not disaggregate for small and large businesses, the Treasury modellers (Kouparitsas et al., 2016) and Murphy (2016) estimate a positive GNI increase but less than the GDP increase, and Dixon and Nassios (2016) estimate a positive GDP increase but a negative GNI effect.¹⁵

Consider next the distribution of a lower corporate income tax rate between shareholders and the government following the investment response. Figure 1 considers the case for non-resident shareholders. Suppose for simplicity an infinitely elastic supply of non-resident funds and that non-resident equity shares fund the marginal investment. If non-residents require a global market determined after Australian tax return of r^* , for an Australian corporate tax rate of T_c (and assuming constant current withholding taxes) the required pre-tax return is $r = r^*/(1 - T_c)$. With a funds supply function S reflecting the after-tax return to the saver and a demand for funds for investment function D reflecting the pre-tax return on investment, the market sets investment and the capital stock at K . Corporate tax collected by Australia is given by area $a+b+c+d$. Note that the corporate tax base is the residual return to equity, and the tax collected includes a share, T_c , of the above normal return on infra-marginal investments and on the economic rents earned on geographic immobile investments, namely area a .

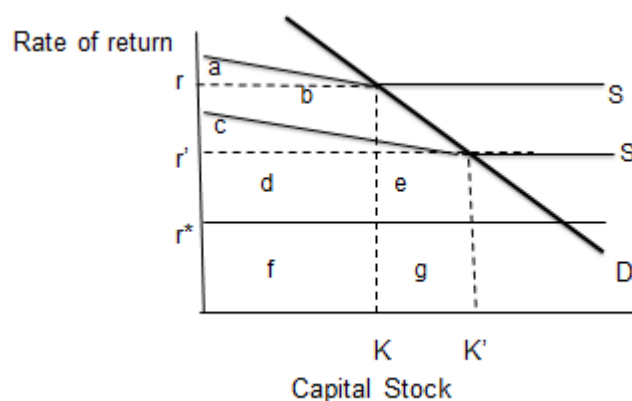
Now, reduce the corporate tax rate so that the required pre-tax return falls to $r' = r^*/(1 - T_c - \Delta TEI)$, with ΔTEI being the lower effective tax rate from (1). The lower supply function of equity funds, from S to S' , results in higher investment and an increase of the capital stock from K to K' . Corporate tax collected on income earned on the original capital stock falls by area $a+b$, with the share held by non-residents a transfer from the Australian Treasury to non-residents. Additional tax of area e is collected at the lower tax rate on income earned on the additional capital funded by non-residents.¹⁶ Only with a very large investment demand elasticity, and beyond the

¹⁵ Potential explanations for the different results include: the former assumes a higher labour for capital substitution elasticity giving a larger investment and GDP response; and the latter does not include the effect of a lower statutory tax rate reducing profit shifting by multinational companies which reduces the transfer to non-residents.

¹⁶ Note that this result conflicts with the words of Kouparitsas et al. (2016) and Murphy (2016) stating that there is no gain to non-residents because the pre-tax return falls, r to r' in Figure 1, to offset the lower tax rate. While this is true for marginal investments, the lower corporate tax rate continues to collect a share of above normal returns on infra-marginal investment, area c , albeit a lower sum than area $a+b$.

values available in the literature, would the revenue gain on extra investment, e , exceed the revenue loss on existing investment, $a + b$.

Figure 1: A Lower Corporate Income Tax Rate



In addition, and not shown in Figure 1, a lower Australian corporate income tax rate will likely reduce the magnitude of profit shifting by multinational companies from Australia to lower tax rate countries. If estimates of profit shifting to lower statutory tax rates for Europe by de Mooij and Devereux (2011) are generally applicable to Australia, a lower statutory corporate tax rate would reduce the magnitude of profit shifting by multinational companies and provide additional Australian company tax revenue to that shown in Figure 1.

By contrast, for small companies with resident shareholders, the first round government revenue loss from a lower corporate tax rate will be much less than for large companies with non-resident shareholders. For resident shareholders, under the imputation system a reduction of franking credits on dividends with a lower corporate tax rate is offset by a higher personal tax payment, and over time some of the lower corporate tax paid on retained earnings is recaptured as tax on higher capital gains or future higher dividends.

In addition to the partial recapture of the first round revenue cost of a lower corporate tax rate from shareholders, in the longer run the larger economy as measured by the increase in GDP means higher other tax bases and additional revenue. These gains include the larger labour income induced by the larger capital stock to increase income tax and payroll tax receipts. With a lower corporate tax rate inducing a larger investment increase, and then GDP increase, these second round revenue gains will be larger for a reduction of the corporate tax rate for large companies than for small companies.

An idea of the magnitude of revenue recapture from a larger economy promoted by a lower corporate income tax rate is given by the computable general equilibrium model studies. Assuming a representative firm for each industry, as opposed to the disaggregation into small and large businesses considered in this paper, the reported

Given that the increase in GNI is less than the increase in GDP, and extra tax revenue of area e is collected on the additional investment, the reported model results in the bulk of these papers seeming more consistent with the Figure 1 model than with the above wording in these papers.

net revenue gain is an aggregate or average. In aggregate, Kouparitsas et al. (2016) and Murphy (2016) estimate that about half of the first round revenue cost of a lower corporate tax rate would be recaptured; the smaller investment and GDP response estimate by Dixon and Nassios (2016) would generate a smaller recapture rate.

5. CONCLUSION

The many potential definitions of small and large businesses using characteristics such as turnover and employment, and then the characteristic quantity, are arbitrary. There is no general evidence that any of these measures of business size effectively classify businesses by relative contributions to the economy or by the form of, and magnitudes of, market failures to warrant a different corporate income tax rate on small versus large businesses.

In comparing and contrasting the effects of a lower corporate income tax rate on small and large businesses in Australia, a key distinguishing characteristic is the mix of resident and non-resident shareholders. Resident shareholders dominate small companies, and for most the shareholders are family. By contrast, many large companies, and in particular multinational companies, have a large share of non-resident shareholders, and in many cases a 50 per cent and above share. Differences in the capital income taxation of residents versus non-residents, and differences in the elasticity of supply of funds for investment in Australian businesses from family shareholders and from non-resident shareholders of large companies, significantly influence the magnitudes, but not the direction, of the effects of a lower corporate income tax on business investment and the wider economy.

A lower corporate income tax rate will induce a much larger reduction in the effective tax rate for non-resident shareholders relative to resident shareholders, and hence a larger increase in the incentives and rewards for additional investment by large businesses. For resident shareholders, under the imputation system for dividends, which represent about two-thirds of corporate income, the lower corporate tax is offset by a higher personal tax collection; and for the third of corporate income retained and invested, a portion of the initial lower corporate tax is recaptured in later years from additional capital gains tax and income tax on higher future dividends. By contrast, in the case of non-resident shareholders and many large businesses, under the current system of withholding taxes a reduction in the company tax rate initially is close to a dollar for dollar transfer from the Australian Treasury to the shareholder.

The relative magnitude of the stimulus of a lower corporate tax rate to more investment by large as compared to small companies is further boosted by the higher supply elasticity of funds for additional investment from non-resident versus resident shareholders. Small companies heavily dependent on family funds face a low aggregate household savings elasticity and portfolio competition for the allocation of household saving to property, financial deposits or the company. By contrast, non-resident shareholders consider their investment in Australia as just one option in a much larger global capital market. Together, the much larger effect of a lower corporate tax rate on reducing the effective capital income tax rate faced by non-resident shareholders compared with resident shareholders and the larger elasticity of supply of funds from non-resident investors into Australia mean a many-fold larger increase in investment response to a lower corporate tax rate for large versus small companies.

Other important drivers of the magnitude of the investment response to a lower corporate tax rate include the elasticity of the investment demand function, the share of debt and equity, and the share of income distributed. On average, the elasticity of the investment demand function and the time profile of investment response to a lower effective tax rate is likely to be similar across different businesses sizes. A lower corporate tax rate will reduce the current tax concession for debt over equity for non-residents but not for residents, and it will make retained earnings more attractive relative to dividends for residents but not for non-residents. These greater tax neutrality and efficiency gains effects of a lower corporate tax rate are likely to be small relative to the effects of the aggregate investment response.

There are two sets of opposing forces influencing the net cost to revenue of a lower corporate income tax rate on small versus big businesses. The initial or first round revenue loss is much larger for large businesses with their higher share of non-resident shareholders. For residents and dividends, the lower company tax is offset in full by more personal and superannuation fund income tax, and some of the lower tax on reinvested income is recovered in the future. By contrast, non-resident shareholders of large companies receive close to all of the first round lower corporate tax rate reduction. However, the much larger investment response by large businesses to a lower corporate tax rate results in a much larger GDP response than for small businesses. In turn, the larger GDP means larger income and expenditure tax bases, and associated revenue collection. Whether these larger second round taxation gains exceed the larger first round loss for large versus small businesses becomes an empirical question dependent on many parameters for which there is much uncertainty.

If the political debate for a lower corporate income tax is to include options of a lower rate for small businesses, future computer general equilibrium modelling should replace the current representative or average business with at least two business types to recognise the key differences of the resident/non-resident shareholder mix, the different effective tax burdens on residents and non-residents, the elasticity of funds supply, and perhaps also differences of the tax treatment of equity returns distributed as dividends or retained to fund additional investment.

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Wine options of Australian tax reform

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Abstract

Australia's indirect tax policies for wine, the Wine Equalisation Tax (WET) and the WET rebate are very different to the policies of 'old world' wine countries and emerging competitors, and industry leaders have identified these tax policies as stymieing the industry. In light of these concerns and the current tax reform enquiry this paper critiques Australia's wine taxes and evaluates reform options. This paper supports the repeal of the WET. The WET (as well as the wine excise alternative) raise small amounts of tax revenue but damage economic efficiency, fail to target externalities (the wine abusers), appear inequitable and are too complex, particularly for the thousands of small wine producers. Without a WET, it follows that the WET rebate also needs to be repealed, as it is costly, inefficient and inequitable. Assistance would be needed to help those affected by the transition away from a WET.

Key words: Wine equalisation tax, Wine equalisation tax rebate, sales tax, tax policy, GST

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1. INTRODUCTION

From the 1980s to 2007 the Australian wine⁴ industry experienced explosive growth built on exports, innovation and differentiation.⁵ This came at the expense of ‘old world’ wine countries (such as France and Italy). Since 2007 the growth changed to a contraction with the value of domestic wine sales remaining flat and exports declining by 38 per cent between 2007–12.⁶ The decline coincided with emerging new competitors from Chile, Argentina and South Africa and a more competitive old world wine industry.⁷ Additionally, consumption habits in traditional and new wine consuming countries are converging, with premium wines gaining a considerable market share.⁸

Australia’s indirect tax policies for wine, the Wine Equalisation Tax (WET) and the WET rebate are very different to the policies of old world wine countries and emerging competitors. In the wake of a persistent grape surplus industry and low profitability, industry leaders have identified these tax policies as stymieing the industry’s ability to adapt to the increased competition.⁹ However, the Australian wine market is fragmented¹⁰ and thus other industry leaders and bodies argue for the status quo.¹¹ In light of these concerns the Commonwealth is currently proposing changes to wine taxation. In the 2016–17 Budget, the government announced that it will reduce the WET rebate cap from \$500 000 to \$350 000 on 1 July 2018 and tighten eligibility criteria. Additionally, producers who exceed the rebate cap can access a \$100 000 per annum grant to encourage wine tourism.¹²

This paper seeks to critique Australia’s supplementary indirect taxes on wine (hereinafter referred to as ‘wine taxes’). The aim is to inform the process of setting an

⁴ This paper focuses on unfortified alcoholic grape wine.

⁵ Emiliano Villanueva, ‘The Anglo-Saxon New World Wine Producers’ Paradigm Shift in Wine Business’ (2015) 1 *Global Business & Economics Anthology* 45, 45 found that the competitive advantages were: a better approach to new consumers; an innovative operational and productive approach; simpler marketing and communications strategy; and a strong cohesive public and private support to exports.

⁶ Centaurus Partners, ‘Wine Industry Report for Wine Makers Federation of Australia — Expert Report on the Profitability and Dynamic of the Australian Wine Industry’ (Report, August 2013) Appendix 2, 13 <https://www.wfa.org.au/assets/noticeboard/Expert-Review-Report.pdf>

⁷ Ibid 5.

⁸ Luigi Cembalao, Francesco Caracciolo and Eugenio Pomarici, ‘Drinking Cheaply: the Demand for Basic Wine in Italy’ (2014) 58 *Australian Journal of Agricultural and Resource Economics* 374, 375. Non-premium wine now only comprises 1/7th of the value of global wine and half of the volume. There is greater homogeneity in non-premium wines since they have simple attributes, little quality complexity, and not much differentiation.

⁹ Pernod Ricard Winemakers, Submission to the Tax White Paper Task Force, June 2015, 1–2 <http://bettertax.gov.au/publications/discussion-paper/submissions/>; Treasury Wine Estates, Submission to the Tax White Paper Task Force, June 2015, 5 <http://bettertax.gov.au/publications/discussion-paper/submissions/>.

¹⁰ Marketline, *Wine in Australia* (May 2015), 19, 21 <www.marketline.com>. Four producers accounted for around 56 per cent of the market.

¹¹ Accolade Wines, Submission to the Tax White Paper Task Force, 1 June 2015 <http://bettertax.gov.au/publications/discussion-paper/submissions/>.

¹² Kelly O’Dwyer and Anne Ruston, ‘Backing Australia’s Wine Industry’ (Joint Media Release, 2 December 2016) <http://kmo.ministers.treasury.gov.au/media-release/108-2016/>

optimal wine tax for Australia by evaluating reform options. This is highly relevant given the Commonwealth government's current wine tax review process.¹³

First, this paper sets out the supplementary wine taxes employed by Australia, and compares these to Italy, France, New Zealand and South Africa. The paper then examines the operation of the WET and the rebate before considering the recent wine tax review processes. An analysis of Australia's policy settings for wine taxation and reform options is then made having regard to four well accepted tax policy criteria: fiscal adequacy; economic efficiency; equity; and simplicity.

Five options for wine tax reform emerge: do nothing; repeal the WET; replace the WET with an excise; replace the WET with a higher goods and services tax (GST) rate on wine; and/or repeal the WET rebate. Whilst doing nothing appears to be the politically easiest option, an analysis of the tax policy criteria and industry concerns point to a need for reform. This paper supports the repeal of the WET. The WET (as well as a wine excise alternative) only raise small amounts of tax revenue but damage economic efficiency, fail to target externalities, appear inequitable and are too complex, particularly for the thousands of small wine producers. Without a WET, it follows that the WET rebate also needs to be repealed, as it is costly, inefficient and inequitable. Assistance would be needed to help those affected by the transition away from a WET.

2. SUPPLEMENTARY WINE TAXES COMPARED

A number of different indirect taxes are levied on domestically produced or consumed unfortified wine: the value added tax (VAT) (known as the GST in Australia and New Zealand); excise duties; and sales tax (such as the WET). Since the VAT on wine is applied at standard rates applicable to most other goods and services in all of the countries examined in this paper, this tax is not considered to be a wine tax and is not compared. The following wine taxes apply.

In Europe, the European Union in the EC Treaty Article 93 (ex 99) provides for the harmonisation of legislation concerning excise duties to the extent that such harmonisation is necessary to ensure the establishment and functioning of the internal market.¹⁴ Under the harmonisation of excise rates in *Council Directive 92/83* member states must apply an excise to wine which must be fixed by reference to the number of hectolitres of finished product.¹⁵ For still and sparkling wine, member states must levy the same rate of excise on all products chargeable with the duty.¹⁶ However, since 1 January 1993 the minimum rate of excise on still and sparkling wine has been zero euros per hectolitre of finished product.¹⁷ Italy applies a zero excise on still wine (where under 15 per cent alcohol by volume) and France has a minimal excise on wine in addition to the standard rate of VAT.

¹³ Ibid.

¹⁴ Laurence Gormley, *EU Taxation Law* (Richmond Law & Tax, 2005) 11.

¹⁵ *Council Directive 92/83/EEC of 19 October 1992 on the harmonization of the structures of excise duties on alcohol and alcoholic beverages* [1992] OJ L 316/21, arts 7(1), 7(2).

¹⁶ Ibid art 9(2).

¹⁷ *Council Directive 92/84/EEC of 19 October 1992 on the approximation of the rates of excise duty on alcohol and alcoholic beverages* [1992] OJ L 316/29, art 5.

In New Zealand a substantial excise applies in addition to the standard rate of GST. Australia imposes the WET, a wholesale sales tax of 29 per cent in addition to the standard rate of GST on wine. However, a rebate of WET applies for wine producers.¹⁸

The following table provides a recent comparison of these taxes on bottles of non-premium, premium and super premium priced wine in Australia and selected competitor countries: Italy; France; South Africa; and New Zealand (in Australian equivalent dollars).

Table 1: Comparison of Wine Tax in Australia, Italy, France, South Africa and New Zealand in Australian Dollar Tax Equivalents on a 750 ml Bottle of Unfortified Wine¹⁹

	\$A tax equivalent on a \$5 750 ml bottle of non-premium wine	\$A tax equivalent on a \$12 750 ml bottle of premium wine	\$A tax equivalent on a \$32 750 ml bottle of super premium wine
Australia WET ²⁰	0.52	1.80	4.80
Italy Excise	0	0	0
France Excise	0.04	0.04	0.04
South Africa Excise	0.26	0.26	0.26
New Zealand Excise	2.07	2.07	2.07

The above table illustrates the minimal excises of old world wine producers Italy and France that apply to all price points of wine. South Africa, another ‘new world’ country has a relatively minor excise, whilst New Zealand has a significant excise, especially on non-premium wine. In contrast Australia moderately taxes non-premium wine but provides a significant tax on premium and super premium wine. Similarly, in 2010 Anderson found that relative to other wine exporting new world countries and certainly European wine exporting and other new world countries, Australia does indeed have higher ad valorem equivalent excise taxes for non-premium, premium and super premium priced wine.²¹ Yet as discussed above, premium wine is the growing world wine market that Australia needs to target.

¹⁸ *A New Tax System (Wine Equalisation Tax) Act 1999* (Cth) s 19-5(1).

¹⁹ Exchange rates on 8 February 2016: A\$1 = EU\$0.6115; A\$1 = NZ\$1.0264; A\$1 = RD10.84 (Exchange Rates UK (8 February 2016) < <http://www.exchangerates.org.uk/currency-calculator.html>>).

²⁰ Winemakers’ Federation of Australia, ‘Australian wine: regional, sustainable essential’ (2008). The Winemakers’ Federation of Australia estimates that the WET (29 per cent of the wholesale sale value) would account for 15 per cent of the retail price. On this basis this analysis assumes that the WET accounts for 15 per cent of the \$50 retail price.

²¹ Kym Anderson, ‘Excise and Import Taxes on Wine Versus Beer and Spirits: An International Comparison’ (2010) 29(2) *Economic Papers* 215, 218.

3. AUSTRALIA'S WINE EQUALISATION TAX

The WET commenced on 1 July 2000 and was designed to replace the former wholesale sales tax²² on wine.²³ The former wholesale sales tax was abolished on 30 June 2000 with the introduction of the GST and the WET. The WET imposes a wine tax on the taxable value of assessable dealings²⁴ with wine²⁵ in Australia.²⁶ The tax is applied to both Australian produced wine and imported wine. The primary types of assessable dealings are: wholesale sales;²⁷ retail sales;²⁸ application of wine for own use;²⁹ and certain importations.³⁰ Some assessable dealings such as exports are exempt.³¹

The following diagram provides an overview of the WET:³²

²² Formerly the *Sales Tax Assessment Act 1992* (Cth), *Sales Tax (Exemptions and Classifications) Act 1992* (Cth), *Sales Tax Imposition (Excise) Act 1992* (Cth), *Sales Tax Imposition (Customs) Act 1992* (Cth), *Sales Tax Imposition (General) Act 1992* (Cth) and *Sales Tax Imposition (In Situ Pools) Act 1992* (Cth).

²³ Prior to the WET the last wholesale sale of wine was subject to a sales tax at the rate of 41 per cent. Given the GST rate of only 10 per cent wine prices would have dropped severely.

²⁴ *A New Tax System (Wine Equalisation Tax) Act 1999* (Cth) s 5-5. Assessable dealings include selling wine, using wine, or making a local entry of imported wine at the customs barrier.

²⁵ *Ibid* ss 31-1, 31-2, 31-3, 31-4, 31-5, 31-6, 31-7. Wine is defined to include: alcoholic products that contain more than 1.15 per cent by volume of ethyl alcohol that are grape wine; grape wine products (such as marsala, vermouth, wine cocktails and creams); fruit wines or vegetable wines; and cider, perry, mead and sake.

²⁶ *Ibid* s 5-5.

²⁷ *Ibid* s 33-1: A wholesale sale 'means a sale to an entity that purchases for the purpose of resale, but does not include a sale of wine from stock in a retail store (or retail section of a store) to make up for a temporary shortage of stock of the purchaser, if the wine is of a kind that: (a) is usually *manufactured by the purchaser; or (b) is usually purchased by the purchaser for resale'. The most common assessable dealing involves the sale of wine by a winery to a retailer, or a sale of wine by a distributor to a retailer.

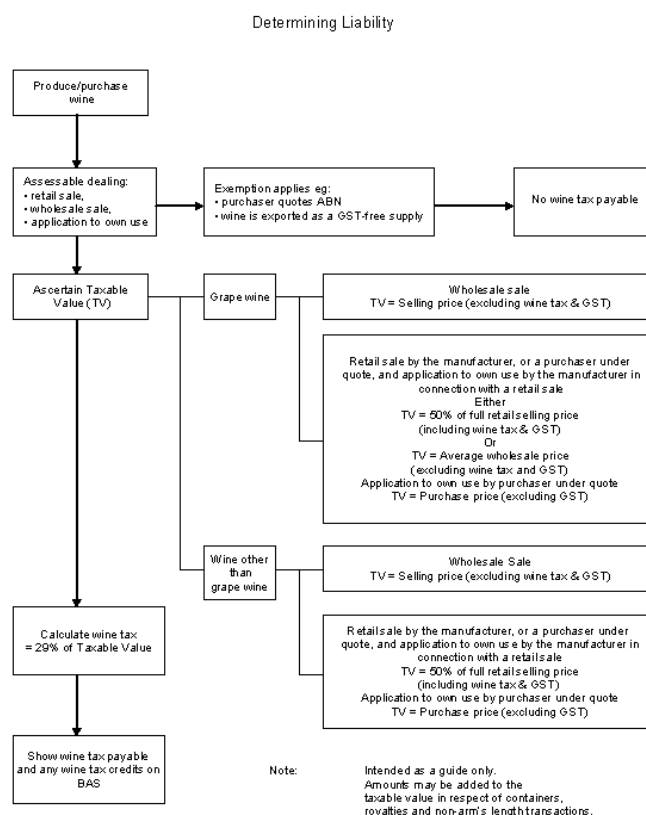
²⁸ *Ibid*: A retail sale is 'any sale that is not a *wholesale sale'. This commonly is a sale made to a person who does not purchase the wine for the purpose of resale. For example, a sale at the cellar door of a winery.

²⁹ Australian Taxation Office, *Wine Equalisation Tax Ruling Wine Equalisation Tax: the Operation of the Wine Equalisation Tax System*, WETR 2004/1, para 33. This usually involves: 'wine used for cellar door tastings; wine used for tastings at exhibitions; wine used for wine shows; wine used for promotions; wine donated to charity; wine given to retailers, restaurants and so on, as samples; wine given to staff; and wine taken for personal consumption'.

³⁰ Such as the entry of imported wine for home consumption.

³¹ *A New Tax System (Wine Equalisation Tax) Act 1999* (Cth) s 7-5.

³² Australian Taxation Office, *Wine Equalisation Tax Ruling Wine Equalisation Tax: the Operation of the Wine Equalisation Tax System*, WETR 2004/1, Appendix C.

Figure 1: How the WET Works

As evident from the above diagram calculating the WET is complex, requiring taxpayers to consider factors such as the type of wine product, point of sale, exemption status and taxable value. The WET is payable by wine manufacturers, wine wholesalers and wine importers. Wine can be bought and sold numerous times and the WET is deferred and generally applied at the last wholesale sale of wine. Up until the last wholesale sale of wine, businesses quote their Australian Business Number (ABN) to gain exemption from WET (called 'quoting'). Quoting is also used for exports. In this way WET is passed on in the price of the wine to the end domestic consumer. Retailers of wine pay WET in the sense that their payments to suppliers for wine include a mark up for WET paid. WET is calculated at the rate of 29 per cent³³ of the taxable value of assessable dealings with wine in Australia.³⁴ The WET is calculated on the selling price of the wine excluding wine tax and GST. Where wine is not the subject of a wholesale sale, for example where it is sold at the cellar door or used for tastings or promotional activities the WET provides for the calculation of alternative values for the tax payable.³⁵

³³ *A New Tax System (Wine Equalisation Tax Imposition — General) Act 1999* (Cth); *A New Tax System (Wine Equalisation Tax Imposition — Customs) Act 1999* (Cth); *A New Tax System (Wine Equalisation Tax Imposition — Excise) Act 1999* (Cth).

³⁴ *A New Tax System (Wine Equalisation Tax) Act 1999* (Cth) s 5-5.

³⁵ *Ibid* div 9.

The WET forms part of the GST tax base and GST is payable on the value of the wine including any WET component. For imports, an assessable dealing with wine is taxable when it enters Australia. The taxable value is equal to the GST importation value of the wine.³⁶ The GST importation value is the customs value plus the costs of transport, insurance and duty.³⁷

The WET³⁸ and the GST³⁹ provide a concessional cash accounting rule for businesses with annual turnovers of less than \$2 million. This means that eligible small wineries do not pay WET or GST until they actually sell the wine. Just 20 entities paid 89 per cent of the WET that totalled \$826 million in 2013–14, out of 3880 entities paying WET.⁴⁰

3.1 Imported wine

Imported wine into Australia has increased in recent years with New Zealand accounting for much of this growth (providing 64 per cent of wine imports in 2014).⁴¹ WET is paid by the importer unless an ABN is quoted for wine undergoing further processing and distribution. A wine tariff of 5 per cent also applies to imports unless a free trade agreement provides an exemption, as it does with New Zealand.⁴²

4. WET REBATE

A rebate of WET applies for producers of rebatable wine that are registered or required to be registered for GST in Australia.⁴³ The Explanatory Memorandum's rationale for the WET rebate asserted that it would effectively allow a majority of wine producers to be able to fully offset their WET liability by accessing the WET rebate and help small wine producers in rural and regional Australia to reduce or offset entirely their WET liability.⁴⁴ The WET rebate is significant amounting to \$311

³⁶ Assessable dealing AD10 in the assessable dealings table in *A New Tax System (Wine Equalisation Tax) Act 1999* (Cth) s 5-5.

³⁷ *A New Tax System (Goods and Services Tax) Act 1999* (Cth) ss 13-20, 33-1, 195-1.

³⁸ *A New Tax System (Wine Equalisation Tax) Act 1999* (Cth) s 21-10.

³⁹ *A New Tax System (Goods and Services Tax) Act 1999* (Cth) s 29-40.

⁴⁰ Commonwealth of Australia, 'Final Budget Outcome 2013–14' (2014) Table 4: Australian Government General Government Sector (Accrual) Revenue.

⁴¹ Australian Bureau of Statistics, 'Shipments of Wine and Brandy in Australia by Australian Winemakers and Importers' (Cat No 8504.0, June 2014); *Australian and New Zealand Wine Industry Directory 2015* (Winetitles, 2015).

⁴² No tariff applies to wine produced in the United States, New Zealand, Singapore, Chile, Thailand, Papua New Guinea, Malaysia, Japan, the Association of Southeast Asian Nations (ASEAN) countries, Pacific Island Forum countries, developing countries and least developed countries.

⁴³ *A New Tax System (Wine Equalisation Tax) Act 1999* (Cth) s 19-5(1).

⁴⁴ Explanatory Memorandum, Tax Laws Amendment (Wine Producer Rebate and Other Measures) Bill 2004 (Cth) [1.7]. See also the press release of the then Treasurer the Hon Peter Costello MP: Peter Costello, 'Wine Industry Assistance' (Press Release No 30) <<http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2004/030.htm&pageID=003&min=phc&Year=2004&DocType=0>>.

million in 2013–14 (25 per cent of WET).⁴⁵ Given this highly favourable rebate the vast majority of small wine producers do not have to pay WET.⁴⁶

From 1 July 2006, the maximum amount of rebate an Australian producer, or group of associated producers,⁴⁷ can claim in a full financial year is \$500 000.⁴⁸ This is equivalent to about \$1.7 million in the wholesale value of eligible sales and applications to own use per annum. To claim a rebate an entity must also be liable to pay WET on the wine or would have been liable to pay WET on the wine had the purchaser of the wine not quoted for the sale of the wine.⁴⁹ Producer is defined widely to include entities registered for GST that have manufactured wine, or provided their produce to a contract winemaker to make wine on their behalf, or have subjected purchased wine to a process of wine manufacture.⁵⁰ Many entities can access the rebate as follows:⁵¹

1. grape growers who undertake manufacture themselves (that is, crush grapes and ferment the juice);
2. grape growers who have the grapes processed into wine on their behalf;
3. winemakers who purchase grapes and manufacture the wine;
4. blenders and entities undertaking other further manufacturing processes;
5. contract winemakers (in some cases);
6. ‘virtual winemakers’ who have no involvement in the winemaking process (they do not own or lease vineyards, have no plant or equipment or a cellar door). These virtual producers acquire grapes and/or wine and contract out the manufacturing or blending process in order to claim the WET rebate;
7. producers of branded wine where the producer owns the brand;
8. producers of branded wine where the wholesaler or retailer owns the brand;
9. producers of bulk and unbranded wine; and
10. non-resident producers — producers that are based overseas but undertake winemaking in Australia.

Whilst New Zealand does not impose a WET, from 1 July 2005 the Australian WET producer rebate was extended to eligible New Zealand wine producers that have their

⁴⁵ Commonwealth of Australia, above n 40, Table 4: Other alcoholic beverages are those not exceeding 10 per cent by volume of alcohol (excluding beer, brandy and wine). This includes so-called ‘alcopops’ or ‘ready-to-drink’ beverages.

⁴⁶ Winemakers’ Federation of Australia, ‘Australian wine: regional sustainable essential’, above n 20, 20.

⁴⁷ *A New Tax System (Wine Equalisation Tax) Act 1999* (Cth) s 19-20.

⁴⁸ *Ibid* s 19-15. Previously, from 1 October 2004 to 30 June 2006, the maximum amount of rebate was \$290 000, ie exempting \$1 million (wholesale value) of sales per annum.

⁴⁹ Australian Taxation Office, *Wine Equalisation Tax Ruling Wine Equalisation Tax: Operation of the Producer Rebate for Other than New Zealand Participants*, WETR 2009/2, 6.

⁵⁰ *Ibid*.

⁵¹ Commonwealth Treasury, ‘Re:Think Tax Discussion Paper, Better Tax System Better Australia’ (March 2015) 17 <http://bettertax.gov.au/publications/discussion-paper/>

wine exported to Australia.⁵² The maximum amount of rebate a New Zealand producer, or group of associated producers, can claim in a full financial year is the same as Australian producers.⁵³ Old world countries such as France and Italy (or any other countries), though, cannot access the WET producer rebate.

New Zealand wine producers can claim a rebate of 29 per cent of the approved selling price of the wine in Australia. The approved selling price is the price for which the wine is sold net of any expenses unrelated to the production of the wine in New Zealand. In order to obtain the rebate, a New Zealand winemaker must produce wine in New Zealand that is exported to Australia and substantiate that WET was paid in Australia on the sale of the wine.⁵⁴ Whilst the wine must be ultimately sold in Australia, a New Zealand producer does not have to sell the wine in Australia since a wholesaler or distributor can make the sale in Australia. In line with rising exports to Australia the New Zealand rebate has grown quickly from \$5 million in 2006–07 to \$25 million 2013–14. The Australian National Audit Office (ANAO) also noted that the increase arose from an increased incidence of New Zealand grape growers accessing the New Zealand rebate by using contract winemakers' facilities to enable them to register as wine producers.⁵⁵

A fundamental administrative flaw exists with the WET rebate. The Australian Taxation Office (ATO) data does not distinguish between WET rebates and other refunds, and thus does not allow a proper analysis of who gets the rebate.⁵⁶ This is a major problem for a rebate designed to assist small wine producers in rural and regional Australia.

5. RECENT WINE TAX REVIEWS

Prior to the Tax White Paper reform process there were nine recent government reviews that all recommended that the WET be replaced with a volumetric tax.⁵⁷ This included the 2009 Henry Review which found that 'all alcoholic beverages should be taxed on a volumetric basis, which, over time, should converge to a single rate, with a

⁵² *A New Tax System (Wine Equalisation Tax) Act 1999* (Cth) s 19-5(2). New Zealand wine producers may apply to the Australian Commissioner of Taxation to become approved New Zealand participants.

⁵³ *Ibid* s 19-15.

⁵⁴ Australian Taxation Office, *Wine Equalisation Tax — Producer Rebate for New Zealand Wine Producers* (3 December 2015) <https://www.ato.gov.au/Business/Wine-equalisation-tax/In-detail/WET-and-New-Zealand-wine-producers/Producer-rebate-for-New-Zealand-wine-producers/>

⁵⁵ Auditor-General, 'Administration of the Wine Equalisation Tax' (Audit Report No 20, Australian National Audit Office, 2010–11) 17 [30].

⁵⁶ Centaurus Partners, above n 6, 42.

⁵⁷ Foundation for Alcohol Research and Education, Submission to the Tax White Paper Task Force, June 2015, 14 <<http://bettertax.gov.au/publications/discussion-paper/submissions/>>:

Reviews that have recommended a volumetric tax be applied to wine include: the 1995 Committee of Inquiry into the Wine Grape and Wine Industry; 2003 House of Representatives Standing Committee on Family and Community Affairs Inquiry into Substance Abuse; the 2006 Victorian Inquiry Into Strategies to Reduce Harmful Alcohol Consumption; the 2009 Australia's future tax system (Henry Review); the 2009 National Preventative Health Taskforce report on Preventing Alcohol Related Harms; the 2010 Victorian Inquiry into Strategies to Reduce Assaults in Public Places; the 2011 WA Education and Health Standing Committee Inquiry Into Alcohol; the 2012 Australian National Preventive Health Agency Exploring the public interest case for a minimum (floor) price for alcohol, draft report and the 2012 Australian National Preventive Health Agency Exploring the public interest case for a minimum (floor) price for alcohol, final report.

low-alcohol threshold introduced for all products'.⁵⁸ The Henry Review asserted that the rate of alcohol tax should be based on evidence of the net marginal spillover cost of alcohol. However, no known compelling evidence has ever demonstrated that the externality costs associated with wine were at similar levels to other forms of alcohol such as beer and spirits. Not surprisingly, in view of the lack of evidence and concerns about the impact on the viability of the Australian wine industry such recommendations have never been adopted.⁵⁹

In March 2015 as part of a wider Tax White Paper reform process, Treasury released the tax discussion paper 'Better Tax System Better Australia'.⁶⁰ This paper briefly noted issues with wine taxes that offered favourable tax treatment particularly for low-value wine compared with other forms of alcohol such as beer and spirits, and how this influences production and consumption decisions.⁶¹ As part of this process the 'Wine Equalisation Tax Rebate Discussion Paper' was released in August 2015.⁶² This paper sought to better inform discussion and analysis of the WET rebate.

The discussion paper noted the many differences of wine production compared to the alternatives of beer and spirits. Wine production is subject to external factors such as climate and disease, less flexible, more capital intensive and less profitable.⁶³ The paper found that the wine industry faced significant challenges with low wine grape prices and weaker export performance resulting in many Australian winemakers and grape growers being unviable.⁶⁴ The paper observed a consensus of a sustained oversupply of wine.

Citing a 2011 Auditor-General report this review process identified problems with the administration of the WET rebate.⁶⁵ Tax schemes operated to improperly gain the rebate with wholesalers and retailers minimising WET liability and maximising WET rebates.⁶⁶ Arrangements to maximise the rebate included: bulk wine sales by grape growers to enable eligibility to growers; blending and further manufacture and the creation of interposed entities; restructuring contracts to inflate rebates; and virtual wine producers that acquire grapes or wine and contract out manufacture.⁶⁷ Thus the WET rebate may be distorting production patterns of wine by: leading to the oversupply of wine and wine grapes; preventing necessary industry adjustment; preventing market consolidation; and trapping businesses in the industry.⁶⁸

⁵⁸ Commonwealth of Australia, 'Australia's Future Tax System' (Report, 2009) 93
http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/pubs_reports.htm

⁵⁹ Wine Grape Growers Australia, Submission to the Tax White Paper Task Force, May 2015, 5, 6
<<http://bettertax.gov.au/publications/discussion-paper/submissions/>> referred to modelling that a volumetric tax on wine would result in a 34 per cent reduction in wine sales, 20 per cent reduction in grape production and loss of 12 000 jobs mostly in regional Australia.

⁶⁰ Commonwealth Treasury, 'Re:Think Tax Discussion Paper, Better Tax System Better Australia', above n 51.

⁶¹ Ibid 61.

⁶² Ibid.

⁶³ Ibid 4–5.

⁶⁴ Ibid 1.

⁶⁵ Auditor-General, above n 55, 17, para 30.

⁶⁶ Commonwealth Treasury, 'Re:Think Tax Discussion Paper, Better Tax System Better Australia', above n 51, 18.

⁶⁷ Ibid 18–22.

⁶⁸ Ibid 23.

Industry participants also raised concerns to the Tax White Paper review about the adverse impact of the WET rebate.⁶⁹ The paper found a number of ways the WET rebate could be reformed to ensure the sustainability of the wine industry:

1. abolishing the WET rebate;
2. phasing out the rebate with a grant to existing recipients;
3. restricting eligibility for the WET rebate by excluding bulk, unpackaged and unbranded wine;
4. tightening the definition of 'producer of wine';
5. demonstrating that the WET has been paid on wine;
6. reducing the maximum amount of the WET rebate;
7. rebating less than the full amount of WET payable;
8. replacing the WET rebate and the Brewery Refund with a rebate scheme for all independent alcohol producers; and
9. removing the New Zealand rebate.

The paper then concluded with a summary of discussion questions. In response to the WET rebate discussion paper numerous industry and other submissions were received in September 2015 and published online.⁷⁰ A brief overview of the key submissions below illustrates the divisive nature of the reform process.

Reflecting the fragmented nature of the industry there was no consensus in the industry responses. Two major premium wine producers (Pernod Ricard Winemakers and Treasury Wine Estates) provided similar submissions that sought to replace the WET with a volumetric tax that would be revenue neutral for the industry, that is, levied at \$1.40 per litre if the WET rebate was removed or at \$2.20 per litre otherwise.⁷¹ However, Accolade Wines, a significant non-premium wine producer, sought to retain the status quo. Accolade Wines reasoned that a volumetric tax on wine risks devastating a wine industry that is undergoing restructuring.⁷² The differing views reflect the varying focus on premium and non-premium wines between these three wine companies.

Other wine bodies were generally against a volumetric tax. Wine Grape Growers Australia opposed a volumetric tax on wine, finding that such a tax would greatly reduce vineyards and jobs, as well as be too complex.⁷³ Riverland Wine similarly opposed the tax asserting it would have a devastating impact on the Riverland wine

⁶⁹ Ibid 1.

⁷⁰ See Australian Government, *Re: Think Better Tax, Better Australia Discussion Paper* <http://bettertax.gov.au/publications/discussion-paper/submissions/> Unhelpfully the wine submissions were published along with submissions on other tax issues making analysis difficult.

⁷¹ Pernod Ricard Winemakers, above n 9, 1–2, Treasury Wine Estates, above n 9, 5.

⁷² Accolade Wines, above n 11, 1.

⁷³ Wine Grape Growers Australia, above n 59.

industry.⁷⁴ Murray Valley Winegrowers pleaded that a volumetric tax on wine at a time when the industry is at its lowest would be catastrophic.⁷⁵ Wine Tasmania also argued that the WET be retained⁷⁶ as increasing wine tax would severely impact the industry.⁷⁷ The Winemakers' Federation of Australia sought a differentiated tax rate on wine but (not surprisingly) did not have a position on the preferred structure of the wine tax due to the different business models of its members.⁷⁸

Health and health-related bodies advocated replacing the WET with a volumetric tax. The National Alliance for Action on Alcohol argued for a volumetric tax since increasing the price of alcohol was one of the most effective policy interventions to reduce consumption and harm.⁷⁹ The Foundation for Alcohol Research and Education argued that the high number of health problems provided a sound rationale for such reform.⁸⁰ The Cancer Council, noting that alcohol is a risk factor for cancer as well as an important cause of illness, injury and death,⁸¹ called for a volumetric tax as the most cost effective way of reducing alcohol consumption and alcohol-related health harm.⁸² On the other hand the Australian Liquor Stores Association asserted that the majority of the population (80.7 per cent) consume alcohol in moderation so there is no reason to increase alcohol taxes.⁸³

There was considerable consensus for reforming the WET rebate. Most submissions advocated removing bulk, unbranded wine and foreign producers from eligibility for the rebate.⁸⁴ Some argued that the WET rebate should be abolished.⁸⁵ The New Zealand government stated that equal treatment of New Zealand producers was

⁷⁴ Riverland Wine, Submission to the Tax White Paper Task Force, 1 June 2015, 1, 3, 11–12 <<http://bettertax.gov.au/publications/discussion-paper/submissions/>> referred to modelling that a volumetric tax on wine would increase a 4 litre cask price from \$18.99 to \$42.79; this would result in a 43 per cent drop in demand for Riverland fruit, equating to about one half of the growers leaving the industry.

⁷⁵ Murray Valley Winegrowers, Submission to the Tax White Paper Task Force, June 2015, 7 <<http://bettertax.gov.au/publications/discussion-paper/submissions/>>.

⁷⁶ Wine Tasmania, Submission to the Tax White Paper Task Force, May 2015, 2 <<http://bettertax.gov.au/publications/discussion-paper/submissions/>>.

⁷⁷ Ibid.

⁷⁸ Winemakers' Federation of Australia, Submission to the Tax White Paper Task Force, 29 May 2015, 4 <<http://bettertax.gov.au/publications/discussion-paper/submissions/>>.

⁷⁹ National Alliance for Action on Alcohol, Submission to the Tax White Paper Task Force, June 2015, 2 <<http://bettertax.gov.au/publications/discussion-paper/submissions/>>.

⁸⁰ Foundation for Alcohol Research and Education, above n 57.

⁸¹ Cancer Council, Submission to the Tax White Paper Task Force, June 2015, 7 <<http://bettertax.gov.au/publications/discussion-paper/submissions/>>.

⁸² Ibid 7.

⁸³ Australian Liquor Stores Association, Submission to the Tax White Paper Task Force, 2 <<http://bettertax.gov.au/publications/discussion-paper/submissions/>>.

⁸⁴ Accolade Wines, above n 11, 2; Riverland Wine, above n 74, 15–16; Wine Tasmania, above n 76, 2; Murray Valley Winegrowers, above n 75, 4; Pernod Ricard Winemakers, above n 9, 2, 13; Wine Grape Growers Australia, above n 59, 8–9.

⁸⁵ Foundation for Alcohol Research and Education, above n 57, 5; Cancer Council, above n 81, 10. Also, Pernod Ricard Winemakers, above n 9, 11; Treasury Wine Estates, above n 9, 5 noted that the removal of the rebate would allow a lower revenue neutral volumetric tax to be levied at \$1.40 per litre, rather than \$2.20 per litre if the rebate remained.

required under the Australia–New Zealand Closer Economic Relations Trade Agreement and thus asserted that the WET rebate should be preserved.⁸⁶

The Commonwealth government established the WET Rebate Consultative Group⁸⁷ to examine the submissions and provide advice to the government on options for reform. In the next step in the tax reform process a Green Paper was proposed in the second half of 2015. Following further community consultation on possible reforms a White Paper was expected to be published in 2016.⁸⁸ With the change of the Prime Minister and Treasurer in November 2015 this process appears to have been rescheduled.⁸⁹ Additionally, the Senate referred certain matters on the Australian grape and wine industry to be reviewed by the Senate Rural and Regional Affairs and Transport References Committee, and this included the impact and application of the WET rebate on grape and wine industry supply chains.⁹⁰ The WET was found to work against the profitability of the wine industry and was subject to unlawful claims or rorting. The Committee recommended that the WET rebate be phased out over five years, with the savings to assist the industry and include an annual grant to genuine cellar door operators to support their continued operation.⁹¹ Also, the Committee urged the government to undertake a comprehensive reform of wine taxation.⁹²

6. POLICY PERSPECTIVES FOR WINE TAX

A partial policy analysis is undertaken with a view to gaining an understanding of the wine tax options for Australia. This analysis is undertaken from the perspective of four well accepted tax policy criteria: fiscal adequacy; economic efficiency; equity; and simplicity. These criteria have been used by optimal tax theorists who seek to maximise social welfare⁹³ and have become prominent in certain tax reform processes.

⁸⁶ New Zealand government, Submission to the Tax White Paper Task Force, 28 May 2015, 4 <<http://bettertax.gov.au/publications/discussion-paper/submissions/>>.

⁸⁷ The Consultative Group members are: Mr Russell Campbell — General Manager, Small Business Tax Division, The Treasury (Chair); Mr Tony D'Aloisio AM — President, Winemakers' Federation of Australia; Mr Darren De Bortoli — Managing Director, De Bortoli Wines (NSW); Ms Rebecca Duffy — Winemaker, Holm Oak Vineyards (Tas); Nigel Gallop — Owner, Fraser Gallop Estate (WA); Mr Tom Harvey — Chairman, McLaren Vale Group Wine and Tourism Association (SA); Mr Robert Hill-Smith — Chairman, Yalumba (SA); Mr Larry Jorgensen — CEO, Wines of Western Australia (WA); Mr Anthony Murphy — Managing Director, Trentham Estate Wines (Vic); Mr Roger Sharp — Director, Group Corporate Affairs, Treasury Wine Estates (Vic); and Mr Lawrie Stanford — Executive Director, Wine Grape Growers Australia (SA).

⁸⁸ Commonwealth Treasury, 'Re:Think Tax Discussion Paper, Better Tax System Better Australia', above n 51.

⁸⁹ In September 2015 the former Prime Minister Tony Abbott was replaced by Malcolm Turnbull.

⁹⁰ Senate Rural and Regional Affairs and Transport References Committee, Parliament of Australia, *Australian Grape and Wine Industry* (2016)

<http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Rural_and_Regional_Affairs_and_Transport/Australian_wine_industry>.

⁹¹ Ibid 34.

⁹² Ibid.

⁹³ An optimal tax balances these often conflicting tax policy objectives. James Alm, 'What is an "Optimal" Tax?' (1996) 49(1) *National Tax Journal* 117, stated: 'A central issue in public economics is the appropriate design of a tax system. Such a system is usually viewed as balancing the various desirable attributes of taxation: taxes must be raised (revenue-yield) in a way that treats individuals fairly (equity), that minimizes interference in economic decisions (efficiency), and that does not impose undue costs on taxpayers or tax administrators (simplicity)'. Bruno Frey, 'Excise Taxes: Economics, Politics and Psychology' in Sijbren Cnossen (ed), *Theory and Practice of Excise Taxation* (Oxford

For example, in Australia these four tax policy criteria were central to policy formulation in recent tax reform processes, the 1999 Ralph Review and the 2010–11 Henry Review.⁹⁴ Limitations of this study are acknowledged, since policy settings are also the result of other factors such as political, social, cultural and historical, which are beyond the scope of this paper. Additionally, this paper refers to a number of international studies on alcohol taxes and it is noted that much caution must be exercised in comparing or applying such research between countries. Further, a number of minor levies and other imposts also apply to wine⁹⁵ but these are also beyond the limits of this paper.

6.1 Fiscal adequacy

Fiscal adequacy⁹⁶ appears to be one of the primary reasons cited for specific alcohol taxes. For example, in respect of wine taxation, the Australian government provided revenue raising as its rationale for significant increases in the wholesale sales tax on wine in 1993 and 1997.⁹⁷ However, comparatively small amounts of revenue are raised by wine taxation. WET only represents 0.2 per cent of total tax revenue of Commonwealth government tax revenue.⁹⁸ A broadly based tax, such as a comprehensive GST set at a uniform rate, provides a more continual revenue source and is hence preferable for indirect taxation.⁹⁹

6.2 Economic efficiency

As evident in the current wine tax review, the arguments for and against wine taxation on economic efficiency¹⁰⁰ grounds are strongly debated. It is argued that higher taxes on wine are justified since they focus on the high external costs associated with

University Press, 2005) 233, noted that optimal taxation theory indicates a preference for broadly based taxes that impose less distortions on the allocation of resources and provide better sources of tax revenue over narrowly based taxes.

⁹⁴ Review of Business Taxation, 'A Tax System Redesigned, More Certain, Equitable and Durable' (Report, Australian Government Publishing Service, Canberra, July 1999) 9, 13; Australian Treasury, 'Australia's Future Tax System, Report to the Treasurer' (2009) Part One Overview, Objective 2, vii.

⁹⁵ For example, Australia levies a wine export charge on exporters to provide funds for the Australian Wine and Brandy Corporation to undertake international promotional work and increase wine demand. Also, a Grape Research Levy and Wine Grapes Levy are imposed to assist the wine industry.

⁹⁶ Fiscal adequacy refers to the ability of taxation law to finance government expenditure. Fiscal adequacy is a fundamental requirement for a tax system given the government's need for revenue to ensure good governance.

⁹⁷ For example, in Australia, on 18 August 1993 the Commonwealth government increased the tax on wine from the general wholesale sales tax rate (WST) of 20 per cent to 31 per cent. The rationale for this increase is clear given the name of the amending legislation: *Sales Tax (General) (Deficit Reduction) Act 1993*; *Sales Tax (General) (Wine - Deficit Reduction) Act 1993*. Also, on 6 August 1997 when the WST rate for wine increased from 26 per cent to 41 per cent the government provided revenue raising as its rationale. The Explanatory Memorandum to the *Sales Tax Assessment Amendment Act 1997* stated:

In order to protect the future revenue of States and Territories, and in response to the unanimous request of the States and Territories, it is proposed that Commonwealth excises on petroleum and tobacco and sales tax on alcoholic beverages be increased to collect the revenue which would be lost by the States and Territories [as a result of constitutional invalidity of the state franchise fee on alcohol].

⁹⁸ In 2013–14 the WET produced \$826 million of revenue and total tax revenue in 2013–14 was \$433 885 million: Australian Bureau of Statistics, 5506.0 — *Taxation Revenue, Australia 2013–14* <<http://www.abs.gov.au/ausstats/abs@.nsf/mf/5506.0>>.

⁹⁹ Frey, above n 93, 233.

¹⁰⁰ Alm, above n 93, 117. In respect of taxation, Alm defines economic efficiency as a tax that minimises interference in economic decisions.

alcohol consumption. It is also argued that wine has an inelastic demand and therefore, there are minimal distortions with taxes levied at a higher rate. Additionally, alcohol is seen as a complement to leisure and thus should be taxed at a higher rate. Further, it is argued that such taxes correct information failure. On the other hand, it is contended that wine should be taxed at the same rate as other goods to minimise economic distortions that impede the competitiveness of an important industry. There may also be adverse unintended consequences associated with wine taxation. Externalities should be addressed by corrective taxation that targets alcohol abusers.

6.3 Arguments for wine taxes

6.3.1 Corrects externalities

The externality costs generated from abusive alcohol consumption provide a seemingly sound rationale for supplementary taxes on alcohol. These costs are not included in the market price of the goods. External costs include the direct costs of abusive drinkers' car accidents, property damage and violence¹⁰¹ and the indirect costs of government-funded hospitals and health services for alcohol abuse and other government expenditures such as police.¹⁰² The costs to the individual alcohol consumer, though, from poor health and loss of work are not considered to be external costs.¹⁰³ Estimating health costs is difficult given that the private health insurance of individual victims of alcohol abuse will need to be excised from the external costs calculation. Since health costs can be a significant part of the external costs it appears that external costs will vary significantly between countries with mainly publicly-funded systems versus privately-funded systems. This creates problems in comparing externality costs between countries.

Without a supplementary tax on goods generating external costs, individuals engage in more of the activity than is socially optimal. Studies of alcohol consumption have found that higher prices reduce the consumption of alcohol.¹⁰⁴ A World Health Organisation committee found that taxes that increased the price of alcohol reduced the number of young people who are heavy drinkers and delayed the intention of younger teenagers to commence drinking.¹⁰⁵ A United States study found, though, that generally a 1 per cent rise in the price of alcohol resulted in less than a 1 per cent fall in consumption.¹⁰⁶

6.4 Designing an alcohol tax to address externalities

Under a Pigouvian tax the efficient consumption or production levels could be attained through an excise on the activity equal to the marginal cost of the damage caused to

¹⁰¹Stephen Smith, 'Economic Issues in Alcohol Taxation' in Sijbren Cnossen (ed), *Theory and Practice of Excise Taxation* (Oxford University Press, 2005) 67.

¹⁰²Ibid.

¹⁰³Ibid.

¹⁰⁴Philip Cook and Michael Moore, 'Alcohol' (Working Paper No 6905, National Bureau of Economic Research, 1999); L Crawford, Z Smith, and S Tanner, 'Alcohol Taxes, Tax Revenues and the Single European Market' (1999) 20 *Fiscal Studies* 287.

¹⁰⁵World Health Organisation, 'Expert Committee on Problems Related to Alcohol Consumption' (Technical Report Series No 944, Second Report, Provisional Edition, 2007) 42–3.

¹⁰⁶James Fogarty, 'The Demand for Beer, Wine and Spirits: Insights from a Meta Analysis Approach' (Working Paper No 31, American Association of Wine Economics) www.wine-economics.org

other people.¹⁰⁷ Hence alcohol content is commonly used as a basis for a wine tax, thus an excise on wine is preferred over a wholesale sales tax or retail tax. Alcohol content is used in Australia and elsewhere¹⁰⁸ to ascertain the excise tax on spirits and beer. Such an excise reflects that large scale spirits and beer industries are able to control the alcohol content, and an excise based on alcohol content is therefore practical in its compliance and administration. In Europe the wine excise is based on the volume of wine since producers (which include many small producers) are unable to change the alcohol content of still wine. With less control over alcohol content, a volume based tax is a practical solution.

The excise should be targeted at abusive drinkers since the external costs for moderate or low wine consumption may be zero or negligible. There may be benefits from low or moderate consumption of wine.¹⁰⁹ Also, the above normal drinkers of alcohol are not all abusive. An excise levied only on abusive drinkers would result in an imposition per-drink basis at a tax rate equal to the external costs. This would be very complex and impractical.

Given that most people drink alcohol in moderation, a uniform excise tax on alcohol content or volume consumed for the taxation of externalities constitutes a very imperfect proxy Pigouvian tax. Additionally, shifting to a wine excise tax has high transitional costs. Anderson et al and Fogarty et al provided economic modelling of national and regional implications of a change to a volumetric tax on domestic wine.¹¹⁰ Anderson et al modelled a change to a volumetric tax on domestic wine sales set at a light strength beer tax rate of \$28/litre of alcohol or a standard strength beer tax rate of \$40.82/litre of alcohol.¹¹¹ These changes would have a great impact on hot areas with a fall in regional GDP of about 19 per cent. The impact would be slightly positive for the warm areas but significantly benefit cool areas with an 8.9 per cent GDP gain. Domestic wine sales would fall significantly by 11.9 per cent and 15.1 per cent respectively for the light strength beer tax rate and the standard strength beer tax rate.¹¹² The burden would fall on non-premium wine where production would fall by about one-third. Commercial premium wines would fall between 8 to 13 per cent. Super premium wines would significantly gain with increases of about 15 per cent. Fogarty et al similarly found an adverse impact on the wine industry.¹¹³ There is also the complexity of a new excise tax which would be very regressive for the thousands of small wine businesses.

¹⁰⁷ Arthur Pigou, *The Economics of Welfare* (McMillan, 1918).

¹⁰⁸ Stephen Smith, above n 101, 74.

¹⁰⁹ Serge Renaud and Michel De Lorgeril, 'Wine, Alcohol, Platelets and the French Paradox for Coronary Heart Disease' (1992) 339 *Lancet* 1523; J E Kinsella et al, 'Possible Mechanisms for the Protective Role of Antioxidants in Wine and Plant Foods: Physiological Mechanisms by which Flavonoids, Phenolics, and other Phytochemicals in Wine and Plant Foods' (1993) 47 *Journal of Agricultural and Food Chemistry* 85.

¹¹⁰ Kym Anderson, Ernesto Valenzuela and Glyn Wittner, 'Wine Export Shocks and Wine Tax Reform in Australia: Regional Consequences Using an Economy Wide Approach' (2011) 30(3) *Economic Papers* 386, 392; James Fogarty and Guy Jakeman, 'Wine Tax Reform: The Impact of Introducing a Volumetric Excise Tax on Wine' (2011) 44(4) *Australian Economic Review* 387, 399–400.

¹¹¹ Anderson, Valenzuela and Wittner, above n 110, 392.

¹¹² Ibid 393.

¹¹³ Fogarty and Jakeman, above n 110, 399–400 modelled replacing the WET with a revenue neutral volumetric excise tax and found that this would have a small negative overall impact on the wine industry. The non-premium hot growing areas would be greatly affected whilst the premium wine areas would benefit.

Australia's WET is based on wholesale values and thus even less effectively targets the external costs associated with wine consumption. Additionally, alcohol tax may not greatly affect external costs. For example, people do not stop drinking alcohol because of a higher wine tax, since alcohol is addictive. Whilst price elasticities vary with consumption levels for heavy drinkers, the response to price is small compared to light and moderate drinkers.¹¹⁴ Measuring the externalities presents another problem in designing an alcohol tax.

6.5 Estimating the external costs of alcohol

Collins and Lapsley estimated that the tangible costs of alcohol in Australia were between 0.9–1.0 per cent of GDP. Crime, health cost and lost production amounted to \$11 billion¹¹⁵ and further intangible costs associated with the loss of life and pain were estimated at \$4.4 billion.¹¹⁶ Marsden Jacobs Associates estimated the cost of alcohol harm in Australia to be over \$15 billion per annum.¹¹⁷ The Foundation for Alcohol Research and Education estimated \$9.3 billion per annum for tangible social costs from an individual's alcohol misuse and \$14 billion for tangible costs in harm to others.¹¹⁸

These estimates appear high. Crampton disputes the Collins and Lapsley study.¹¹⁹ By applying mainstream accounting practices to the costs of alcohol the costs to society were found to be within the tax revenue collected.¹²⁰ Additionally, the intangible costs included in these studies are largely borne by the abusers of alcohol and these are not considered to be external costs. Any private health insurance costs of individual victims also need to be excluded.

Externality cost estimates can have a broad range of error.¹²¹ Different methods are used to calculate estimates and certain amounts such as costs to the individual of poor health should be excised from external costs. Further, a large part of external costs

¹¹⁴ Siu Leung and Charles Phelps, 'My Kingdom for a Drink...? A Review of Estimates of the Price Sensitivity of Alcoholic Beverages' in M E Hilton and G Bloss (eds), *Economics and the Prevention of Alcohol-Related Problems* (National Institutes of Health, NIH Publication 93-3513, 1993); Padmaja Ayyagari et al, 'Sin Taxes: Do Heterogenous Responses Undercut their Value?' (Working Paper No 15124, NBER, July 2009) <<http://ssrn.com/abstract=1434638>>

¹¹⁵ David Collins and Helen Lapsley, 'The Cost of Tobacco, Alcohol and Illicit Drug Abuse to Australian Society in 2004/05' (Monograph Series No 64, Department of Health & Ageing, 2008).

¹¹⁶ Ibid.

¹¹⁷ Foundation for Alcohol Research and Education, above n 57, 11.

¹¹⁸ Ibid.

¹¹⁹ Eric Crampton, Matt Burgess and Brad Taylor, 'The Costs of Costs Studies' (Working Paper No 29/2011, Department of Economics and Finance College of Business and Economics University of Canterbury, 2011); Eric Crampton and Matt Burgess, 'The Price of Everything, the Value of Nothing: a (Truly) External Review of BERL's Study of Harmful Alcohol and Drug Use' (Working Paper No 10/2009, University of Canterbury, 2009) 16. The authors estimated that in New Zealand the actual net external annual costs of abusive alcohol consumption was \$146.3 million, a 96.9 per cent reduction from Business and Economic Research Limited's (BERL) figure of \$4.794 billion in total costs. BERL published 'Costs of Harmful Alcohol and Other Drug Use', a report jointly commissioned by the Ministry of Health and Accident Compensation Corporation.

¹²⁰ Crampton, Burgess and Taylor, above n 119.

¹²¹ Eric Single and Brian Easton, 'Estimating the Economic Costs of Alcohol Misuse: Why We Should Do It Even Though We Shouldn't Pay Too Much Attention to the Bottom Line Results' (Paper presented at the Annual Meeting of the Kettil Bruun Society for Social and Epidemiological Research on Alcohol, Toronto, May 2001). The paper found that such social costs are difficult to measure and that there is no consensus on how to measure such costs.

comprises the impact on economic output.¹²² Whether this constitutes external costs depends on the extent to which alcohol affects worker productivity as seen in wages.¹²³ The costs of lower wages are costs to the individual and are not considered to be external costs. Research in the United Kingdom has actually linked a moderate level of alcohol consumption with higher wages than light or heavy drinkers.¹²⁴

6.6 Estimating the external costs of wine

External costs associated with bottled wine consumption appear to be significantly lower than with beer and spirits. The New Zealand Tax Review 2001 similarly found that whilst a wine excise could be justified on externality grounds, such a tax should be well below the excises currently imposed.¹²⁵

The consumption of wine is generally not abusive.¹²⁶ An Australian Institute of Health and Wellbeing survey found that wine is consumed in moderation with food and by older consumers at home or in restaurants.¹²⁷ Thus, wine is not generally consumed by the young who constitute most of the abusive alcohol consumers. However, other research points to the high costs associated with cheap cask wine in Australia.¹²⁸

Srivastava and Zhao found heavy binge drinkers mainly drink regular strength beer or RTD spirits.¹²⁹ These drinkers were more likely to be under the influence of alcohol and drive a car or operate hazardous machinery or miss work.¹³⁰ Also, Gruenewald et

¹²² Alan Maynard, Christine Godfrey and Geoff Hardman, 'Conceptual Issues in Estimating the Social Costs of Alcohol' (Paper prepared for an International Symposium on the Economic Costs of Substances Abuse, Baniff, Canada, 11–13 May 1994).

¹²³ Ziggy MacDonald and Michael Shields, 'The Impact of Alcohol Consumption on Occupational Attainment in England' (2001) 68 *Economica* 427. This study examined the relationship between alcohol drinking and hourly wages. They found an inverse U shaped drinking wage profile. Moderate alcohol drinkers had higher wages than light or heavy drinkers. For men, 210 ml of alcohol per week (or two bottles of 750 ml wine at 14 per cent alcohol content per week) and women, 140 ml per week were associated with the maximum wage.

¹²⁴ Ibid. For men, 210 ml of alcohol per week (or two bottles of 750 ml wine at 14 per cent alcohol content per week) and women 140 ml per week were associated with the maximum wage.

¹²⁵ New Zealand Treasury, 'Tax Review 2001' <<http://www.treasury.govt.nz/publications/reviews-consultation/taxreview2001/taxreview2001-report.pdf>>.

¹²⁶ Wine Grape Growers Australia, above n 59, 7.

¹²⁷ Australian Institute of Health and Wellbeing, '2007 National Drug Strategy Household Survey, Detailed Findings' 29–37 <https://www.aihw.gov.au/>

¹²⁸ Tim Stockwell et al, 'Consumption of Different Alcoholic Beverages as Predictors of Local Rates of Night-Time Assault and Acute Alcohol-Related Morbidity' (1998) 22(2) *Australian and New Zealand Journal of Public Health* 237, showed that in Western Australia local rates of per capita consumption of cask wine (as well as high strength beer) are most highly associated with local rates of violent incidents and alcohol-related hospital admissions. By comparison, rates of consumption of bottled wine and low strength beer were weakly or not at all related to local rates of these problems. Maggie Brady and David Martin, 'Dealing with Alcohol in Alice Springs: an Assessment of Policy Options and Recommendations for Action' (Working Paper No 3, Centre for Aboriginal Economic Policy Research, Canberra, 1999) found that the Alice Springs region with a population of less than 35 000 people drank over 1.2 million litres of cask wine in 1998. This was equivalent to over 5500 four-litre casks per week. Because most of the population did not drink cask wine, this suggests the harmful levels of consumption by those that did.

¹²⁹ Preety Srivastava and Xueyan Zhao, 'What do the Bingers Drink? Micro-Unit Evidence on Negative Externalities and Drinker Characteristics of Alcohol Consumption by Beverage Types' (2010) 29 *Economic Papers* 229, 250.

¹³⁰ Ibid.

al found no impact from wine sales at licensed premises on drink-driving incidents.¹³¹ Rather, spirits and beer sales were associated with drink-driving and drink-driving incidents.¹³² Thus, it is reasonable to argue that wine consumption is associated with lower externality costs than other beverages.¹³³

Italy, one of the largest wine consumers¹³⁴ has the lowest estimated external costs in a survey of ten developed countries.¹³⁵ This suggests that external costs may only be moderately associated with wine consumption. Further, there are zero/minimal wine taxes in Italy and France yet these countries face a downward trend in domestic wine consumption.¹³⁶ This indicates that the nexus between higher taxes on wine and lower levels of consumption and external costs may not be strong. Further research is needed to assess this impact. A non-uniform excise for different types of alcohol would appear to be appropriate to address the different levels of associated external costs.

Additionally, health benefits are associated with low to moderate consumption of wine. Kinsella proposed that the natural antioxidant phenolic compounds of wine may protect against heart disease.¹³⁷ Renaud and De Lorgeril found that France's high consumption of fats but low incidence of heart disease may be explained by their high wine consumption.¹³⁸

6.7 Should wine, spirits and beer be taxed on a similar basis?

A number of submissions to the Tax White Paper Task Force discussed whether wine, spirits and beer should be taxed on a similar basis according to the amount of alcohol.¹³⁹ It may be efficient to subsidise or tax other goods that are substitutes for or complements the externality causing activity.¹⁴⁰ However, research in the United Kingdom¹⁴¹ and Europe¹⁴² has found that wine, spirits and beer are not close substitutes. Wine and spirits might be moderate complements.¹⁴³ Consequently a

¹³¹ Paul Gruenewald et al, 'Beverage Sale and Drinking and Driving' (1999) 20(5) *Australia and New Zealand Wine Industry Journal* 21, 46.

¹³² Ibid.

¹³³ Srivastava and Zhao, above n 129, 250.

¹³⁴ Wine Institute, *World Wine Production By Country, Per Capita Wine Consumption by Country, World Wine Consumption by Volume, World Vineyard Acreage by Country* (13 Apr 2010) <https://www.wineinstitute.org/resources/statistics>

¹³⁵ Sijbren Cnossen, 'Excise Taxation in Australia' (Draft presented at the Australia's Future Tax System Conference, 2009) 10 <<http://taxreview.treasury.gov.au>>. The other countries were Australia, France, Ireland, England, Wales, the United States, New Zealand, Germany and Canada.

¹³⁶ International Organisation of Vine and Wine, *World Vitivinicultural Statistics 2007* <http://www.oiv.int/>

¹³⁷ Kinsella et al, above n 109.

¹³⁸ Renaud and De Lorgeril, above n 109.

¹³⁹ See Pernod Ricard Winemakers, above n 9; Treasury Wine Estates, above n 9.

¹⁴⁰ Jerry Green and Eytan Sheshinski, 'Direct Versus Indirect Remedies for Externalities' (1976) 83 *Journal of Political Economy* 797.

¹⁴¹ Zoe Smith, 'The Revenue Effect of Changing Alcohol Duties' (1999) (Briefing Note 4, Institute for Fiscal Studies).

¹⁴² Customs Associates Ltd, 'Study on the Competition between Alcoholic Drinks, Summary of Final Report for the European Commission' (February 2001) https://ec.europa.eu/taxation_customs/sites/taxation/files/docs/body/study_comp_between_alcohol_drinks_en.pdf

¹⁴³ Zoe Smith, above n 141.

Pigouvian tax on alcohol can be different especially since wine, spirits and beer generate different levels of external costs. As discussed above, in Australia the external costs of wine appear to be significantly lower than of beer and spirits. On this basis, low levels of supplementary alcohol tax should apply to wine in Australia. It appears unlikely that premium wine would be the choice of abusive drinkers. A Pigouvian tax would result in a very low tax on expensively priced wine. As discussed above, increasing wine tax revenue, though, will have a substantial negative impact on the wine industry.¹⁴⁴

6.8 Limitations of alcohol tax

Why only target the external costs of alcohol and a few other products with a supplementary tax, why not target all of the numerous goods and services that involve externalities?¹⁴⁵ For example, a supplementary tax on all sports that cause serious injury and on all food that contribute to obesity given the associated expensive health costs. The rationale for supplementary taxes that only address the difficult to measure externalities from wine and which do not target a minority of wine abusers is weak.

6.8.1 Inelastic demand

It is argued that wine taxes provide minimal distortion to economic decisions. Ramsey found that goods with inelastic demand should be taxed more heavily as such a tax minimises consumption distortions.¹⁴⁶ Alcohol is considered to have a highly inelastic demand schedule as it has few substitutes, and is addictive and indispensable. Consumption is minimally affected by a small increase in price.

However, Doran et al found that abolishing the WET and replacing it with a higher volumetric tax would reduce total alcohol consumption by 1.3 per cent, indicating the elastic nature of wine.¹⁴⁷ As noted above, Italy and France have zero/minimal supplementary wine taxes yet these countries face a downward trend in domestic wine consumption.¹⁴⁸ Wine consumption in these countries appears to be relatively elastic.

Leung and Phelps reviewed studies of price elasticity of alcohol in the United States and found elasticities of -0.3 for beer, -1.0 for wine and -1.5 for spirits.¹⁴⁹ Price elasticities vary with consumption levels; heavy drinkers are not very responsive to price, but light and moderate drinkers are.¹⁵⁰ The New Zealand Tax Review 2001 found that the demand for wine is often more elastic than the demand for petrol, tobacco and beer.¹⁵¹ Smith's literature review concluded that alcohol demand is insufficiently price-inelastic to warrant higher than average taxation on the basis of the

¹⁴⁴ Anderson, Valenzuela and Wittner, above n 110, 392; Fogarty and Jakeman, above n 110. Both papers reached this conclusion from analysing the replacement of the WET with a packaged beer volumetric excise tax.

¹⁴⁵ Frey, above n 93, 231.

¹⁴⁶ Frank Ramsey, 'A Contribution to the Theory of Taxation' (1927) 37 *Economic Journal* 47–61.

¹⁴⁷ Christopher Doran et al, 'Estimated Impacts of Alternative Australian Alcohol Taxation Structures on Consumption, Public Health and Government Revenues' (2013) 199 *Medical Journal of Australia* 619.

¹⁴⁸ International Organisation of Vine and Wine, above n 136.

¹⁴⁹ Leung and Phelps, above n 114.

¹⁵⁰ Ibid.

¹⁵¹ Robert McLeod et al, 'Tax Review 2001 — Issues Paper' (2001) 28.

Ramsey inverse elasticity rule.¹⁵² Having regard to these studies there appears to be no strong argument for wine taxes due to inelastic demand.

6.8.2 *Alcohol as a leisure complement*

Some consider that goods that are complementary with leisure should be taxed higher as this provides a proxy for a missing tax on leisure. A United Kingdom study by Crawford, Keen and Smith found that utility is not weakly separable between consumption and leisure, and that changes in the relative price of goods do impact on labour.¹⁵³ Therefore, goods complementary with leisure should be taxed at a relatively higher tax rate and goods complementary with work should be taxed at a relatively lower tax rate.¹⁵⁴

It is inconclusive, though, whether alcohol is complementary with leisure.¹⁵⁵ On the one hand the more leisure, the more time to drink alcohol. On the other hand alcohol may be complementary with work through social drinking with colleagues and unwinding from stress. At low consumption alcohol may be complementary with work but not at high levels. If alcohol is complementary with work, there is a basis for a lower average tax.¹⁵⁶ Overall, there is no clear reason to tax alcohol highly as a leisure complement.

6.8.3 *Corrects information failure*

Young people may not be fully aware of the adverse health impacts of drinking alcohol, thus, it is argued that a supplementary tax or excise would raise the price of alcohol and thus reduce consumption.¹⁵⁷ United Kingdom studies have found that the price elasticity of demand for alcohol among the young is on average twice the price elasticity of adults.¹⁵⁸ Thus, an excise or supplementary wine tax would appear to achieve this aim. The young, though, appear to drink relatively low amounts of wine in Australia.¹⁵⁹ Also, such an excise may only result in the young substituting alcohol for illegal alcohol or drugs, or homemade alcohol. Further, this results in a higher burden on older drinkers.

Advertising, education and restrictions on consumption targeted at young people are alternative strategies to supplementary wine taxes. However, more research is needed to assess cost effectiveness.

¹⁵² Stephen Smith, above n 101, 62.

¹⁵³ Ian Crawford, Michael Keen and Stephen Smith, 'Value-Added Tax and Excises' (Background Paper for the Mirrless Review, Reforming the Tax System for the 21st Century, 2008).

¹⁵⁴ Ibid.

¹⁵⁵ Ibid.

¹⁵⁶ Ibid.

¹⁵⁷ World Health Organisation, above n 105.

¹⁵⁸ Thomas F Babor et al, *Alcohol: No Ordinary Commodity Research and Public Policy* (Oxford University Press, 2003).

¹⁵⁹ Australian Institute of Health and Wellbeing, above n 127.

6.9 Arguments against wine taxes

6.9.1 Minimises distortions

The significant size of the Australian wine industry and its export orientation in a globalised wine world necessitates a competitive industry. As discussed above, concerns have been raised with the WET in harming the industry. For the economy to efficiently allocate resources and permit industry to compete effectively the indirect tax system should be competitive. To minimise efficiency costs the indirect tax base should be broad, including all goods and services taxed at one low rate.¹⁶⁰ This will cause fewer changes in the consumption and production decisions by the impact of tax on the prices of goods and services. A narrowly based wine tax is inefficient.

A wine tax such as an excise or WET has different impacts on consumers and producers and this creates different distortions. Specific (excise) taxation tends to lead to higher consumer prices, lower consumption and thus reduces tax collections.¹⁶¹ For example, the New Zealand Tax Review calculated that excises have high deadweight costs (losses in consumption efficiency) per dollar of additional tax revenue raised, relative to broadly based forms of taxation.¹⁶² However, excises do not directly distort manufacturers' decisions to invest in product quality;¹⁶³ rather such taxes have an improving impact on product quality.¹⁶⁴

Ad valorem taxation (WET) raises consumption and tax revenue but induces firms to reduce prices, downgrade product quality, and reduce advertising and marketing costs.¹⁶⁵ Ad valorem taxation has a multiplier effect, as increases or decreases in producer prices will have a larger effect on the price charged to the consumer.¹⁶⁶ Thus, ad valorem taxes dissuade costly product quality improvements and encourages price competition by producers. Further, ad valorem taxes are more attractive to producers who have a degree of monopoly power and where there is little product differentiation. In contrast the world wine industry has no high degree of monopoly power and there is considerable product differentiation.

The significant and growing world demand for premium wine and the high cost structure of Australian non-premium wine suggests that specific (excise) taxation is preferable over the WET. Anderson finds that if the switch to excise happens it will encourage more Australian vignerons to produce and more Australians to consume finer wines and in doing so bring Australia's tax system close to a socially optimal regime.¹⁶⁷ However, excises will inflate the price of non-premium wine and thus damage that part of the industry, having major implications for regional distribution of

¹⁶⁰ Australian Treasury, 'Architecture of Australia's Tax and Transfer' (2008) 277, Table 2.1 <http://taxreview.treasury.gov.au/content/Paper.aspx?doc=html/publications/report/section_2-03.htm>; Sijbren Cnossen, *Excise Systems a Global Study of the Selective Taxation of Goods and Services* (John Hopkins University Press, 1977) 116 observed that in industrial countries efficiency appears to dictate a broad based sales tax that interferes as little as possible with economic behaviour.

¹⁶¹ See Cnossen, 'Excise Taxation in Australia', above n 135, 13.

¹⁶² McLeod et al, above n 151.

¹⁶³ Stephen Smith, above n 101, 73.

¹⁶⁴ Ibid.

¹⁶⁵ Yoram Barzel, 'An Alternative Approach to the Analysis of Taxation' (1976) 84(6) *Journal of Political Economy* 1177.

¹⁶⁶ Michael Keen, 'The Balance between Specific and Ad Valorem Taxation' (1998) 19 *Fiscal Studies* 1.

¹⁶⁷ Anderson, above n 21, 218.

wine grape production¹⁶⁸ and small wine producers. Consequently, as noted previously, the wine tax reform debate is balanced between the interests of the premium wine industry, small wine producers and the non-premium wine industry.

Premium Australian winemakers have supported a move to excise taxation as long as the overall level of wine taxation revenue does not increase. Wine industry leaders note that the WET and the rebate are significant factors in preventing the industry from restructuring.¹⁶⁹ Treasury Wine Estates argues the current wine taxes are

threatening the wine industry's sustainability in Australia whilst simultaneously eroding its premium positioning globally. Continuing with the current tax arrangements will mean more of the same, consigning the Australian wine industry to an unprofitable and oversupplied market.¹⁷⁰

Pernod Ricard Winemakers concludes:

The current structure of the Wine Equalisation Tax and its rebate encourages oversupply, contributes to this structural imbalance and distorts both the domestic market and Australia's wine export markets.¹⁷¹

6.9.2 *Undesired side effects*

High priced wine results in the relative price of substitute goods (beer, spirits, homemade alcohol and illegal drugs) falling and the consumption of the substitute goods rising. United States research found that increasing the price of alcohol raised the consumption of marijuana.¹⁷² As discussed above, wine consumption is not generally complementary with beer and spirits.

6.9.3 *Corrective taxation*

Corrective taxation is most efficient where the external costs are taxed directly.¹⁷³ People who abuse alcohol should be targeted. Australian studies have found that the young in particular are likely to binge drink.¹⁷⁴ In a United Kingdom study, Mathews and Richardson found that young people are more likely to binge drink and become involved in drink-driving and crime.¹⁷⁵ Drinking is a habit and young people are susceptible. Drinking from adolescence to adulthood creates problems for human capital and family development.¹⁷⁶

¹⁶⁸ Ibid.

¹⁶⁹ Pernod Ricard Winemakers, above n 9, 11; Treasury Wine Estates, above n 9.

¹⁷⁰ Treasury Wine Estates, above n 9, 11.

¹⁷¹ Pernod Ricard Winemakers, above n 9, 1.

¹⁷² Matthew Farrelly et al, 'Response of Adults to Increases in Cigarette Prices by Sociodemographic Characteristics' (2001) 68 *Southern Economics Journal* 156.

¹⁷³ Australian Treasury, 'Architecture of Australia's Tax and Transfer', above n 160, 280.

¹⁷⁴ Stockwell et al, above n 128.

¹⁷⁵ Sian Mathews and Anna Richardson, 'Findings from the 2003 Offending Crime and Justice Survey: Alcohol Related Crime and Disorder' (Home Office Findings 261, 2005) <http://webarchive.nationalarchives.gov.uk/20110218135934/http://rds.homeoffice.gov.uk/rds/pdfs05/r261.pdf> In the United Kingdom 18–24 year old binge drinkers commit 24 per cent of violent offences, versus 16 per cent by moderate drinkers and 5 per cent by non-drinkers in the same age group.

¹⁷⁶ Philip Cook and Michael Moore, 'The Economics of Alcohol Abuse and Alcohol-Control Policies' (2002) 21(2) *Health Affairs* 120.

This problem can be resolved to some extent through intervention and regulation. Individual based interventions, generally by doctors, has proven to be an effective way to reduce abusive alcohol consumption.¹⁷⁷ Also, government regulation of wine and alcohol is stringent. There are restrictions on the time and place alcohol is sold, the minimum age for purchase, and advertising and sales is regulated. There are limits on the legal blood alcohol concentration when driving; for young people the limit is zero. The Henry Review asserted that the increased regulation of bars through licences with licence fees linked to the number and severity of violent incidents could address certain external costs.¹⁷⁸ However, Cobiac et al found that interventions targeted at young people were less effective than a minimum price of alcohol through a volumetric tax of reducing alcohol-related harm.¹⁷⁹

In the United Kingdom, Babor et al found that the enforcement of drink-driving laws and regulating the physical availability of alcohol are very effective.¹⁸⁰ Fleming et al also found in the United States that advertising is effective in influencing abusive young alcohol consumers.¹⁸¹ However, Babor et al concluded that advertising bans, designated drivers, voluntary codes of bar practice and educational and persuasion efforts are not very effective.¹⁸²

6.9.4 Summary

A wine tax impedes the economic efficiency of a significant export-orientated industry that faces an increasingly globalised wine industry where most competitors impose little or zero wine taxes. There are significant external costs associated with alcohol consumption but the external costs associated with wine consumption appear to be significantly lower than other forms of alcohol. More research is needed to quantify the externalities of abusive wine consumption. However, a wine tax is unable to target the sources of these externalities, those who abuse alcohol. There is no apparent reason why these external costs are addressed whilst many other substantial external costs are ignored. Overall there is a case on economic grounds for either a zero wine tax given the importance of the wine industry, or a revenue neutral wine tax. If a wine tax is retained, the WET should be repealed given its economic distortions. The WET could be replaced by either a revenue neutral excise based on the volume of wine (a complex tax) or a revenue neutral higher GST rate on wine (a far simpler tax). Assistance would be needed to help those affected by the transition away from a WET.

¹⁷⁷ David Collins and Helen Lapsley, 'The Avoidable of Alcohol Abuse in Australia and the Potential Benefits of Effective Policies to Reduce the Social Costs of Alcohol' (Monograph Series No 70, Department of Health and Ageing, 2008).

¹⁷⁸ Australian Treasury, 'Australia's Future Tax System, Final Report: Part 2 — Detailed Analysis' (2010) Vol 2, 434.

¹⁷⁹ Linda Cobiac et al, 'Cost Effectiveness of Interventions to Prevent Alcohol Related Disease and Injury in Australia' (2009) 104 *Addiction* 1646; John Holmes et al, 'Effects of Minimum Unit Pricing for Alcohol on Different Income and Socioeconomic Groups: A Modelling Study' (2014) 383 *Lancet* 1655.

¹⁸⁰ Babor et al, above n 158.

¹⁸¹ Kenneth Fleming, Esther Thorson and Charles Atkin, 'Alcohol Advertising Exposure and Perceptions: Links with Alcohol Expectancies and Intentions to Drink or Drinking in Underaged Youth and Young Adults' (2004) 9 *Journal of Health Communications* 3.

¹⁸² Babor et al, above n 158, 178.

6.10 Equity

Indirect taxes such as wine taxes may have a regressive impact since such taxes are not based on one's ability to pay.¹⁸³ The following Australian Bureau of Statistics survey compares household expenditure on alcohol for five (low to high) gross income quintiles:¹⁸⁴

Table 2: Australian Bureau of Statistics Household Expenditure and Characteristics, By Equivalised Disposable Household Income Quintile Groups 2009–10

	Gross Income Quintiles				
	1	2	3	4	5
<i>Expenditure relative to Income:</i>					
Alcoholic Beverages	1.9%	2.3%	2.9%	2.9%	2.7%

The above table shows that high income earners spend about 50 per cent more of their income on alcohol as people in the lowest income quintile. However, there is no data on the household expenditures of wine so it is not clear whether the WET has a regressive or progressive impact in Australia. There is a progressive element to the WET, though, since it increases in value on more expensive wines.

A wine tax is arguably unfair since alcohol taxation is non-uniform (higher taxes apply per unit of alcohol to beer and spirits), thus breaching horizontal equity.¹⁸⁵ This issue though is not significant given that wine and other forms of alcohol consume a small part of household income. Also, a wine tax is inequitable in a sense since it places an extra tax people who consume responsibly, since it is impractical to target the abusers of alcohol.¹⁸⁶

Other countries have significant differences in patterns of wine consumption and income distribution and caution thus must be exercised in making comparisons. In the United Kingdom, a study of the distributional impact excise taxes on alcohol on households with different income levels found that tax on wine has a progressive incidence (beer has a proportional incidence to income and spirits is marginally regressive).¹⁸⁷ This supports research that argues that excises on luxury goods with an income elasticity of demand exceeding unity will improve the progressivity of the tax system.¹⁸⁸ This assumes, though, that consumption by higher income classes is substantial.¹⁸⁹

¹⁸³ Glen Barton and Dale Pinto, 'The WET: is it a Good Drop?' (2014) 18(2) *The Tax Specialist* 54, 56.

¹⁸⁴ Australian Bureau of Statistics, *1301.0 — Year Book Australia, Household Income, Expenditure and Wealth* (2012), Table 9.8
<<http://www.abs.gov.au/ausstats/abs@.nsf/Lookup/by%20Subject/1301.0~2012~Main%20Features~Household%20income,%20expenditure%20and%20wealth~193>>.

¹⁸⁵ Barton and Pinto, above n 183, 56.

¹⁸⁶ *Ibid.*

¹⁸⁷ Stephen Smith, above n 101, 64.

¹⁸⁸ Cnossen, 'Excise Taxation in Australia', above n 135, 11.

¹⁸⁹ *Ibid.*

Studies of distributional affects in the United States have found alcohol taxes to be regressive.¹⁹⁰ The finding of the studies varied according to the time line of the analysis; the longer the time line the less regressive.¹⁹¹ Using lifetime shares of income spent on alcohol there were about 40 per cent greater in the poorest lifetime income quintile than in the highest.¹⁹² In New Zealand, the Tax Review 2001 concluded that wine excises could not be justified on tax equity grounds.¹⁹³

Gruber and Köszegi analysed the implications of an increase in cigarette excise taxes and noted that an excise may work to be progressive in another way.¹⁹⁴ Cigarette excise taxes, serving as a self-control function, may benefit a low income smoker under the assumption that their demand for cigarettes is more price-sensitive. Thus, taking a wider view on the incidence of excise taxes, an excise on alcohol could be progressive since those who are most sensitive to the price of tobacco (low income earners) benefit the most from a price increase.

Wine only consumes a relatively modest proportion of one's income. The overall distribution incidence of all taxes (and government welfare support) appears to be more significant than the distributional incidence of one particular tax on the consumption of one good, assuming there are relatively few excises or regressive taxes and the overall distribution of taxes is sufficiently progressive. The progressive income tax rate structures and social welfare policy in Australia means that the equity criteria is not a material factor in designing an optimal wine tax.

6.11 Simplicity

Excises or wholesale sales taxes are in a sense relatively easy to comply with and administer given that there are relatively few producers or wholesalers. Further, it is argued that the administration costs of an excise depend on technological developments and the advances in computer technology have simplified the operation of such taxes.¹⁹⁵

Notwithstanding the computer technology advances, the more levels of indirect tax on wine (such as excises or sales taxes), the higher the levels of compliance costs for the wine industry (the many small winemakers) and administration costs for the government. Australia's WET provides a vivid example of the complexity involved.¹⁹⁶ This is evident from the legislation¹⁹⁷ and from the number of ATO publications.¹⁹⁸ Many of these publications are highly technical and lengthy. For example, WET Ruling 2004/1¹⁹⁹ on the operation of the WET system runs to some

¹⁹⁰ Stephen Smith, above n 101, 65–6.

¹⁹¹ Ibid.

¹⁹² Ibid.

¹⁹³ McLeod et al, above n 151, v.

¹⁹⁴ Jonathan Gruber and Botond Köszegi, 'Tax Incidence when Individuals are Time-Inconsistent: the Case of Cigarette Excise Taxes' (2004) 88 (9–10) *Journal of Public Economics* 1959.

¹⁹⁵ Sijbren Cnossen, 'Tax policy in the European Union: a Review of Issues and Options' (2002) 58 *Finanzarchiv* 466–558.

¹⁹⁶ Barton and Pinto, above n 183, 56 note that the WET fails the simplicity test.

¹⁹⁷ *A New Tax System (Wine Equalisation Tax) Act 1999* (Cth).

¹⁹⁸ There are 3 ATO Rulings, 8 Fact Sheets, 2 Forms, 3 How to complete your business activity statements and 8 New Zealand WET rebate papers.

¹⁹⁹ Australian Taxation Office, *Wine Equalisation Tax Ruling Wine Equalisation Tax: the Operation of the Wine Equalisation Tax System*, WETR 2004/1: 'The operation of the wine equalisation tax system'.

146 paragraphs. WET provides a complex second regime for alcohol taxation that sits uneasily with the excise system that applies to beer and spirits. The WET is very regressive for the thousands of small wine producers that need to claim the WET rebate.

A different set of difficulties arise under an excise as noted in the submissions to the Tax White Paper Task Force²⁰⁰ Complexity would arise from costly bonded warehouses, inspections and permissions to move wine.²⁰¹ It would also be very regressive for the thousands of small wine producers affected. Significant transitional costs would arise in moving from the WET to an excise.

Ideally, from a simplicity point of view, a wine tax should be part of a comprehensive indirect tax base with a common tax rate such as a GST. This would remove a layer of tax law and the use of a uniform rate would remove the problem of having to classify goods against a range of taxation rates and/or structures. If an additional tax on wine was required, imposing a higher rate of GST on wine would provide a far simpler option than either a WET or excise.

7. WET REBATE

The WET rebate damages fiscal adequacy with a significant and growing cost to revenue. In its first year the WET rebate refunds amounted to \$199 million in 2006–07 and has increased each year, with \$311 million refunded in 2013–14.²⁰² In 2013–14 1967 entities claimed WET rebates and the number of entities claiming WET rebates has increased since its introduction.²⁰³ The rebate also leads to significant economic efficiency issues as it subsidises the inefficient producers²⁰⁴ and thus inhibits the industry from restructuring to clear the oversupply problems. It encourages an oversupply of low value wine that is damaging the export market²⁰⁵ and damages the profitability of the industry.²⁰⁶ It also provides a competitive advantage to the New Zealand wine industry that can access the rebate. New Zealand wine producers are not subject to the same tax compliance checks as Australian businesses but are able to claim the rebate, and do not lodge an Australian income tax return or Business Activity Statement (BAS) statement. The rebate was designed to help small producers but as the Foundation for Alcohol Research and Education points out it has not worked very effectively since 24 wine companies account for 90 per cent of the wine production.²⁰⁷ There are also serious equity problems with the WET rebate

²⁰⁰ Pernod Ricard Winemakers, above n 9, 16; Murray Valley Winegrowers, above n 75, 6–7; Riverland Wine, above n 74, 3; Accolade Wines, above n 11, 1, 23.

²⁰¹ Pernod Ricard Winemakers, above n 9, 16.

²⁰² Commonwealth Treasury, 'Wine Equalisation Tax Rebate Discussion Paper' (2015) 9 https://static.treasury.gov.au/uploads/sites/1/2017/06/C2015-045_WET_Rebate_Discussion_Paper_2015.pdf

²⁰³ Ibid.

²⁰⁴ Pernod Ricard Winemakers, above n 9, 1.

²⁰⁵ Pernod Ricard Winemakers, above n 9, 1; Treasury Wine Estates, above n 9, 11–12.

²⁰⁶ Senate Rural and Regional Affairs and Transport References Committee, above n 90, 34.

²⁰⁷ Foundation for Alcohol Research and Education, above n 57, 10.

which has been subject to rorting.²⁰⁸ However, abolishing the WET rebate would have a significant negative affect on small wineries.²⁰⁹

8. CONCLUSION

There are five readily apparent options for wine tax reform: do nothing; repeal the WET; replace the WET with an excise; replace the WET with a higher GST rate on wine; and/or repeal the WET rebate.

Retaining the existing WET or replacing it with an excise cannot be justified from a tax policy perspective. The WET or a wine excise only marginally aids tax revenue collection and consequently fiscal adequacy is considered to be of lesser importance. Whilst the WET or wine excise may be regressive, equity does not appear to be of prime importance given the presence of progressive income tax rates and social security benefits. The WET and wine excises clearly fail the simplicity criteria. They also both create economic distortions that damage the competitiveness of the wine industry. In particular, the WET should be repealed since it encourages the production of non-premium wine when the world is moving to the consumption of premium varieties. The main competitor wine producing countries Italy and France do not have to face such substantial taxes. The external costs from wine abuse have not been quantified and do not appear to be as significant as externalities from beer and spirit consumption, and these taxes do not specifically target the alcohol abusers. Overall, such complex wine taxes are difficult to justify given the economic distortions and the significant size of the Australian wine industry and its strong export orientation. There is a strong case to abandon any additional taxes on wine, thus the WET should be repealed and not replaced by any excises.

From a political-economic aspect, politicians generally develop tax policies that provide minimal public resistance, thus it is likely that the existing WET will either be retained, or replaced by another additional tax on wine so as to be revenue neutral. There is no case to increase the overall revenue from a wine tax, given the research that shows lower levels of externalities associated with wine consumption. A tax revenue neutral reform option as recommended by the many wine industry submissions to the White Paper process appears to constitute a reasonable second best position.

An excise tax based on alcohol volume would better aid economic efficiency than the WET,²¹⁰ although there would be significant transitional costs. Complexity would be a real issue for the many small wine businesses. Replacing a WET with another tax

²⁰⁸ Treasury Wine Estates, above n 9, 13; Murray Valley Winegrowers, above n 75, 4. See Australian Treasury, 'Australia's Future Tax System, Final Report: Part 2 — Detailed Analysis', above n 178, 438: 'The rebate has created risks for tax avoidance, through "double dipping" and attempts by small producers to transfer the value of the rebate to larger operators in the supply chain.' See also Australian Taxation Office, 'Uncommercial Contract Manufacture Arrangements to Claim the Wine Equalisation Tax (WET) Producer Rebate' (Taxpayer Alert 2009/7). This alert describes uncommercial and collusive arrangements where one or more growers use a contract winemaker, so each such grower can attempt to claim the WET producer rebate by retaining title to their produce and resulting wine, until a pre-arranged sale to the winemaker. See also Senate Rural and Regional Affairs and Transport References Committee, above n 90, 34.

²⁰⁹ Fogarty and Jakeman, above n 110.

²¹⁰ Barton and Pinto, above n 183, 57 conclude that the WET is not a good tax having regard to the hallmarks of sound tax law.

will provide serious political challenges. This is especially so given Australia's long standing minimal tax policy in respect of inexpensive wine. Consequential economic distortions/costs (employment losses) of excises would be significant in certain parts of regional Australia and the large wine players are politically very influential. Social and cultural factors may also be important given the popularity of wine and the regressive impacts.

Replacing the WET with a modest increase to the GST rate for wine so as to be revenue neutral would be a far simpler alternative and would appear to have a softer impact on regional Australia than an excise.

Community acceptance of a wine excise or higher GST rate for wine may be attainable through extensive education and marketing campaigns that promote the health benefits of the excise or a higher GST rate on a harmful good and focus on the economic benefits of removing the WET. Governments could facilitate a smoother transition for the wine industry by providing restructuring assistance for affected communities and producers. Additionally, wine tax reform could be phased in over a medium term period to enable consumers and producers to adjust.

To better inform the process of setting the optimal wine excise and other related policy settings further research is needed to quantify: the externalities of abusive wine consumption; the economic distortions of the WET, wine excises and a higher GST rate; and the cost effectiveness of alternative education and regulation policies.

Additionally, it is submitted that the WET rebate should be repealed. However, before removing the rebate, research into the value of the additional consumer surplus generated by additional wine consumption choices²¹¹ and the value of tourism and economic impact on regional economies should be assessed. To the extent that industry assistance is found necessary a direct grant could replace the rebate.

²¹¹ Fogarty, above n 106, 401.

Tax compliance of ethnic minority immigrant entrepreneurs: A social capital perspective

Sue Yong¹ and Fiona Martin²

Abstract

This paper examines the impact of social capital on migrant entrepreneurs' tax compliance behaviours in Auckland, New Zealand. It analyses the behaviour of small business owners who have migrated to New Zealand. For this study the authors use the ethnic definitions of Asians and Pacific peoples established by the New Zealand government. The authors focus on these migrant groups due to their collectivistic and transnational orientations. The research is based on qualitative interviews conducted from 2007 to 2011, with follow-up interviews in 2013. The interview subjects were 18 migrant entrepreneurs of small businesses, their family members, business experts and tax practitioners. The results demonstrate how social capital can have both positive and negative influences on tax compliance behaviours.

Key words: migrant entrepreneurs, social capital, tax compliance

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1. INTRODUCTION

Over the past three decades, developed countries have experienced unprecedented demographic changes and diversity due to new waves of immigration (Department of Labour, 2010; Lee, 2015). According to Vertovec (2007), the early post-war migration pattern of replacement labour from a clearly defined handful of former colonial countries has been overtaken by 'super-diversity'. Super-diversity represents a new wave of migrants who migrate as a result of various factors such as safety, work and financial and they originate from countries with numerous political, legal and social backgrounds (Ram et al., 2011). Researchers note that there has been an international trend in immigrant business ownerships (Ram & Smallbone, 2003; Smallbone, Kitching & Athayde, 2010). There has also been significant research undertaken into the backgrounds, access to resources, social, human and cultural capital of these entrepreneurs and how this has impacted on their success or lack of it (Kloosterman & Rath, 2010).

The effect of immigrants has starkly changed the outlook of some major cities such as Auckland, London, Los Angeles, Sydney, Toronto and Brussels which are becoming distinctly more cosmopolitan. It is estimated that the percentage of foreign-born populations in 2015 was 39 percent for Auckland, Sydney and Los Angeles, 37 percent for London and New York, 46 percent for Toronto and 62 percent for Brussels (Lee, 2015). Further, immigrant entrepreneurs are affecting cities in numerous ways, for example, by revitalising formerly dilapidated shopping streets (Obeng-Odoom & Jang, 2016) and introducing new products and marketing strategies (Bagwell, 2008). They also pose challenges to the existing compliance framework by engaging in informal economic activities (Kloosterman, van der Leun & Rath, 1999; Yucedogru & Hasseldine, 2016).

The rise in immigrant entrepreneurship is partly due to their need to find alternative employment opportunities apart from mainstream employment. Many have encountered obstacles with the labour market due to non-recognition of foreign qualifications, and language and cultural difficulties (Strickland, 2013; van Hulten & Ahmed, 2013). Some ethnic immigrants find themselves in a marginalised position from a socio-economic point of view as unemployment is generally higher for them (Department of Labour, 2010; Katila & Wahlbeck, 2011; Kloosterman, van der Leun & Rath, 1999). Others do not have the required educational qualifications and therefore often end up in businesses that only produce goods or services at the lower end in markets where there are low barriers to entry (Kloosterman, 2010). Migrant entrepreneurs generally service co-ethnic markets due to lack of cultural capital i.e. lack of familiarity with local business and financial environments (Basu, 2006; Pitrus, 2015). However, co-ethnic markets are often very competitive and dependence on them is likely to constrain business performance and growth since they also operate with low profit margins (Barrett et al., 2002).

Researchers have considered a number of factors when examining the entrepreneurial activities of migrants. Ideas of social capital and access to resources have been added to the concepts of human, financial and cultural capital: people's proclivity for entrepreneurship and their entrepreneurial success rates have been found to be related to the size, density and nature of their social networks and their ability to mobilise these networks for economic purposes (Kloosterman & Rath, 2010; Granovetter, 1983, 1995). Significance has also been found in relation to the interaction between the

personal resources of migrants, the resources of migrant communities, such as access to financial support, consumers, suppliers and advice, and the opportunities presented by the host country with respect to labour market structures and regulation, government incentives and public opinion (Kloosterman & Rath, 2010).

Survival can often be difficult for migrant businesses and profits can be very low and sometimes, non-existent. The survival of immigrant businesses leads to owners working long hours without pay or evading income tax and under-declaring wages so as to render workers eligible for state benefits (Jones & Ram, 2010). Their survival is often only made possible because these migrant entrepreneurs are embedded in social networks that enable them to reduce their transaction costs in both formal and informal ways (Deakins, Ishaq & Smallbone, 2007; Portes & Sensenbrenner, 1993). Co-ethnic ties and family support are also important to their daily business operations. Utilising family and co-ethnic ties and labour resources assists with reducing labour costs and promotes efficiencies in communication (Strickland, 2013).

Due to low profit margins with fierce business competition, self-exploitation amongst migrant entrepreneurs is commonly accepted as part of surviving in a new country (Jones & Ram, 2007; Ram & Jones, 2008). Many have experienced very poor returns on their labour, capital and risk bearing (Jones & Ram, 2007). Migrant entrepreneurs also experience difficulty accessing mainstream finance in their host countries (Irwin & Scott, 2010; Ram, Smallbone & Deakins, 2002). To address this, migrant entrepreneurs often resort to non-mainstream finances with higher interest rates or they borrow from family, friends and local communities (van Hulten & Ahmed, 2013). They also face structural disadvantages such as unfamiliarity, lack of knowledge of local conditions and regulatory requirements, language barriers and social exclusion based on cultural factors (Pitrus, 2015). Often their activities do not seem to be prominent within 'mainstream' research and therefore migrant entrepreneurs are not consulted in public policies.

To compensate for low profit margins, Sanders and Nee (1996) argue that ethnic migrants' ability to mobilise family members gives them the decisive competitive advantage of having a cheap and flexible labour force (a form of social capital). Social capital can be a very valuable resource for ethnic migrant entrepreneurs and can represent a very important advantage for migrant businesses that have migrant population as their clientele (Clark & Drinkwater, 2010). Social capital is referred to as the tangible and virtual resources that facilitate actors' attainment of goals and that accrue to actors through social structure (Portes, 1998). Ethnic social capital could be especially significant for those immigrants who have substantial cultural differences with respect to the local community (Altinay & Altinay, 2006).

The issue of social capital has been discussed in migrant businesses in Finland (Katila & Wahlbeck, 2011), in the United Kingdom (UK) (Barrett et al., 2002), in Australia (van Hulten & Ahmed, 2013), in the Netherlands (Kloosterman, van der Leun & Rath, 1998), in the United States of America (USA) (Honig, 1998) and in Scotland (Deakins, Ishaq & Smallbone, 2007). Most of this research discusses the use of social capital by migrant businesses to start up a business, or to obtain cheap labour and financial resources but not in relation to tax compliance activities.

Given all these issues, this study aims to address the need to provide research on the role of social capital in tax compliance behaviours of migrant entrepreneurs in New Zealand. Specifically, this study attempts to answer the following research questions:

1. How does social capital impact on the Asian and Pacific³ entrepreneurs' ability to file their tax returns and pay their taxes on time?
2. Does social capital influence the attitudes of Asian and Pacific entrepreneurs' towards the informal economy in New Zealand?

The article is divided into five sections. After the introduction, it provides a summary of the migration of Asian and Pacific peoples to New Zealand, which is section 2. Section 3 discusses the meaning of social capital and its application to ethnic migrant businesses. Section 4 of this article explains the research methodology and design used in the study. It then goes on to discuss and analyse the results of the research with particular emphasis on the factors that influence the preparation of tax returns by migrant entrepreneurs and their tax payment timeliness. The article concludes in section 5 with a synthesis of the research, a summary of its limitations and the implications of the findings for policy and academia.

2. ASIAN AND PACIFIC MIGRANTS IN NEW ZEALAND

Most studies of ethnic businesses have been conducted in Australia, the USA, the UK and the Netherlands where there is a long history of immigration and the number of immigrants is substantial (McEvoy, Hafeez & Keoy, 2010). Immigrants entering these countries usually become members of fairly large and longstanding ethnic communities, for example the Indians, Pakistanis and Bangladeshis in the UK and Vietnamese, Greeks and Italians in Australia. New Zealand offers an interesting point of comparison in this respect as New Zealand is comparatively new as a country of immigration and its immigrant groups tend to be small and fragmented relative to Australia, the UK and the USA (Ministry of Business Innovation and Employment, 2013). A general observation is that many immigrants resort to establishing their own businesses to secure employment due to discrimination in workplaces (Ram, Jones & Villares-Varela, 2017). New Zealand migrants are also encouraged to start their own business as establishing a business is relatively easy in New Zealand (The World Bank, 2013). According to the World Bank (2013), New Zealand has consistently ranked number one in terms of ease of setting up a business with relatively simple regulatory and compliance requirements. Furthermore, New Zealand has, relatively recently, adopted a migration policy that favours migrants with entrepreneurial skills and business experience (New Zealand Immigration, 2017).

Auckland is the main gateway for migrants to New Zealand and it is known as the Pacific city of the world due to it having the highest concentration of Pacific peoples outside the Pacific Islands (Robie, 2009). Auckland is the most ethnically diverse city

³ These are the categorisations given by the New Zealand government as provided by Statistics New Zealand (2010) 2006 census data (QuickStats-about-culture-and-identity-tables.xls), available at <http://www.stats.govt.nz/Census/2006CensusHomePage/QuickStats/quickstats-about-a-subject/culture-and-identity.aspx#>. The four largest ethnic groups as classified by the New Zealand government are Europeans, Asians, Māori and Pacific peoples.

in the country as more than one-third of its population were born overseas. This puts it on par with Sydney and New York (Lee, 2015). The Asian and Pacific peoples groups are the two fastest growing ethnic groups and they constitute two of the four largest ethnic groups in New Zealand after Europeans and indigenous Māori (Statistics New Zealand, 2013). The number of Asian-born people in New Zealand almost doubled in size from 6.6 percent in 2001 to 11.8 percent in 2013, or 471,700 people. This compares with 295,900 for Pacific Island populations (Spoonley, 2014).

In acknowledging the knowledge gap of migrant business owners regarding their tax compliance behaviours, the New Zealand Inland Revenue commissioned a mixed method report to study the migrant groups from the UK, Australia, China and India (Inland Revenue, 2014). The report highlighted several issues. First, the need to better understand migrant businesses and their tax compliance behaviours and attitudes, as little is known about them. This information gap needs to be filled in order for a country's tax authority to appropriately respond to the changing nature of the country's population. Second, although migrant business owners are diverse in ethnicity and countries of origin, there appears to be more similarities between the UK and Australian migrants compared to the Chinese and Indian migrants in terms of tax perceptions, use of accountants and the practice of the cash economy. Third, the UK and Australian business migrants appeared to have integrated better into New Zealand society whereas the Chinese and Indian migrants tended to feel that they were being treated 'differently' because of their ethnicity (Inland Revenue, 2014, p. 1). Fourth, the Chinese and Indian business migrants reported a higher level of trust and had more positive perceptions of the tax authority compared to the UK and Australian business migrants. Fifth, more work needs to be done to understand ethnic minority groups which are born overseas such as Pacific and Asian peoples (Inland Revenue, 2014) due to the knowledge gap of this group of taxpayers. This present study heeds the call to study overseas-born Pacific and Asian business owners operating in New Zealand.

This study aims to identify some aspects of tax compliance behaviours of ethnic minority migrant Asian and Pacific entrepreneurs in New Zealand. The Asian and Pacific entrepreneurs are of interest in this study due to their collectivistic traits (Podsiadlowski & Fox, 2011) and transnational orientation (Bagwell, 2008). Most still have strong ties with their home countries and are in constant contact with their home countries (Macpherson, 2004; Ram et al., 2011; Urbano, Toledano & Ribeiro-Soriano, 2011). Their collectivistic traits suggest that individuals tend to give priority to the demands of the group over their own personal demands (Podsiadlowski & Fox, 2011; Yong & Martin, 2016). In return, the group gives the individuals a sense of belonging and access to valuable human, financial and social resources (Schwartz, 1990).

Historically, these migrant groups have encountered negative experiences at the point of entry into New Zealand with past discriminatory legislation and other action from the New Zealand government.⁴ These groups had therefore suffered negative effects

⁴ For more information, see TEARA's (2016) discussion on the *Chinese Immigrants Act 1881* (NZ), *Chinese Immigrants Amendment Act 1892* (NZ) and *Chinese Immigrants Amendment Act 1907* (NZ) which imposed a poll tax on Chinese people in New Zealand, the *Immigration Restriction Amendment Act 1920* (NZ) for Asians (particularly the Chinese), and the raids on Pacific homes in the 1970s by the Labour government for over-stayers at <http://www.teara.govt.nz/en/ethnic-and-religious-intolerance/page-3> and <https://www.teara.govt.nz/en/ethnic-and-religious-intolerance/page-4>.

due to their displacement and also discrimination on the part of the receiving society. However, in more recent times, there is greater acceptance of migrant groups and there has been a greater influx of these migrants to New Zealand since the widening of access to citizenship (Friesen, 2015; Ministry of Business Innovation and Employment, 2013).

Asian migrants who are professionally qualified often migrate to developed countries for a better quality of life; however, many are unable to obtain similar professional employment in the host country due to lack of cultural capital and recognition of overseas qualifications. Many therefore resort to lower skilled employment or self-employment (Cooke, Zhang & Wang, 2013; Department of Labour, 2010).

Large waves of Asian migrants initially started arriving in New Zealand during the 1990s (Friesen, 2015). During the early 1990s immigration into New Zealand from Asia, especially from Hong Kong, Taiwan, and the Republic of Korea, increased sharply following the introduction of a points-based selection system in 1991 which targeted skilled immigrants. Specific business migration and talent visa schemes were also designed to assist in achieving the objective of encouraging migration by entrepreneurs and people experienced in business (Bedford, 2003). Asian migrants were quick to seize these opportunities and by 2013 made up 11.8 percent of the New Zealand population (Spoonley, 2014).

Pacific peoples commenced arriving in the 1950s and in larger numbers from the 1970s (TEARA, 2016). Active recruitment by the New Zealand government of Pacific peoples commenced in the 1950s so that these workers could work in New Zealand's rapidly developing industrial and agricultural sectors. In fact, from the late 1960s formal work permit schemes were introduced mainly in agriculture and forestry, first for Fijians and then for Tongans and Western Samoans (Lee, 2009).

In 1986 there was a brief period of visa-free entry for some Pacific Islanders however this led to such a surge in migration from Fiji, Tonga and Western Samoa that the scheme was abandoned after only a few months (Stahl & Appleyard, 2007). At that point the New Zealand government decided to shift immigration policy in favour of skilled migrants, and reduced migration options for unskilled workers. This development has had a significant and ongoing impact on the nature of Pacific Islanders' movement into New Zealand and our research highlights the fact that many of the Pacific peoples in our study are from an unskilled worker background. In 2002 the New Zealand government introduced the Pacific Access Category which allowed 250 migrants from Tonga, 75 from Kiribati and 75 from Tuvalu, and, since 2003, a further 250 migrants from Fiji. In late 2006 New Zealand again shifted its migration policies towards the Pacific and reopened access for seasonal agricultural workers, including those from Melanesia, first through the Seasonal Work Permit Policy (Stahl & Appleyard, 2007) then subsequently the Recognised Seasonal Employer scheme. The latter scheme is specifically aimed at eligible Pacific Islands Forum member nations and they are recruited to work in the horticulture and viticulture industries. This scheme was originally for 5,000 workers and, in 2015 was increased to 9,500 places per year (New Zealand Immigration, 2017).

Both these groups often lacked social relationships with local Europeans and Māori. However, this lack of integration in the local society was compensated for by a strong social cohesion within their own ethnic migrant groups (Podsiadlowski & Fox, 2011; Yong & Martin, 2016). This is where social capital could play a crucial role within these groups as a mechanism to compensate for the deficiency of integration with the rest of the society. This is evidenced by the strong bonding amongst the Pacific peoples groups in churches. Pacific churches model the Pacific way of living in the islands and are therefore integral in ensuring Pacific migrants integrate into New Zealand society (Gershon, 2007; Macpherson & Macpherson, 2004; Tiatia, 1998). These mechanisms provide security, protection and support for migrants and a sense of belonging to a group despite being away from home (their country of origin). Hence, the church for ethnic Pacific peoples serves as a 'source of adaptive advantage' (OECD, 2001, p. 42) when they first arrive in New Zealand.

3. SOCIAL CAPITAL

There are many definitions of social capital and no one agreed definition. This study uses the definitions from the OECD (2001) and Putnam (2000). The OECD defines social capital as 'networks together with shared norms, values and understandings that facilitate cooperation within or among groups' (OECD, 2001, p. 41). Social capital refers to the resources gained through social ties, memberships of networks and sharing of norms (OECD, 2001). It can play an important role in information sharing.

On the other hand, Putnam defines social capital as 'connections among individuals – social networks and the norms of reciprocity and trustworthiness that arise from them' (Putnam, 2000, p. 19). Putnam also distinguishes between bonding and bridging social capital. Bonding social capital refers to 'ties to people who are like you in some important way', whereas bridging are ties 'to people who are unlike you' (Putnam, 2000, p. 143). Some highly bonded groups can embody high levels of internal trust and reciprocity and can generate benefits for the individuals. This level of internal trust and reciprocity therefore obliges the individuals to conform to the group's requirements and expectations and is a form of bonding social capital.

One of the major advantages of social capital is when an individual has access to information and influence through social networks which confer private benefits on the individual. Social networks can also be used by individuals or groups to exclude others and reinforce dominance or privilege (Katila & Wahlbeck, 2011). Alternatively, these bonds can hinder people from integrating into larger society. This is especially relevant for tightly knit communities who have strong social bonds with individuals who share their ethnicity. Their lack of social bridges with people beyond their social networks can turn them into eternal outsiders of wider society and at times hinder their economic progress (Katila & Wahlbeck, 2011). Like most forms of capital, social capital can also be harmful to the individuals when individuals do not reciprocate the demands placed on them by their group members (Gargiulo & Bernassi, 1999).

Portes and Sensenbrenner (1993) engaged in significant research on ethnicity and social capital. They noted that elements of reciprocity, bounded solidarity, enforceable trust and the existence of social obligations were key features of the relationship between ethnicity and social capital. Ethnic groups can be sources of

financial and human capital for emerging entrepreneurs, as strong kinship ties encourage funding for their business ventures and provide cheap and flexible labour (Geertz, 1973). Ethnic ties will often provide valuable information on the local business, financial and labour market (Basu & Altinay, 2002). However, ethnicity may serve simultaneously as a way to bind some people together while keeping others apart (OECD, 2001). Keeping the group separate can be a long-term disadvantage as it can alienate the group from the wider business community and therefore limit significant business opportunities.

Recent research in New Zealand has found some relationships between social capital and the ethnic groups of Māori, Pacific peoples and Asians in relation to tax compliance behaviours (Yong, Northcott & Hooper, 2014). In particular, the study has found some significant differences in the sources of tax assistance used and the manner in which these groups kept and filed their tax records. Unlike the Asians, both the Māori and Pacific peoples groups were more dependent on their accountants as they lacked accounting and tax knowledge. On the other hand, the Asians relied on their social networks for free tax assistance and information in order to save on tax compliance costs. They engaged their accountants for tax advice only when it was necessary.

More recent research on collectivistic ethnic groups also showed that tax payment ability and difficulties can be related to the assistance given and demands placed on them by their social networks (Yong & Martin, 2016). In particular, this study found that Asian small business operators experienced no tax payment difficulty as they had financial assistance from their social networks. On the other hand, the financial demands and pressures placed on the Pacific peoples and Māori groups resulted in tax payment difficulties. These tax payment difficulties were attributable to meeting their obligations towards their social networks. Consequently, these groups experienced higher tax compliance costs compared to the Asian group (Yong & Martin, 2016).

4. RESEARCH METHODOLOGY AND DESIGN

The present study relied on chain referral sampling (Biernacki & Waldorf, 1981), which is an extension of snowballing sampling (Gobo, 2007) because the sample is drawn from a variety of networks. The strength of chain referral sampling is that 'multiple networks are strategically accessed to expand the scope of investigation beyond one social network' (Penrod et al., 2003, p. 102). This approach is particularly valuable in getting a cross-section of the sample. The sample studied was drawn from a variety of sources including churches, migrant intermediary government-funded agencies, and community-based associations and personal networks.

Given the dearth of knowledge on tax compliance behaviours of migrant entrepreneurs in developed countries, an exploratory study using the in-depth qualitative interviewing approach and observations was chosen to provide feedback on the research questions. Literature has shown that migrant entrepreneurs prefer interviews instead of surveys due to trust issues (Chaganti & Greene, 2002; Romero & Yu, 2015). The interview and observation approach to analyse and explain migrant entrepreneurial issues has become increasingly accepted in the literature (Barrett et al., 2002; Ram et al., 2011).

The target group was businesses owned by Asians and Pacific peoples who had migrated to the Auckland region of New Zealand. This group was chosen because Asian and Pacific peoples are the two fastest growing ethnic groups in New Zealand and they are the largest ethnic groups in New Zealand after Europeans and Māori (Statistics New Zealand, 2013). They also come from cultures that demonstrate collectivist cultural traits.

The selection process of the Asian and Pacific migrant entrepreneurs began with contacting migrant intermediary government-funded agencies, churches, community associations and personal networks. Informal contacts were maintained with each of these organisations and groups, in order to gather more information about each ethnic group. In the second stage, 18 migrant entrepreneurs, nine from each ethnic group were interviewed. Data was collected using semi-structured interviews and observations from 2006 to 2010 with informal follow-up interviews in 2013. The interviews were conducted by the first author and varied in duration from one to two and a half hours. All interviews, with the exception of two, were recorded with the permission of the interviewees.

The field notes that the first author compiled consisted of observations and interviews. To triangulate the field notes, interviews were also conducted with 15 business experts who included business support professionals, government agencies and mentors and eight tax practitioners. Their advice supplemented, corroborated or verified the accounts given by the migrant entrepreneurs.

4.1 Data collection and interviewing method

Information collected consisted of biographical data of 18 Asian and Pacific migrant small businesses. Small to medium businesses are defined in New Zealand as businesses that employ fewer than 20 employees (Ministry of Economic Development, 2012). The biographical data was supplemented with detailed semi-structured interviews with the principals of the businesses. In some businesses, the spouses and other family members were also interviewed. Questions asked concerned the country of origin of the business owners, the nature of their business, their start-up process and tax preparation and tax payment arrangements. Informal follow-up interviews about the businesses took place in 2013. Only five businesses were contactable for the follow-up interviews as some businesses had ceased to exist and others were not available. The follow-up interviews were informal in the sense that there were no set interview questions, as there had been in the first series of interviews. All the interviewees were born overseas and were either from Asian countries or the Pacific Islands (see Appendix 1 for their countries of origin).

Qualitative interview methods were employed to obtain a broad picture of the interviewee's own understanding of their situation (Creswell, 2006). All the interviews were carried out by the first author personally as trust is important to these migrant groups and it was unlikely that they would agree to be interviewed by someone else not known or recommended to them by a friend (Brown, Tower & Taplin, 2005; Tsui-Auch, 2004). The interviews were later transcribed to facilitate the analysis. The analysis was based on template analysis where data was coded and analysed to identify and explore themes, patterns and relationships (Denzin & Lincoln,

2005). Some of the codes were known beforehand from prior literature and some were new findings as the analysis advanced.

The next section details the thematic findings of the migrant entrepreneurs' tax compliance behaviours and the role of social capital for their businesses.

4.2 Research findings and discussion

The demographic and biographic details of each of the Asian and Pacific peoples businesses are recorded in Appendix 1. The findings of the role of social capital on migrants' business and tax compliance activities are divided into the following themes:

1. Business start-ups and tax information
2. Tax return preparation and tax payments
3. Practices and perceptions of the informal economy

The role of social capital and its impact on the above themes are discussed in the ensuing sections. In particular, the similarities and differences between the two migrant groups will be highlighted.

4.2.1 Business start-ups and tax information

4.2.1.1 Asian entrepreneurs

The majority of the Asian entrepreneurs started their businesses after working for a few years with New Zealand corporations. This complements previous literature on Asian immigrant entrepreneurs which suggests that they usually start their businesses after a few years working for others (Dhaliwal, 2000; Romero & Yu, 2015). Some migrants received financial assistance transnationally from their social networks to start their businesses. All but two entrepreneurs operate their businesses to service their own ethnic community i.e. their clients are predominantly from their own ethnic group. In doing so, they claimed stiff competition from other Asian businesses and therefore experienced low profit margins.

Asian immigrants tend to be tertiary qualified (Cooke, Zhang & Wang, 2013; Department of Labour, 2010). All but one Asian entrepreneur interviewed was professionally qualified in the accounting, engineering, education or finance disciplines. This is consistent with the New Zealand government policy of encouraging skilled migrants as discussed in section 2 of this article and which has been successful in encouraging significant migration by Asian peoples.

Consequently, most of the Asian entrepreneurs interviewed were familiar with the tax requirements of New Zealand. Some were previously employed in the accounting and finance sectors and had built social networks from these professions. Information on tax obligations were sought from peers and they themselves were often familiar with tax requirements due to being employees in New Zealand. Consequently, all Asian entrepreneurs (or their family members) with the exception of one, prepared and filed their own goods and services tax (GST), pay as you earn (PAYE) and Income Tax returns without any paid assistance. The following are common statements in regards to fulfilling their tax obligations for the Asian sample:

Being a mortgage broker, I advise people on tax issues and therefore I would say I am very knowledgeable with the tax requirements... I do all the accounts myself like the payroll, income tax and GST. (Asian entrepreneur 2: Male in the financial services industry)

If I have a tax issue, I would speak to my boss first as he is an accountant and has 30 years of experience. I would also speak to a lawyer as we share the same office who knows about trusts and stuff like that. (Asian entrepreneur 3: Female who assist her husband's equestrian exporting business)

I am fairly knowledgeable with the tax requirements in New Zealand as I am an accountant. If I need clarification with some tax issue, I will ask my CA friend because I feel they have more up-to-date knowledge of what is going on. (Asian entrepreneur 8: Female who assists her husband's IT business)

Five of the Asian entrepreneurs were motivated to commence their businesses due to workplace discrimination in mainstream employment. On the other hand, the remaining four chose self-employment to achieve a better work-life balance; this is characterised as a pull factor. Many came to New Zealand for better opportunities for their children's education and a better quality of life compared to their countries of origin. They left their countries as they could not tolerate the rampant corruption and dictatorial regimes that they had experienced there, where equal opportunity for them was non-existent.

4.2.1.2 *Pacific entrepreneurs*

Historically, Pacific migrants were drawn to New Zealand to take up low skilled employment (TEARA, 2016). Most of the Pacific entrepreneurs in this study started their businesses without working for New Zealand corporations for any length of time. They were generally employed in low or semi-skilled jobs which did not require qualifications. With the exception of one, none were professionally qualified. Again, this is consistent with the New Zealand immigration policy and its prioritising of migration by unskilled workers from the Pacific Islands as discussed in section 2. Many were motivated to start a business as a means of wealth creation. Like the Asian entrepreneurs some also received financial assistance transnationally from their extended families to start their businesses. All but two Pacific entrepreneurs in this study operated their businesses to service the Pacific community.

Unlike the Asian group, the Pacific entrepreneurs started their businesses because they possessed a skill or trade and without first enquiring about business and tax requirements. Business and tax knowledge were only sought *after* commencing their businesses. Some accessed tax knowledge from their social networks but unfortunately most of the information acquired was either incorrect or outdated. Consequently, the Pacific entrepreneurs found tax requirements to be onerous and difficult. To overcome this difficulty, many employed tax practitioners to help file their tax returns which increased their tax compliance costs. The following are common statements in regards to fulfilling their tax obligations for the Pacific peoples sample:

If I have a tax query, I will go to our accountant. He charges us \$3,000 a month and makes sure we are GST compliant. He checks our GST returns

and prepares the business income tax returns. My mum is kicking a fuss because he is charging us a lot of money. (Pacific entrepreneur 1: Male in the health provider business)

I am not very knowledgeable with the tax requirements in New Zealand... I do not look at tax to really study it as I haven't taken the time nor am I interested because I would look at it and say 'pass'. I rather do something else than to do that. (Pacific entrepreneur 6: Female in the tailoring business)

In summary, the Asian entrepreneurs in this sample had more tax knowledge before commencing their businesses due to their own qualifications or information provided by their social networks. Consequently, they did not find tax compliance to be difficult or onerous compared to the Pacific peoples group. This is because their Asian peers were able to provide relevant tax information which reduced their tax compliance costs. On the other hand, the Pacific peoples group was not able to access the required assistance from their social network regarding filing tax returns. Instead they had to resort to paid assistance which increased their tax compliance costs. Contrary to the Asian group, the social capital possessed by the Pacific peoples group did not benefit them in reducing tax compliance costs. But it is not just social capital, but also human capital in the form of education, that accounts for the differences in the capacities of these groups to deal with business and tax compliance requirements. The lack of academic education on the part of Pacific peoples and the high level of academic education on the part of Asian migrants are a direct result of the New Zealand government immigration policy. Such policies have however, had the unwanted effect of failing to encourage and assist Pacific entrepreneurs. This research finding is similar to that found by Wahlbeck (2007) in respect of Turkish migrants to Finland. These migrants often end up in the fast-food industry because the Finnish general labour market is not open to them. Wahlbeck argues that Finnish government employment agencies were inadvertently perpetuating this by providing Turkish firms (usually fast-food outlets) with co-ethnic employees within the framework of various training schemes (Wahlbeck, 2007).

The authors' findings contribute to the literature in view of the fact that past research on the social capital of migrants was generally related to reducing business labour costs (Katila & Wahlbeck, 2011) but not tax compliance costs.

4.2.2 Tax return preparation and tax payments

4.2.2.1 Asian entrepreneurs

All nine entrepreneurs relied on commercial accounting packages such as MYOB, Xero or QuickBooks to record their business transactions. This enabled tax returns to be prepared easily and regularly. Business transactions were recorded by the entrepreneurs or their family members. Any taxation query was first referred to members within their social networks. In doing so, accounting fees, and therefore tax compliance costs, were kept at a minimum. Their access to social capital helped to ensure that timely and accurate tax returns were filed to avoid tax penalties and fines.

In addition, none of the interviewees experienced lateness in tax payments. They all perceived that the late payment of taxes was a bad business practice that would draw attention from the tax authority which was a situation they all wished to avoid (Gupta

et al., 2008). Asian entrepreneurs resorted to their extended families in New Zealand and their home countries for financial resources to pay taxes if this was needed. This situation was observed by Business expert 9. He claimed that Asian families would endeavour to pull in financial resources to help their entrepreneurs but that this did not happen for the Pacific peoples group due to their lack of finances. He stated:

I see the Asian community very much work within their group, their own family, their own extended family. They seldom use banks, the family is the bank. But the Pacific Islanders don't work in a similar way because they don't have the money. Where it comes to money it doesn't work like this with the Pacific Islander but where it comes to helping, all the family will come together to help like to pack in the container but not with money as there is no money. (Business expert 9: Male from a government agency)

As one Asian entrepreneur commented:

I am helping my family in the bakery and have been for three years. I have to look after the business and do the accounts every weekend when I am not working for someone else. (Asian entrepreneur 4: Female who is helping her family bakery business)

Access to social capital in terms of filing tax returns and tax payments have enabled Asian entrepreneurs to comply with their tax requirements with relative ease. This invaluable social capital in terms of accessing labour and finances also helped reduce tax compliance costs for Asian businesses.

4.2.2.2 *Pacific entrepreneurs*

Five of the Pacific entrepreneurs used accounting packages MYOB and Xero to record their business transactions. However, they also paid bookkeepers to record the data as they were not familiar with the accounting packages. To them, the filing of tax returns was onerous and expensive. The other four entrepreneurs recorded their business transactions manually or on spreadsheets. This meant that tax return preparation could be time-consuming. The majority of the Pacific entrepreneurs were not confident with filing their own tax returns unless they had been perused by an accountant. They did not have readily available networks or family members who were familiar with the tax requirements, and thus incurred higher tax compliance costs. This finding is consistent with the discussion in section 2 of this article of the history of patterns of immigration by Pacific peoples to New Zealand. As discussed, New Zealand government policy has, since the 1950s, consistently encouraged the migration of unskilled Pacific peoples to work in the agriculture, forestry and viticulture industries. Academic education and financial literacy were therefore not a priority for these workers. This has influenced the types of industries that they commence businesses in and their ongoing ability to deal with the paperwork required for operating a business. This can be contrasted with the Asian entrepreneurs who have migrated to New Zealand under skilled migrant programs and who have mainly tertiary qualifications.

Seven of the nine Pacific entrepreneurs consistently had difficulty meeting tax payments. Lateness in tax payments incurs tax penalties and fines which adds to their tax compliance costs. It has been observed by business experts and tax practitioners that Pacific peoples' tax payment difficulties are also closely related to financial demands made by their social networks. These demands include financial

contributions to the church, remittances back to their home countries and paying for extended families' birthdays, weddings and funerals. These financial demands on Pacific peoples are well documented in the literature (Connell & Conway, 2000; Macpherson, 1992; Macpherson & Macpherson, 2004). Business experts also claimed that most Pacific entrepreneurs were willing to help their social networks but to their own detriment. The following statements point to the reasons for tax payment difficulties for Pacific entrepreneurs as being the financial contributions to their social networks:

The Pacific Islanders bring to the business their cultural values of families... In some ways, family can get in the way of the business. For example someone has a business and others think they can go to them and get things for free because they are my family. (Business expert 10: Female from a government agency)

The cultural tradition of giving to the family is very strong. ... My dad had to fight against all his family regarding the Samoan fa'avae (traditional giving and reciprocity) and there was so much trouble with that. When he said no to the financial giving, that was it and even his own personal family wanted to kill him... The culture to give to your family is ingrained in you the minute that you are born. Your whole existence is to give to the church and to give to the family. (Pacific entrepreneur 6: Female who helps with her husband's arts and craft business)

No I don't do the stereotypical Samoan way of giving anymore because at 21 I left home and left the church and just cut ties with all that... there is a feeling that you are obliged to give and in some church giving there is a competition between some families as they announce the church giving... It is more like the Island's cultures and the whole competition of having a high standing even though I may go hungry because I give to others. (Pacific entrepreneur 2: Male in the clothing design industry)

The expectation of Pacific Islander entrepreneurs to contribute financially to their families and social networks is extremely strong and cannot be denied. Failure to financially contribute to families and social networks when the need arises will lead to adverse repercussions not only to the Pacific Islander entrepreneurs but also their families. Refusal to financially assist with their social networks can result in losing their credibility and societal standing. Consequently, it is difficult for these entrepreneurs to prioritise their business income and resources towards fulfilling taxation and financial demands over the demands from their social networks. Many resort to business resources to fulfil social demands as they do not have access to mainstream finance.

Lack of access to social capital in terms of information about filing tax returns have deterred Pacific entrepreneurs from filing their tax returns without the assistance of paid accountants. They also experienced the negative side of social capital in terms of financial contributions required to meet the needs of their social networks. These demands hindered their ability to pay their taxes on time thereby increasing tax compliance costs resulting from tax penalties and fines.

In summary, the Asian entrepreneurs experienced the positive side of social capital whereas the Pacific peoples group encountered the downside of social capital in terms of tax compliance. This is because the Asian group had assistance from their social networks with tax return preparation and tax payments. On the other hand, no assistance was available for the Pacific peoples group in terms of tax return preparation. Instead of receiving financial assistance from their social networks for tax payments, often Pacific entrepreneurs were required to financially contribute to their social networks as a priority which led to tax payment difficulties. Hence, social capital can constrain or facilitate successful tax compliance for the different ethnic migrant groups.

4.2.3 *Practices and perceptions of the informal economy*

A question was asked regarding Asian and Pacific entrepreneurs' experiences with 'cash jobs'. Cash jobs are cash transactions without declaring taxes, in other words a form of tax evasion (Morse, Karlinsky & Bankman, 2009). It is also referred to in some literature as the shadow economy (Yucedogru & Hasseldine, 2016). All the entrepreneurs in this sample were aware of these practices amongst their peers. Due to low profit margins and strong business competition, most migrant entrepreneurs are tolerant of cash job practices amongst their peers. None of the entrepreneurs admitted to selling goods and services through cash jobs even though they admitted to purchasing them from their peers at a lower price. Some argued that many small businesses would not survive without cash jobs. These ethnic migrants justified their peers' cash job practices with those who blatantly rip tax revenues off the government in terms of sickness and dependency welfare benefits. They did not view their peers as committing benefit/tax fraud when compared to those long-term welfare recipients. Business experts and tax practitioners claimed rampant cash economy amongst small businesses including migrants. This is also motivated by the demands from the public to charge lower prices.

None of the Asian and Pacific entrepreneurs admitted to earning revenue through cash jobs. However, migrants' participation in the informal economy is well documented in the literature (Kloosterman, van der Leun & Rath, 1999). Both the Asian and Pacific entrepreneurs could provide specific examples of practices in the cash economy by their peers and the justification for the cash economy:

The main reason for not declaring the cash job is because they do not have to pay taxes like GST and Income Tax. The main culprit is not the tradesmen. If they have to pay taxes on the cash jobs, they will starve. The ones that are creaming and benefiting are the ones with the takeaways as they ask for cash without receipts. (Asian entrepreneur 2: Male in the finance business)

The takeaways are involved with a lot of the cash jobs as they don't give receipts and so they don't go through the till and they get very grumpy when you ask for a receipt because the transactions are very small amounts. (Pacific entrepreneur 3: Male in the catering business)

Both Asian and Pacific entrepreneurs were sympathetic to their peers who undertook cash jobs because of low profit margins and extensive paperwork in recording business transactions:

There is always cash job like for friends and family. There is no cash job in our business because then we can't deduct the expenses. Cash jobs are really based on the industries especially with the building industry. (Pacific entrepreneur 5: Male in the IT business)

I am not saying that I am doing cash jobs but the average people will pocket the cash jobs of \$100. Because the amount is so small and that the person can control the money coming in ... small businesses do not earn a lot of money and to compensate that, cash jobs would help... Yes, we have experienced people offering us cash jobs for some work to be done with the different pricing. (Asian entrepreneur 6: Female in the education business)

Though none of the migrant entrepreneurs admitted to selling goods or services in the informal economy, observations by business experts and tax practitioners have claimed otherwise:

With the Asians, they have issues with record keeping. My understanding is that they are very astute business people but they do not necessarily want to be 100 percent transparent so we will see what they want us to see. It is also compounded by the fact that a lot of their activities are within their own community so we only see stuff at the border... so cash reporting is an issue... Record keeping for the Pacific probably is not as good as the traditional European style but not too bad. They also have a lot of small value cash items like in the markets. (Business expert 6: Male and from a government agency)

Small businesses do participate in cash jobs. At the end of the day, the onus is on the small businesses to disclose the cash jobs themselves. If you don't disclose and there is no paper transaction, then nobody knows. It all comes down to the person who is discharging their money for services whether they are prepared to forego the documentation. If they are prepared to do that, then we can't stop them. As long as there is a willing buyer and seller, there is no paper trail. (Tax practitioner 2: Male and a sole practitioner)

Even though the migrant entrepreneurs knew of their peers' cash job practices, none of them reported these practices to the tax authority. This is because their peers are part of their social networks and they would not betray their internal trust by reporting them to the authorities. If they made such a report it could damage their social capital and their standing within their social networks. Hence social capital discourages migrant groups from disclosing their peers' cash job practices to the government. It can be seen as tolerating unwarranted tax practices in order to protect their social networks and social capital.

In summary, the role of social capital on the Asian and Pacific entrepreneurs' tax compliance behaviours is shown in Table 1 below:

Table 1: Role of Social Capital on the Migrants' Tax Compliance Behaviours

Ethnic origin	Business start-ups and tax information	Tax return preparation and tax payments	Practices and perceptions of the informal economy	Impact of social capital
Asian	Received transnational funding to start business. Facilitated understanding of tax requirements in New Zealand. Helped to reduce tax compliance costs.	Facilitated tax return preparation and tax payments. Helped to reduce tax compliance costs.	Participated in the informal economy by purchasing from peers. Would not report the cash job practices to the authority.	<i>Overall positive impact on their tax compliance practices.</i> <i>Positive factors:</i> Access to transnational funds; Access to members within their social networks to assist with tax information; Access to social network bookkeepers to process accounting information; Access to financial resources from social networks to always pay their taxes on time.
Pacific peoples	Received transnational funding to start business. Constrained ability to understand tax requirements in New Zealand. Incurred high tax compliance costs.	Constrained ability to file tax returns and make tax payments on time. Incurred high tax compliance costs due to penalties and fines.	Participated in the informal economy by purchasing from peers. Would not report the cash job practices to the authority.	<i>Overall negative impact on their tax compliance practices.</i> <i>Positive factors:</i> Access to transnational funds from their social networks. <i>Negative factors:</i> No access to people within their social network with tax information and tax return preparation skills, therefore have to rely on paid bookkeepers and accountants; No access to financial resources from their social networks to enable them to pay their taxes on time; Financial demands from their social networks reinforced their tax payment difficulties.

5. CONCLUSION AND SUGGESTIONS FOR FUTURE RESEARCH

An increasing number of Asian and Pacific immigrant-entrepreneurs are starting businesses in urban economies such as Auckland, Sydney and Melbourne. The research into these entrepreneurs in Auckland indicates that they are setting up businesses in highly competitive environments and thereby experiencing low profit margins (Kloosterman, 2010).

The aim of this study is to provide insights into the phenomenon of social capital that may influence the tax practices of Asian and Pacific migrant-entrepreneurs in Auckland, New Zealand. Regardless of the general similarities of their collectivistic orientation, a closer look at their tax practices reveals distinct patterns and dynamics. The study indicates that social capital can either constrain or facilitate successful tax practices depending on the context, circumstances, availability and requirements of their social networks.

From an accounting and tax perspective, social capital facilitated successful tax practices for the Asians but was constraining for the Pacific peoples group. This differentiation needs to be acknowledged in assessing the capacity of migrant entrepreneurs to comply with tax requirements in a host country.

The results of this study support the central argument in the literature which suggests that all entrepreneurs are not the same and that even amongst migrant ethnic groups there is some heterogeneity. This research has also produced evidence to contradict the traditional assumption that strong social capital is an asset to migrant ethnic businesses (Davidsson & Honig, 2003; Deakins, Ishaq & Smallbone, 2007).

In light of the above conclusions, a number of implications can be drawn. In terms of policy makers, this research raises the question of whether or not it is useful and/or appropriate to treat migrant entrepreneurs the same as local entrepreneurs. Although some similarities between both Asian and Pacific peoples groups are evident, there are also additional factors, such as accounting and financial assistance and creation of professional networks, which could facilitate successful tax practices especially for the Pacific migrants who are not able to access these skills through their social capital. Community-based business advisers/mentors/coaches who are encouraged to understand the needs of ethnic migrant entrepreneurs and to develop tailored interventions rather than prevailing 'one size fits all' approaches would benefit the Pacific peoples group. Further, tax authorities need to be aware of the role of social capital in constraining and enhancing acceptable tax practices amongst migrant entrepreneurs.

From the academic point of view, this study contributes to the recent call made by several authors to engage in further research related to entrepreneurship and its links to ethnic and migratory factors rather than economic variables (Urbano, Toledano & Ribeiro-Soriano, 2011). The authors argue that a qualitative methodology approach can be useful in uncovering new insights about complex factors that affect tax compliance and that this is demonstrated in this study. However, the findings presented are also limited by the focus of the study and the methodology employed. Like any methodology, qualitative research has its own limitations. Therefore, the conclusions that emerge from this research may not be appropriate in another context

or tax regime. Nevertheless, this exploratory study provides a starting point for future research aimed at analysing tax practices amongst migrant entrepreneurs.

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Appendix 1: Demographic and Biographic Information of Asian and Pacific Entrepreneurship and Tax Compliance

Migrant entrepreneurs A – Asian P – Pacific	Country of origin	Tertiary qualification	Background	Business industry	Length of business	Service ethnic clients	Has access to peers who could assist with tax queries	Experienced tax payment difficulty	Aware of cash jobs practices by peers
A1	Hong Kong	Entrepreneur – No Spouse – Yes	Motor mechanic	Car repairs	12 years	No	No	No	Yes
A2	Malaysia	Yes	Accountant and banker	Financial services	7 years	Yes	Yes	No	Yes
A3	India	Yes	Accountant	Export	3 years	No	Yes	No	Yes
A4	Cambodia	Yes	Accountant	Bakery	3 years	No	Yes	No	Yes
A5	India	Yes	Management	Food	1 year	Yes	Yes	No	Yes
A6	Japan	Yes	Teacher	Education	13 years	Yes	Yes	No	Yes
A7	India	Yes	Management	Food	15 years	Yes	Yes	No	Yes
A8	Malaysia	Yes	Accountant	IT support	11 years	No	Yes	No	Yes
A9	China	Yes	IT and accounting entrepreneur and spouse	Online retailing	Less than 1 year	No	Yes	No	Yes
P1	Niue	Yes	Management	Health provider	10 years	Yes	No	Yes	Yes
P2	Samoa	Part – did not complete tertiary qualification	Teacher and has a European spouse who is an administrator	Clothing designer and retailer	1.5 years	Yes	No	No	Yes

Migrant entrepreneurs A – Asian P – Pacific	Country of origin	Tertiary qualification	Background	Business industry	Length of business	Service ethnic clients	Has access to peers who could assist with tax queries	Experienced tax payment difficulty	Aware of cash jobs practices by peers
P3	Fiji	No	Banker and has a European spouse who is a lawyer	Food catering	7 years	No	No	No	Yes
P4	Samoa	Yes	Body embalmer	Funeral support services	9 years	Yes	No	Yes	Yes
P5	Samoa	Yes	Computing	IT support service	4.5 years	No	No	Yes	Yes
P6	Samoa	No	Tailor	Dressmaker	27 years	Yes	No	Yes	Yes
P7	Samoa	No	Labourer	Arts and craft	Less than 1 year	Yes	No	Yes	Yes
P8	Cook Island	No	Administrator	Transportation services	Not disclosed	Yes	No	Yes	Yes
P9	Samoa	No	Restaurant services	Bar and restaurant services	Not disclosed	Yes	No	Yes	Yes

Tax compliance costs in developing countries: Evidence from Ethiopia

Wollela Abehodie Yesegat, Jacqueline Coolidge and Laurent Olivier Corthay¹

Abstract

This paper estimates tax compliance costs for business taxpayers in Ethiopia; it also assesses factors affecting the magnitude of tax compliance costs. The paper uses survey data from a scientific sample of 1,003 Ethiopian businesses.

Total tax compliance costs in the year 2012/13 were estimated to be about 4.5 percent of tax revenue collection. Tax compliance costs were found to be regressive and there was a higher burden for smaller businesses in Ethiopia than those in Kenya or Nepal. Business profit tax, value added tax (VAT) and turnover tax (ToT) constituted the largest share of tax compliance costs.

Simplifying the tax regime for smaller businesses, reducing the frequency of VAT filing for relatively small businesses, raising the VAT threshold and revisiting mandatory VAT sector specific registration requirements were suggested areas of reform.

Key words: tax compliance costs, cost structure, cost burden, cost drivers

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1. INTRODUCTION

In Ethiopia, tax revenue collection in absolute terms is increasing. Currently, tax revenue covers about 70 percent of government expenditures. However, in terms of the tax to GDP ratio, revenue performance is still at a very low level.² This low revenue performance measured in terms of tax to GDP ratio is likely to create pressure³ on the government to meet its revenue collections, and may lead to unfair procedural practices and also increase the burden on compliant taxpayers (relative to informal businesses). Such pressures on honest taxpayers are likely to lead to increased taxpayer resentment, which may have an adverse impact on taxpayers' willingness to comply voluntarily which in turn is instrumental in enhancing the efficiency and equity of the tax system as a whole (IFC, 2009).

To mitigate tax compliance 'quasi-voluntary compliance' problems (IFC, 2009, p. 24), reducing the burden of compliance requirements (as measured by tax compliance costs) is crucial. This paper offers an estimate of tax compliance costs in Ethiopia and identifies areas in the design and administration of taxes that are associated with excessive tax compliance costs in the country.

The paper is organised into six parts. Part two provides a theoretical framework along with international empirical evidence on tax compliance costs. This is followed by research objectives, questions and hypothesis in part three. Data sources and methods used are presented in part four, while part five presents the results and discussion. Finally, the conclusion and recommendations are provided in part six.

2. THEORETICAL FRAMEWORK AND EMPIRICAL EVIDENCE: TAX COMPLIANCE COSTS

'The term "compliance costs" itself is ambiguous' (Sandford et al., 1989, p. 10). Evans et al. (1996) also noted the apparent debate on the nature of tax compliance costs, the lack of a well-established consensus as to the precise meaning of compliance costs and how such costs could, or should, be measured. With this caveat Johnston (1963, p. 5) defined compliance costs (specifically for federal income tax) as:

...the reduction in the corporation's operating costs, exclusive of the tax itself, which would result if the federal income tax were eliminated. Ideally, it is the amount evolving from the comparison of total administrative costs presently experienced by the firm with the total administrative costs which would be experienced by the firm if the federal income tax were eliminated.

Sandford (1995, p. 1) adopted a similar definition of compliance costs:

They are costs over and above the actual payment of tax and over and above any distortion costs inherent in the nature of tax; costs which would disappear if the tax was abolished.

² Tax to GDP ratio of Ethiopia (about 13 percent) is lower than the average for low income and sub-Saharan African countries (Yesegat, 2016). Further, it remains low in the context of the government's plan of increasing it to 15.3 percent by the end of its Growth and Transformation Plan (GTP), 2014/15.

³ As Gill (2003) notes, tax to GDP percentage is a readily available indicator that gives a sense of the fiscal pressure; and comparing the tax to GDP ratio of countries with similar economic and tax structures gives a sense of the relative effectiveness of the revenue administration.

Sandford (1995, p. 1) went on to stating compliance costs as:

...the costs incurred by taxpayers in meeting the requirements laid on them by the tax law and the revenue authorities.

If the description of compliance costs is understood to refer to all costs (other than the tax payments themselves and associated efficiency costs) incurred by taxpayers that would disappear if the tax was abolished, the scope of tax compliance costs would be broader than just those incurred in the process of complying with tax laws. Further, such a definition would go beyond the scope of Johnston's (1963) definition, which focuses on companies' operating costs. Arguably, compliance costs could include the expected discounted future costs of non-compliance and the lobbying of tax policy makers for lower effective tax rates. However, if the same description is understood in the context of the definition of compliance costs as costs of complying with the requirements of tax laws, the expected costs of non-compliance and of lobbying politicians would be excluded from the notion of compliance costs. Compliance costs would then be confined to costs incurred in complying with the requirements of a tax system.

In light of the above discussion and taking the narrower view, compliance costs can at least conceptually be considered as costs encompassing the following: explicit costs incurred; and payments made by taxpayers trying to fulfil their taxation obligations. These potentially include:

1. gross salaries and wages to internal employees;⁴
2. fees paid to external professional tax advisors;
3. costs of communication, stationery items, required computer hardware and software, postage, and accommodation;
4. costs of acquiring sufficient knowledge (these costs may take the form of conference and seminar costs, training costs and material costs);
5. imputed costs of time spent by taxpayers/business owners (including unpaid helpers) in complying with taxation obligations;
6. psychological costs—the costs of anxiety and stress that taxpayers experience when dealing with a tax legislation; and
7. some elements of compliance costs that may exacerbate efficiency costs (Tran-Nam, 2003).

There are also offsetting benefits to the above definition. These benefits include any legally available allowances or commissions for collecting taxes on behalf of tax authorities and one-time cash subsidies for tax compliance from the government, cash flow benefits, managerial benefits and tax deductibility of certain compliance costs.⁵ For example, managerial benefits could be obtained from improvements to the accounting information system, improvements to controls and savings on other costs (Lignier, 2009). Similarly, less frequent value added tax (VAT) payments provide

⁴ Employees working on tax matters.

⁵ Please see Lignier (2009), Lignier and Evans (2012), Tran-Nam (2003) and Tran-Nam and Glover (2002) for more discussion on offsetting benefits.

more of a cash flow advantage to businesses that are registered to collect VAT, as they can make use of the funds for a period of time, interest-free, before remitting them to the government.

There are measurement problems for some elements of compliance costs.⁶ The first problematic area is the category of psychological costs. By their very nature psychological costs that taxpayers experience in complying with the requirements of a tax system are nearly impossible to be objectively assigned monetary value to. In fact, there has been an attempt by Woellner et al. (2005, 2007) to compare the relative psychological costs incurred by Australian taxpayers when reading and applying the *Income Tax Assessment Act 1936* and *Income Tax Assessment Act 1997*, although monetary values were not assigned. Managerial and cash flow benefits are also difficult to measure with certainty. For instance, the main difficulty with managerial benefits is that even though the concept itself is rather straightforward, the reality of managerial benefits can be elusive because it is dependent on how the accounting information generated by tax compliance activities is valued by business owner-managers and used in business decisions (Lignier, 2009).

The other problem in the measurement of compliance costs is the difficulty of separating the accounting costs of tax compliance from the costs of general business accounting—referred to as core accounting costs by Sandford (1995). For small businesses, which often tend to carry out bookkeeping primarily for the purpose of complying with the tax system, it may seem plausible to treat all their accounting costs as tax compliance costs. However, using their bookkeeping information, these businesses would get such benefits as enhanced and better informed financial decision making and better access to credit markets. Consequently, although the initial and primary purpose for these businesses of keeping accounting records is for tax compliance, they should and often do use the records for other purposes of benefit to their businesses. This reveals the likely overestimation of tax compliance costs as a result of treating the whole of accounting costs as tax compliance costs. The allocation of the joint tax and accounting costs is also problematic in large businesses. In these businesses (that may have separate tax departments) the issue arises because, even though taxation matters are handled by separate departments, the determination of the accounting costs of one tax separately from the others and of the marginal costs of introducing a new tax or changing the existing ones remains a hurdle (Sandford et al., 1989).

There is also another challenge in the measurement of compliance costs, i.e., the valuation⁷ of time spent in complying with the requirements of tax legislation. Pope (1995) identified at least six methods of valuing taxpayers' time. These methods include:

1. each individual's own valuation of time (reported value);
2. each individual's own valuation, subject to a maximum hourly rate;
3. the median (or mean) value of time as reported by individual taxpayers;

⁶ Sandford et al.(1989) note different problems in measuring tax compliance costs; Lopes and Martins (2013) also report that psychological costs are difficult to put a price on.

⁷ The valuation of taxpayers' time is sometimes cited as the most difficult measurement problem (Plamondon, 1993).

4. what taxpayers would pay to be rid of all compliance costs—fair compensation claim (Evans et al. (1997);
5. before-tax hourly wage rate (e.g., from national labour statistics, also with or without overheads); and
6. after-tax hourly wage rate.

The availability of these alternate methods reveals that there is no single way of valuing the time used in the process of compliance with the requirements of a tax law. Variations in the choice of the appropriate method of valuing time may lead to substantially different estimates. In connection with this and the other issues discussed, it is worth stressing that the nature and measurement of compliance costs are ambiguous and considerable caution should be exercised in deriving estimates that can be thought of as indicative.

2.1 Factors affecting tax compliance costs and impact of tax compliance costs

Theoretically there are a number of factors affecting the magnitude of compliance costs. These factors include the complexity of the tax system (including features of the tax law and associated regulations and enforcement practices), business size, the nature of the business, the length of time the business has been operating, general education and bookkeeping training of business owners and staff preparing returns, the accounting system employed and socio demographic factors.⁸

The impact of tax compliance costs was recognised as early as the eighteenth century by Adam Smith in his discussion of the four canons of tax policy—‘equity’, ‘certainty’, ‘convenience’ and ‘economy’⁹ of a good tax system (Smith, 1776 (1952 ed)). Three of Smith’s canons (namely economy, certainty and convenience) for a good tax policy were concerned with tax operating costs. Smith (1776 (1952 ed), p. 362) in discussing the economy canon of a good tax system noted that:

...every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state.

In order to help keep the compliance costs as low as possible, the tax that each taxpayer is obliged to pay should be certain and not arbitrary, according to Smith’s (1776 (1952 ed)) certainty canon. Certainty pertains to the clarity to taxpayers and every other person as to the time of payment, the manner of payment and the amount to be paid. Further, according to Smith’s (1776 (1952 ed)) convenience canon, each tax ought to be imposed at the time or in the manner in which it is most likely to be convenient for the taxpayer to pay it. In the context of these principles, the lack of certainty in tax legislation, and the arbitrariness and inconvenience in the administrative procedures, could increase operating costs by using up the resources of both taxpayers and the government in working through various tax issues. Moreover, the lack of certainty and the arbitrariness and inconvenience prevalent in a tax system

⁸ Please see Hansford et al. (2003), Yesegat (2009), Evans (2003), Smulders et al. (2016), and Evans and Tran-Nam (2014) for more discussion on factors driving tax compliance costs.

⁹ Certainty and convenience are concerned wholly with compliance costs, while economy includes both compliance and administrative costs (Sandford et al., 1989). Although it is not the emphasis of this paper, it is worth noting that the economy canon deals with efficiency loss as well.

would expose taxpayers to unnecessary trouble, vexation¹⁰ and oppression, thereby increasing their overall compliance costs.

The existence of high compliance costs, due partly to the complexity and arbitrariness in the system, would violate the economy canon, which requires operating costs (both compliance costs of the taxpayers and administrative costs of the government) to be as little as possible.

In addition to the above, the relatively heavier burdens of compliance costs on smaller taxpayers erode the built-in progressivity in the tax system and undermine the equitable distribution of the overall burden of taxation. Further, high compliance costs have their own impact on the efficiency of a tax system. For example, because of high (actual or perceived) VAT compliance costs, business taxpayers may restrain business growth or reduce the range of goods supplied giving rise to an efficiency loss. In this regard, Tran-Nam (1999) indicated that business taxpayers may cut back the volume and range of their activities because of high VAT compliance costs.

Discussions thus far reveal problems in the nature and measurement of tax compliance costs, factors affecting them and the impact of tax compliance costs in terms of Smith's (1776 (1952 ed)) canons of a good tax policy. With these theoretical underpinnings, the subsequent discussion presents the increase in the number of empirical studies and the evidence in the estimation and analysis of tax compliance costs.

2.2 Increase in the number of empirical studies and evidence in the estimation of tax compliance costs

In contrast to the long theoretical recognition of tax compliance costs, there have been relatively few empirical studies conducted until recently and most of the earlier literature generally focused on equity and efficiency considerations.¹¹ As a result, little had been done on the measurement and analysis of compliance costs. Sandford et al. (1989, pp. 25-26) noted that, with the exception of McCulloch (1845), the discussions of the two principles—equity and efficiency—(ignoring Smith's (1776 (1952 ed)) certainty, convenience and economy canons¹²) had dominated the main stream of economic literature until recently. The lack of research into tax compliance costs is perhaps explained by factors¹³ including the lack of agreement on the subject¹⁴ and the previously high costs of conducting studies.¹⁵

It was not until the twentieth century¹⁶ that research in tax compliance costs attracted academic researchers, with a relatively systematic measurement of tax compliance costs being attempted by Haig (1935) in the United States of America (USA). Until

¹⁰ Although vexation is not, strictly speaking, expense, it is certainly equivalent to the expense at which every man would be willing to redeem himself from it (Smith, 1776 (1952 ed)).

¹¹ In fact, as Wicks and Killworth (1967) and Sandford et al. (1989) noted, compared to compliance costs, administrative costs have been subjected to some degree of measurement.

¹² As noted previously these are concerned with the operating costs of a tax system.

¹³ See Sandford et al. (1989) and Oster and Lynn (1955).

¹⁴ The lack of agreement pertains to such issues as what constitutes compliance costs, what to include (exclude) and how to measure compliance costs.

¹⁵ See, for example, Pope (1989).

¹⁶ It was in the 1930s that Professor R. M. Haig first endeavoured to measure tax compliance costs (see, for example, Haig (1935), Oster and Lynn (1955) and Sandford et al. (1989)).

the 1960s, other published studies of tax compliance costs took place only in North America. Then, from the mid-1960s to the 1970s the interest appeared to expand from North America to Europe (mainly Germany and the United Kingdom (UK)) (Sandford et al., 1989).

Since the beginning of the 1980s there has been a growing interest in tax compliance costs by academics (e.g., Slemrod & Venkatesh, 2002), governments and others, especially in developed countries. The growth of concern by governments¹⁷ and the proliferation of research in tax compliance costs internationally are evident from the fact that governments (mainly of OECD member countries) have commissioned¹⁸ tax compliance costs studies (before the introduction of a new tax or a change in the existing ones, often estimated ex-ante but not necessarily verified empirically ex-post) by funding research projects and/or becoming directly involved in the research. In addition, some governments¹⁹ require the preparation of regulatory impact assessments for various regulations including taxation before introducing a new law or amending existing ones. For example, Evans and Walpole (1999) wrote that the use of regulatory impact statements to assess the likely consequences of proposed legislative changes has become more and more prevalent internationally and is often a crucial tool in assisting policy formulation and decision making in the area of taxation in many OECD countries. Similarly, since the mid-2000s, many governments in developing countries, including those in Africa, have commissioned tax compliance costs studies with the support of the International Finance Corporation (IFC)/World Bank (Coolidge, 2012).

In particular, the Trade and Competitiveness Global Practice of the World Bank Group²⁰ (WBG) has undertaken numerous tax compliance cost surveys (TCCS) in developing and transition countries over the past several years, and has amassed a wealth of empirical data documenting the severity of the compliance burden for micro,

¹⁷ Focusing on voluntary compliance with the laws has contributed to governments' concern about compliance costs (Sandford, 1995).

¹⁸ To mention some government initiatives, in the USA, the Internal Revenue Services (IRS) commissioned Arthur D. Little & Co. to develop a methodology for estimating taxpayer paper work burden (Arthur D. Little & Co., 1988). In Canada, a study on the administrative and compliance costs of the federal sales tax system with brief comparison to the retail sales tax system of Ontario was conducted by Arthur Andersen & Co. for the Department of Finance (Arthur Andersen & Co., 1985). In Australia, the Revenue Analysis Branch of the Australian Taxation Office (ATO) commissioned a team of consultants from the University of New South Wales (UNSW) to advise the ATO on aspects of the methodology which needed to be used to estimate the costs of taxpayer compliance with proposed amendments to taxation legislation, and to carry out research to establish the values of components to be used in these estimates (Evans et al., 1996).

¹⁹ In reviewing governments' concern about tax compliance costs, Sandford (1995) noted that since 1985 the UK has required its officials to produce compliance cost assessments (CCAs) for all regulations affecting business, including tax regulations. In 1994, the New Zealand Inland Revenue Department (NZIRD) set out a compliance cost reduction strategic plan and put in place a compliance cost reduction unit to implement it. In August 1994, the Australian government announced its intention to accompany all future tax legislation with Tax Impact Statements (TIS) addressing the compliance cost issues of taxpayers. In the Netherlands, since 1985 CCAs (often qualitative rather than quantitative) have been required for changes in tax legislation. The USA introduced a Taxpayers' Bill of Rights in 1988 and concern at the level of compliance costs is evident by the request to taxpayers to indicate on their tax return how long it took to complete.

²⁰ Formerly known as the Investment Climate Department and earlier as the Foreign Investment Advisory Service of the WBG (FIAS).

small and medium enterprises, and perceptions about tax compliance from both formal and informal businesses.²¹

The WBG TCCS database, as of 2016, includes 20 developing and transition countries.²² The methodology used in most WBG TCCS has been stratified random sampling based on the database of active business taxpayers of the respective revenue authority in each country (IFC, 2011). The sample sizes have ranged from about 750–1,000 in each country.

The findings of the WBG surveys cannot necessarily be taken as typical for developing countries, as the majority of governments only requested a TCCS if there was a reason to believe that it was a problem for small business taxpayers (with the exception of South Africa, where the WBG TCCS was first piloted in 2006).

The WBG's TCCS noted a pattern that in some regions, businesses either have one or more certified accountants on staff, or outsource their tax compliance work to external certified accountants. This pattern is usually seen where tax compliance tends to be relatively complicated and onerous (e.g., in former Soviet countries such as Ukraine) or where there is a legal requirement to have returns prepared by a certified accountant (e.g., in some Latin American countries such as Peru). In other countries (e.g., Burundi or Nepal) most small business owners or managers undertake the work themselves (Coolidge, 2012). The latter case makes the valuation of time particularly difficult, as they usually do not pay themselves a salary. The opportunity cost of a business owner's time is problematic to assess: the late evening or weekend hours often devoted to such tasks may not, strictly speaking, take away from time devoted to alternative business activities and might therefore be considered quite low in value (especially for relatively low-profit businesses). On the other hand, time taken by a highly-skilled professional might carry quite a heavy opportunity cost.

The number of tax compliance costs studies continues to grow. The following paragraphs provide very broadly the international evidence on tax compliance costs with a particular focus on those that have been conducted since the 1980s.²³

The literature reveals that there has been a high concentration of tax operating costs studies in developed countries particularly in Australia, Canada, New Zealand, the UK and the USA. However, recently the number of tax compliance cost studies in developing countries has been increasing. For example, in addition to those carried out by the WBG, studies have been carried out in such countries as Croatia, India, Indonesia, Hong Kong Malaysia, South Africa, Tanzania and Ethiopia.²⁴ A review of these studies reveals that most of them relied on mail surveys as their principal way of

²¹ In addition to Coolidge (2012), please see Coolidge and Ilic (2009) and Coolidge and Yilmaz (2015).

²² South Africa, Vietnam, Ukraine, Yemen, Peru, Uzbekistan, Armenia, Georgia, Laos, Kenya, Burundi, Bihar and Rajasthan (India), Nepal, Uganda, Bangladesh, Albania, Colombia, Jamaica, Bosnia and Herzegovina. Repeat surveys (after at least some reforms have been enacted) have been undertaken for South Africa, Georgia and Bihar, and Peru. Related TCCS were carried out in South Africa with cooperation from USAID in 2007 (USAID, 2008a, 2008b).

²³ Such a focus is because of the fact that the number of studies into tax operating costs has tended to grow since the 1980s. Please see Evans (2003), Yesegat (2009), Coolidge (2012) and Susila and Pope (2012) for some detailed reviews of the empirical evidence on tax compliance costs.

²⁴ For more details please see Blazic (2004), Chan et al. (1999), Chattopadhyay and Das-Gupta (2002), Susila and Pope (2012), Klun (2004), Pope and Abdul-Jabbar (2008), Shekidele (1999), Smulders et al. (2016), and Yesegat (2009).

gathering information, which led to a relatively low response rate and likely non-response bias. Most of these studies drew their samples from sources other than tax authorities' databases²⁵—a situation that has contributed to some scepticism about the reliability of the findings. Most of the studies focused on the estimation of the magnitude of compliance costs. Most studies also did not look into specific areas in the tax system that resulted in the estimated level of compliance costs in the respective investigations. However, in making policy relevant proposals (i.e., formulating tax policy), as James and Edwards (2008) noted, it is important to adopt a wider context. Most studies also relied on descriptive statistics in analysing factors affecting compliance costs without attempting to see the strength of the relationship between compliance costs and determining factors and to control for the effects of the interdependence that might exist among the factors.

Although tax compliance cost studies were conducted in different countries, to the knowledge of the authors, in Ethiopia, there has been only one attempt (Yesegat, 2009) to estimate the compliance costs of taxes, VAT in particular.²⁶ This study estimated both tax compliance and administrative costs of VAT in Ethiopia, while the compliance costs of all other tax types were beyond the scope the study and thus remain unquantified. It is, hence, important to study the nature of compliance costs of all taxes in Ethiopia.

3. RESEARCH OBJECTIVE, QUESTIONS AND HYPOTHESIS

The main objective of this study was to estimate tax compliance costs in Ethiopia and assess factors affecting them. Specifically, the research attempted to address the following research questions (RQ) and hypothesis (HP):

RQ1. What is the magnitude of tax compliance costs in Ethiopia?

RQ2. Which types of taxes contribute to the largest share of the estimated tax compliance costs in Ethiopia?

As shown in section two, the literature, among others, Hansford et al. (2003), Yesegat (2009), Evans (2003), Smulders et al. (2016) and Evans and Tran-Nam (2014) discuss the relationship between tax compliance costs and different factors that are expected to affect the magnitude of tax compliance costs. Considering this and the research objective the following hypothesis was developed:

HP1. The magnitude of tax compliance costs in Ethiopia is associated with:

- *business size;*
- *nature of business (business sector);*
- *business age (start date);*

²⁵ This is in fact often because of the lack of cooperation from the side of tax authorities.

²⁶ Such a limited work in the estimation and analysis of tax compliance costs in developing countries, as Ott and Bajo (2001) pointed out in connection with transitional countries, may be because of the difficulty in data collection and estimation, lack of expertise, non-existence or weakness of taxpayer associations and other institutional obstacles.

- *the habit of outsourcing tax compliance activities;*
- *the practice of using computers for bookkeeping purpose;*
- *the practice of maintaining full accounting records;*
- *cash register machine usage status;*
- *business ownership type; and*
- *gender of respondent/ owner.*

4. DATA SOURCES AND METHODS

The study employed the IFC's/WBG's tax compliance costs and perception survey data from Ethiopian business taxpayers.²⁷ The total number of eligible business taxpayers in the sampling frame was 987,923.²⁸ The eligible sampling frame was stratified by region, business sector, category ('A', 'B' and 'C')²⁹ and ownership status, and the sample was randomly selected from businesses located in Addis Ababa and four major cities (Adama, Bahir Dar, Hawassa and Mekelle) of the four largest regional states. The reference year in the survey was 2012/13. The survey was conducted between May 2014 and August 2014 using face-to-face interviews. The number of valid responses was 1,003.

In terms of data analysis, we present below the estimation of tax compliance costs together with the descriptive statistics and the regression analysis undertaken. The tax compliance cost estimation employed the following cost components:

1. In-house cost of time spent by individuals = Time spent by various individuals on tax accounting tasks X salaries (salaries of relevant personnel was asked in the survey)³⁰
2. Outsourcing costs = Outsourcing cost paid to outside professionals for tax accounting tasks
3. Cost of software/hardware/dataware/information ³¹ = Money spent by businesses on acquisition and maintenance of software, hardware, dataware and information in the five-year period before the survey divided by five

²⁷ This paper used the raw survey data along with WBG (2016); the survey covered all business sector and size groups..

²⁸ The list of taxpayers in the population was obtained from the Ethiopian Revenue and Customs Authority's database; in determining the sampling frame, businesses that were not in operation during the entire reference year (2012/13 fiscal year) were excluded.

²⁹ Category A businesses include all incorporated entities and unincorporated entities with annual turnover of more than ETB 500,000 (equivalent to about USD 23,000; USD 1 = ETB 21.73 as of October 26, 2016); category B businesses are those which are not included in A and whose annual turnover is between ETB 100,000 (equivalent to USD 460) and ETB 500,000; category C businesses are those which are not already included in categories A or B and whose annual turnover is up to ETB 100,000 (FDRE, 2002).

³⁰ For salaries the following indirect question was used: 'How much average gross remuneration (including salaries, bonuses, insurance and all other benefits) per month per person do you think a similar business would pay to personnel (bookkeepers/accountants, managers/owners and other workers) working on general bookkeeping and tax accounting related tasks?'

In this study general bookkeeping is defined to include all bookkeeping activities that should be undertaken even if the business did not comply with tax requirements. All other activities are considered under tax accounting, i.e., tax compliance costs.

In the survey respondents were asked about the costs of outsourcing general bookkeeping and tax accounting activities and carrying them out in-house. Respondents were also asked to divide the overall costs into general bookkeeping costs and tax accounting costs. In addition, respondents were asked about the costs of specialised tax software, hardware, and information. The estimation of tax compliance costs is based on taxpayers' own estimation of costs incurred in the process of complying with the tax system. To deal with the problem of allocating costs between tax accounting costs and general bookkeeping costs, this paper estimates tax compliance costs in two scenarios:

1. Tax accounting cost = Cost of in-house time spent on tax accounting + cost of outsourcing the tax accounting activities

or

2. Cost of in-house time spent on tax accounting + cost of outsourcing the tax accounting activities + acquisition and maintenance cost of software/hardware/dataware/information

Average total compliance costs of all taxes were estimated using sampling weights, which considered the stratification criteria (region, size, sector and legal form of ownership). The overall compliance costs of taxes in Ethiopia were, then, estimated by multiplying the average compliance costs by the total number of business taxpayers in the country obtained from the Ethiopian Revenue and Customs Authority.

4.1 Definition of variables and model specification

To assess the association between estimated tax compliance costs and their determinants a multivariate regression analysis was run. The analysis considered such factors as size and sector of business, business ownership type, bookkeeping practice, business age, gender of owners/respondents, cash register machine usage status, and the habit of outsourcing tax compliance activities. Below are the definitions of these variables:

Dependent variable: natural logarithm of the magnitude of tax compliance costs as estimated using the general formula provided previously (both including and excluding costs of amortisable assets required for tax compliance).

Independent variables:

Business size natural logarithm of the reported annual turnover

Business sector (manufacturing and others³² as a reference group)

Dummy variable that equals 1 if the sector is trade and 0 otherwise

³¹ These costs cover both tax accounting and general bookkeeping related software, hardware and information costs; these costs are amortised over a five-year period.

³² This refers to other non-services sectors.

Dummy variable that equals 1 if the sector is other services³³ and 0 otherwise

Bookkeeping practice

Dummy variable that equals 1 if the business keeps full records of revenue and expenses and 0 otherwise (do not keep full records as a reference)

Dummy variable that equals 1 if the business uses computers for tax accounting and 0 otherwise (do not use computer for tax accounting as a reference group)

Practice of outsourcing tax compliance activities variable that takes 1 if tax-related activities are carried out completely in-house, 2 if partially in-house and 3 if completely outsourced

Cash register machine usage status (not use cash register machine as a reference)

Dummy variable that equals 1 if the business uses cash register machine and 0 otherwise

Business ownership type (all other ownership types as a reference group)

Dummy variable that equals 1 if the ownership type is in the form of sole proprietorship and 0 otherwise

Business start time (businesses started on or before the year 2000 as a reference group)

Dummy variable that equals 1 if the business started operations in the year 2000 or after and 0 otherwise

Gender of business owners (male and multiple owners as a reference)

Dummy variable that equals 1 if the gender is female and 0 otherwise (including those with multiple owners)

Gender of respondents (male as a reference)

Dummy variable that equals 1 if the gender is female and 0 otherwise

To examine the conditional association between the magnitude of tax compliance costs and the above listed factors, the following general multivariate regression equation similar to Vaillancourt (1989) and Yesegat (2009) was adopted:

³³ Include services other than trade (wholesale and retail trade).

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 \dots + \beta_n X_n + u$$

where:

Y = natural logarithm of the magnitude of the compliance costs estimate;

X_i = independent variables where i takes the value from 1 to n;

n = number of independent variables;

α = intercept;

β_i = coefficients to be estimated associated with the independent variables X_i (i = 1, 2, 3...n); and

u = classical random error term.

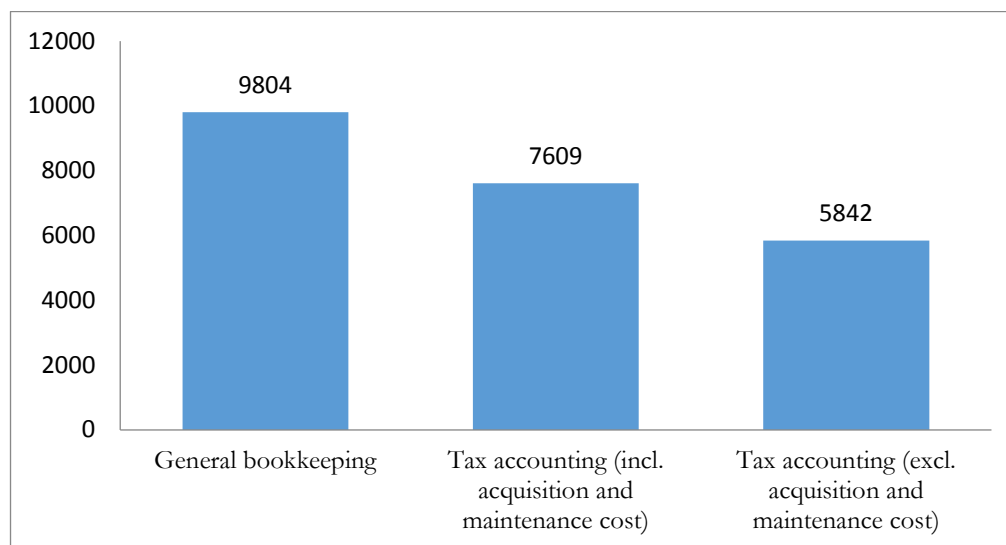
5. RESULTS AND DISCUSSION

This section presents the results and discussion. The estimated compliance costs are presented first; this is followed by descriptive statistics and regression analysis.

5.1 Estimation of tax compliance costs

Using the method presented in section four the average cost of a business for general bookkeeping was estimated to be ETB 9,804 (USD 523.2)³⁴ in the tax year 2012/13. In the same year, the average total tax compliance cost of a business including costs of acquisition and maintenance of software and hardware was ETB 7,609 (USD 406) while the average total tax compliance cost without acquisition and maintenance costs was ETB 5,842 (USD 311.7) (Figure 1).

³⁴ Average exchange rate for the year 2012/13 was USD 1 = ETB 18.59 (NBE, 2012/13).

Figure 1: Average Total Compliance Costs (in ETB)

Source: Tax Compliance Costs and Perception Survey in Ethiopia (WBG 2016)

The average tax compliance cost for a business (including amortised acquisition and maintenance costs of software and hardware) as a share of turnover was estimated to be about 5.4 percent while the share of tax compliance costs on total turnover without acquisition and maintenance costs was 4.7 percent (Table 1). In absolute terms, tax compliance costs for category A businesses were well over five times the costs for category C businesses (both when tax compliance costs include and exclude acquisition and maintenance costs). However, relative tax compliance costs as a share of turnover were larger for category C compared with category A.

Table 1: Average Tax Compliance Costs (in ETB and as a Share of Turnover) by Taxpayers' Category

	Category		
	A	B	C
N	323	199	201
Tax compliance costs in ETB (excl. acquisition and maintenance costs)	17185	10068	2637
Tax compliance costs in ETB (incl. acquisition and maintenance costs)	21639	13162	3203
Tax compliance costs as share of turnover (%) (excl. acquisition and maintenance costs)	3.85%	3.84%	5.03%
Tax compliance costs as share of turnover (%) (incl. acquisition and maintenance costs)	4.70%	5.39%	5.51%

Source: Tax Compliance Costs and Perception Survey in Ethiopia (WBG 2016)

In addition, tax compliance costs as a share of turnover tend to decrease as business turnover increases, suggesting that tax compliance costs are regressive (Figure 2). This is true whether costs of acquisition and maintenance of software and hardware are included or excluded. Those with turnover under ETB 100,000 faced compliance costs of almost 7 percent (for those who had tax hardware/software related costs); it

was 6 percent if hardware and software costs were excluded (Figure 2). In general, the paper indicates that small businesses bore a disproportionately higher compliance cost burden (in the range of 6–7 percent) compared to the largest businesses (under 1 percent).

As can be seen from the analysis of the tax compliance cost burden and the WBG's (2016) study about the perception of taxpayers and review of the micro and small business taxation legal framework in Ethiopia, the tax regime is relatively complex, time-consuming and costly. For the smallest (category C) taxpayers, there are over 90 categories of sectors and nearly 20 turnover bands in the official matrix to determine the tax due. In the implementation of the legal framework, the tax administration relies on daily sales estimates of each and every taxpayer under the regime. The estimation uses mostly such criteria³⁵ as location and nature of the business, the estimated volume of transactions, as well as estimated expenditures for business and non-business purposes. This may open up opportunities for negotiations between taxpayers and tax officials about the daily sales estimates and which category the taxpayer belongs in, which can be time-consuming, and therefore may partly explain the existence of the relatively high tax compliance costs burden on the category C taxpayers in Ethiopia.

In addition, the use of sector specific VAT registration requirements³⁶ together with a registration threshold of ETB 500,000 (annual turnover), which has never been inflation-adjusted, has led to the inclusion of an increasing number of small businesses in the VAT net.³⁷ This, in turn, may have contributed to the disproportionately higher tax compliance burden on smaller businesses. The frequency of filing and paying VAT could be the other factor for the reported high compliance costs burden on relatively small businesses. This is because in Ethiopia, all VAT-registered businesses, regardless of their annual turnover, are required to file and pay VAT on a monthly basis.

It is critical to take steps to reduce the compliance burden on small businesses as much as possible. When tax compliance costs are, say, 5 percent of turnover, it is the equivalent to an additional 5 percent turnover tax (ToT) (which, even assuming a generous profit margin of 20 percent, would be equivalent to a 25 percent profit tax on top of all other taxes being paid by a small business). Such a burden reduces the competitiveness of businesses, especially small domestic businesses. This high burden of tax compliance costs on relatively small businesses is likely to deter them

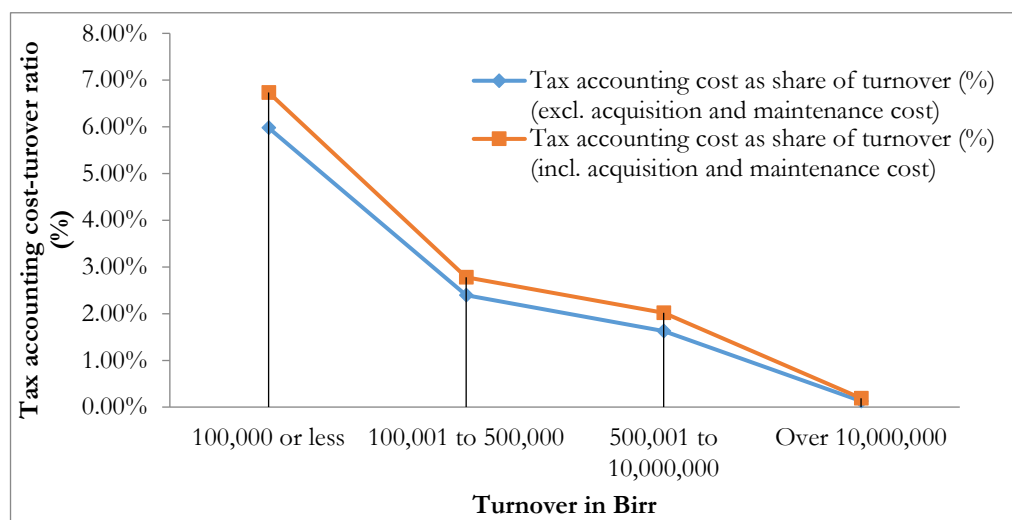
³⁵These criteria are subjective in the sense that they all depend on the opinion of estimation committee members for there is no legally standardised approach to them in Ethiopia.

³⁶In Ethiopia, businesses engaged in such selected sectors as goldsmiths, plastic products manufacturers and computer and accessories suppliers are required to register for VAT regardless of their annual turnover. This may have brought a large number of smaller businesses into the VAT, which, in turn, is contributing to the relatively high compliance costs of small business in Ethiopia compared to those in the countries considered in this paper. The use of a sector specific registration requirement may be particularly a problem in regional states for the volume of operations in the regions is likely to be much less than that in Addis Ababa. As a result, businesses engaged in those selected sectors may have annual turnover of less than the registration threshold of ETB 500,000.

³⁷As Yesegat (2008) showed, the total number of VAT-registered businesses in the year 2008 was 32,840. However, according to information obtained from the Research and Development Directorate of the Ethiopian Revenue and Customs Authority, by February 2017, the total number of VAT-registered businesses had reached 204,131. The majority of these VAT-registered businesses is likely to be relatively small businesses for the Ethiopian business environment is dominated by small and medium businesses.

from fulfilling the tax requirements imposed on them. The burden of tax compliance costs increases the cost of doing business and tends to depress business investment and formalisation.

Figure 2: Tax Compliance Costs as a Share of Turnover by Turnover Band



Source: Tax Compliance Costs and Perception Survey in Ethiopia (WBG 2016)

To gain a better insight into the magnitude of estimated tax compliance costs in Ethiopia, comparison with similar estimates in other countries is worthwhile. However, important differences³⁸ limit the use of comparative analysis in assessing the extent of tax compliance costs. This does not mean that a comparative scrutiny of such costs is completely meaningless. Instead, it is to emphasise that caution needs to be exercised and the caveats ought to be borne in mind in interpreting the results of the comparative analysis. Further, as Evans (2003) argued, the comparative analysis should be used as suggestive though not conclusive.

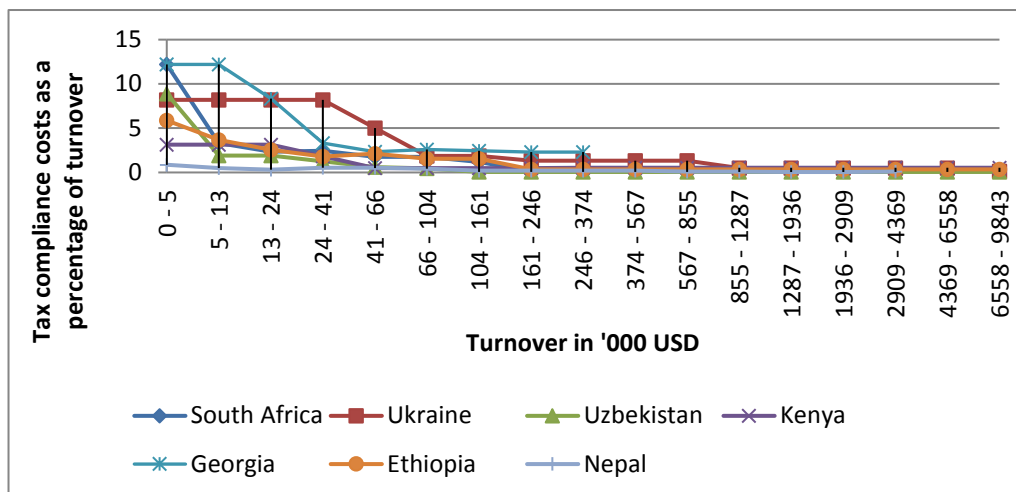
Figure 3 shows tax compliance costs as a percentage of turnover for different countries including Ethiopia. For this purpose we use the tax compliance costs measure for Ethiopia that excludes costs of acquisition and maintenance of software and hardware so that the results are more comparable across countries. Tax compliance costs as a percentage of turnover for Ethiopia are relatively high compared to those of Kenya and Nepal (Figure 3). Tax compliance costs in Ethiopia might be considered high even in comparison to some of the other countries included (also noting that most of the countries that have conducted such a survey were the ones already known to have a problem with tax compliance costs, such as the ex-Soviet countries).

Specifically, the ratio of tax compliance costs to turnover for the smallest businesses in Georgia was over 12 percent while for Nepal it was only about 1 percent. Absolute

³⁸There are differences among countries with respect to such factors as level of development, taxpayers' awareness, tax rates, definition of tax base and the reliability of data obtained from tax offices. This is due to the fact that apart from the inherent differences among the countries being considered, the scope of tax compliance costs estimates, costs included, sectors covered, estimation methods employed, reliability of data used and other details are likely to be different.

tax compliance costs also appear relatively lower in Ethiopia than the other countries due to the very low wage rates in Ethiopia.

Figure 3: International Comparison of Tax Compliance Costs



Source: Coolidge (2012) and WBG (2016)

Based on the results of the survey, with about 1 million businesses in Ethiopia³⁹, total national tax compliance costs were estimated to be about ETB 5.8 billion (about USD 309.5 million⁴⁰) or ETB 7.5 billion (USD 400.5 million) (depending on whether tax compliance costs include acquisition and maintenance costs of software and hardware). These costs represent between 4.5 and 5.8 percent of Ethiopia's total tax revenues collected in 2012/13. The ratio of tax compliance costs to overall tax revenues for Indonesia was about 3.2 percent in 2010 (Susila & Pope, 2012). A similar study in Nepal indicates overall average compliance costs of about 2.7 percent of tax revenue in 2012 (IFC, 2012). In Slovenia, total compliance costs (for personal income tax) accounted for around 2.8 percent of personal income tax revenue (Klun, 2004), while the figure for Croatia was 0.81 percent of personal income tax (Blazic, 2004). Further, tax compliance costs as a share of tax revenue was about 11.5 percent in Armenia (Jrbashyan & Harutyunyan, 2006), while the figure for Canada was 2.7 percent of revenue (Charron et al., 2008). Overall, there is considerable variation in terms of the magnitude of tax compliance costs across countries depending on their economic size, tax code complexity and tax revenue collection performance.⁴¹

Survey respondents were asked to split the costs of tax compliance between the different taxes. In general, business profit tax constitutes the largest share of tax compliance costs (40 percent of total tax compliance costs) followed by VAT (24 percent of the total)⁴² and then ToT (15 percent) (Figure 4). The burden of

³⁹ The total number of businesses was obtained from Management Information Systems Directorate of the Ethiopian Revenues and Customs Authority.

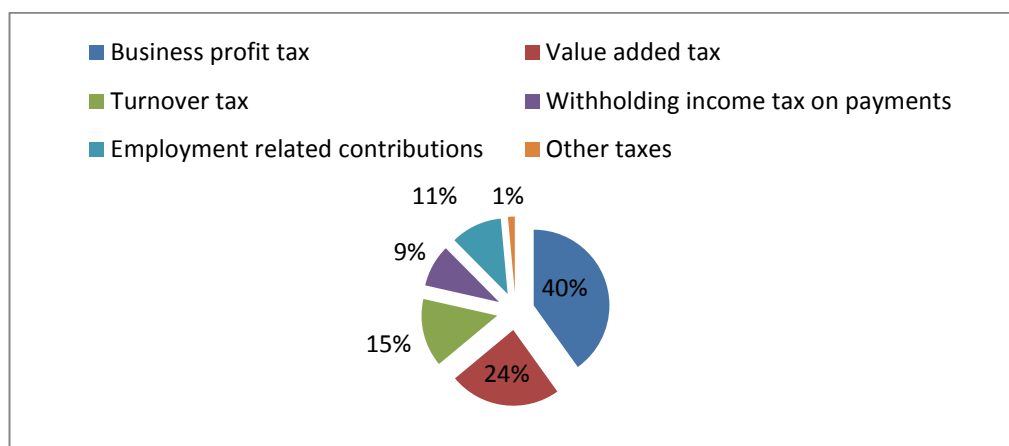
⁴⁰ Assuming average exchange rate for the fiscal year 2012/13, USD 1 = ETB 18.59.

⁴¹ See Yesegat (2009), Coolidge (2012) and Susila and Pope (2012) for detailed review of literature on the magnitude of tax compliance costs.

⁴² In relation to the compliance burden of VAT, WBG (2016) noted that about half of the businesses that are registered for VAT are outsourcing at least some of the tax compliance burden suggesting that the complexity is more than many Ethiopian businesses can currently handle on their own.

compliance costs associated with business profit tax and VAT indicates that these two taxes have complexities that result in taxpayers incurring high costs of compliance in terms of staff time and professional fees paid for external assistance.

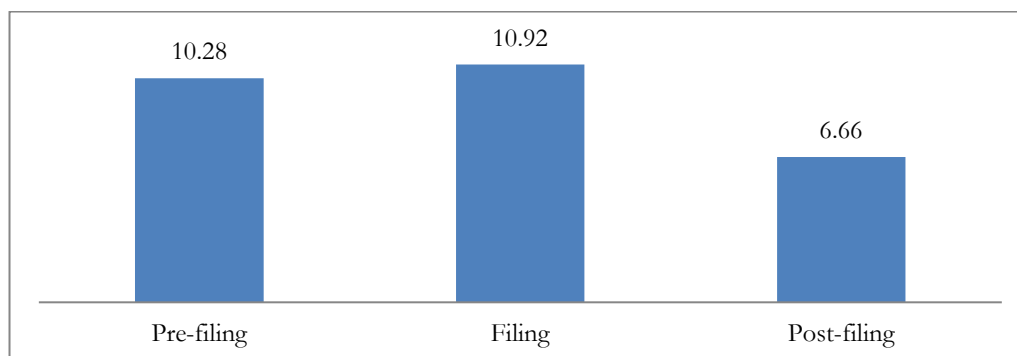
Figure 4: Distribution of Total Tax Compliance Costs by Tax Type (in Percent)



Source: Tax Compliance Costs and Perception Survey in Ethiopia (WBG 2016)

Respondents were also asked to split their total tax compliance work between ‘pre-filing’ activities, ‘filing’ activities (including effecting payment) and ‘post-filing’ activities (such as undergoing inspections, requesting refunds, or appealing assessments). Looking at in-house tax compliance costs by tax activity indicates that, on average, businesses spent about 11 person-days⁴³ on filing activities during the tax year considered; this is the highest time spent by tax activity. Pre-filing took the second highest average time of the three activities (10 person-days), with post-filing taking the smallest average amount of time (about 7 person-days) (Figure 5). This result may be because business taxpayers have to spend a lot of time as the existing system is based on manual taxation where taxpayers have to visit tax offices and queue for a long time.

⁴³ Filing activities estimated to take 11 days if only one person was engaged.

Figure 5: Person-Days Spent on Tax Compliance by Tax Activity (N=627)Source: **WBG (2016)**

5.2 Descriptive statistics and regression analysis

As defined in section four earlier, the study considers factors such as size and nature of business, business ownership type, bookkeeping practice, business start time, gender of owners/respondents, sales register machine usage, and the habit of outsourcing tax compliance activities. Table 2 shows that about 36 percent of respondents were using computers for tax accounting purposes (mostly large businesses) and about 77 percent of respondents reported they maintained full records of revenue and expenses. About 75 percent of the respondents were sole proprietorship form of businesses and 46 percent were engaged in trade (including both wholesale and retail trade). About 63 percent of respondents reported they were also using a sales register machine.

Table 2: Descriptive Statistics only for Variables included in the Regression (N=724)

Variable	Mean	Std. Dev.	Min	Max
Log Compliance costs	8.293	1.722	2.813	14.424
Log turnover	12.714	1.949	7.783	19.519
Dummy for keeping records with computer	0.359	0.480	0	1
Dummy for keeping full records	0.769	0.422	0	1
Dummy for gender owner	0.207	0.406	0	1
Dummy for gender respondent	0.225	0.418	0	1
Dummy for respondent position –owner	0.739	0.440	0	1
Dummy for respondent position manager	0.171	0.377	0	1
Dummy for ownership type	0.747	0.435	0	1
Dummy for trade	0.461	0.499	0	1
Dummy for other services	0.388	0.488	0	1
Dummy for business start time	0.579	0.494	0	1
Dummy for sales register machine	0.630	0.483	0	1
Outsourcing practice	1.704	0.841	1	3

Source: WBG's (2016) Data on Tax Compliance Costs and Perception Survey in Ethiopia and own computation

The overall regression results were found to be statistically significant (P-Value = 0.000) (Table 3). As can be seen in Table 3, the regression results show the existence of a statistically significant relationship between the magnitude of tax compliance costs and such factors as the practice of outsourcing tax compliance tasks, the maintenance of full records of revenue and expenses, the use of computers in keeping records, ownership type, business sector, business size, and use of a cash register machine. Specifically, the results show that sales register machine usage was found to have a statistically significant positive relationship with the magnitude of tax compliance costs. That is, sales register machine usage was found to be associated with increased tax compliance costs. This may be caused by such difficulties associated with using the machine as the need to correct errors, which is both frequent and cumbersome. As noted by WBG (2016, p. 26), the 'difficulty of correcting errors' was perceived by business taxpayers as the biggest disadvantage of using cash register machines in Ethiopia.

The practice of outsourcing tax compliance activities to external tax advisers (professionals) was found to have a positive and statistically significant impact on the magnitude of tax compliance costs. This means businesses outsourcing tax compliance activities were found to have higher compliance costs than those who carry out their tax compliance activities in-house. In terms of business size, the results show that business size and magnitude of tax compliance costs were positively associated in absolute terms (i.e., larger businesses usually have higher tax compliance costs). This is consistent with the findings of nearly all prior studies into tax compliance costs in general. For example, Hasseldine and Hansford (2002) and Hansford et al. (2003) showed with regression analyses that business size had been the strongest determinant of total compliance costs of VAT in the UK. Sandford et al. (1981), Sandford et al. (1989), Malmer (1995), Hasseldine (1998) and Smulders et al. (2016) also noted that compliance costs had increased with the increase in business size.

In terms of the sector of business activity, the results indicate that, all else being equal, 'services (trade)' and 'other services' tend to have lower tax compliance costs than manufacturing. The evidence in the literature, in this regard, appears to be mixed. For example in the case of VAT, Sandford et al. (1981) found that in the UK relatively low average VAT compliance costs were incurred by primary business sectors (including agriculture) while relatively high average compliance costs were incurred by the financial and business services. The agriculture, forestry and fishing industries exhibited the lowest VAT compliance costs while the highest costs were borne by the manufacturing and trade sectors in New Zealand (Hasseldine, 1998). Hasseldine and Hansford (2002) also showed that in the UK, industries such as manufacturing, dealing and services faced lower compliance costs relative to those faced by other sectors.

With respect to the ownership type of businesses, those operating as a sole proprietorship were found to have lower tax compliance costs than other forms of ownership including private limited companies, cooperative societies and others. Maintenance of full records of revenue and expenses, and using a computer for tax compliance tasks were also found to have a statistically significant and positive impact on the magnitude of compliance costs (Table 3). That is, taxpayers using computers in their tax accounting system incurred higher costs of tax compliance than the others. This result is in concordance with the findings of such prior studies as Smulders et al.

(2016) (South Africa), Coolidge and Yilmaz (2014) (Armenia and Nepal), Yesegat (2009) (Ethiopia), Hasseldine and Hansford (2002) (UK) and Hansford et al. (2003) (UK). In contrast, Plamondon (1993) (Canada) noted that no matter what the level of revenues was, taxpayers enjoyed lower compliance costs when computers were used to operate their accounting systems. Sandford et al. (1981) (UK) emphasised that there was no consistent pattern relating the type of accounting system with compliance costs. Generally speaking, larger businesses are more likely to use computers and also more likely to have a lot of complex transactions that could drive up tax compliance costs. The findings of Coolidge and Yilmaz (2014) in Armenia suggest that less well-educated business managers might tend to waste time with computer programs searching for opportunities to minimise tax liabilities, whereas the most well-educated and experienced accountants appeared to make more efficient use of computer programs in tax preparation.

Table 3: Ordinary Least Square Estimates of Tax Compliance Costs (Log Compliance Costs)

Variables	Coefficient	Robust Std. Err.
Log Turnover	0.295***	0.035
Dummy for keeping records with computer	0.255**	0.128
Dummy for keeping full records	0.249*	0.136
Dummy for gender owner	0.122	0.212
Dummy for gender respondent	0.035	0.204
Dummy for respondent position –owner	0.025	0.188
Dummy for respondent position manager	-0.189	0.213
Dummy for ownership type (sole proprietorship)	-0.363**	0.154
Dummy for trade	-0.197	0.156
Dummy for other services	-0.279*	0.157
Dummy for business start date	-0.158	0.102
Dummy for sales register machine	0.789***	0.132
Outsourcing practice	0.388***	0.062
_cons	3.649***	0.552
Number of obs	723	
F(13, 709)	37.35	
Prob > F	0.0000	
R-squared	0.432	

*significant at 10%, ** significant at 5%; *** significant at 1%

Source: WBG's (2016) Data on Tax Compliance Costs and Perception Survey in Ethiopia and own computation

In addition, the regression was run excluding some of the explanatory variables that were shown to have statistically weak effects on the magnitude of tax compliance costs. The variables excluded were gender of owner/respondent, sector, and business start date. As shown in Table 4, the results under this scenario were found to be consistent with the results depicted above.

Table 4: Ordinary Least Square Estimates of Tax Compliance Costs (only Significant Variables Included)

Variables	Coefficient	Robust Std. Err
Log Turnover	0.303***	0.035
Dummy for keeping records with computer	0.232*	0.124
Dummy for keeping full records	0.257*	0.135
Dummy for ownership type (sole proprietorship)	-0.253*	0.134
Dummy for sales register machine	0.803***	0.131
Outsourcing practice	0.374***	0.061
_cons	3.206***	0.486
Number of obs	723	
F(6, 716)	76.95	
Prob > F	0.0000	
R-squared	0.425	

*significant at 10%, ** significant at 5%; *** significant at 1%

Source: WBG's Tax Compliance Costs and Perception Survey in Ethiopia and own computation

6. CONCLUSION AND RECOMMENDATIONS

Using the IFC's/WBG's (2016) tax compliance costs and perception survey data, this study estimated and analysed tax compliance costs for businesses in Ethiopia for the year 2012/13.

6.1 Conclusions

First, the average tax compliance cost per business was estimated to be ETB 6,753 (USD 360) (including amortised acquisition and maintenance costs for tax-related hardware and software) and ETB 5,520 (USD 297) (excluding the acquisition and maintenance costs). Total tax compliance costs for all businesses in Ethiopia in the year 2012/13 were estimated to be ETB 6.7 billion (about USD 360 million). This is between 4.5 and 6 percent of Ethiopia's total tax revenue collected in 2012/13 (depending on whether tax compliance costs include acquisition and maintenance costs of software and hardware).

Second, the paper showed that tax compliance cost estimates as a share of turnover were on average 5.4 percent in the year under consideration. Tax compliance costs as a percentage of turnover for smaller businesses were high compared to those of larger businesses, providing evidence on the regressiveness of tax compliance costs in Ethiopia (as in most countries). Further, in Ethiopia, compliance costs as a percentage of turnover were found to be higher than those in Kenya and Nepal.

Third, the examination of tax compliance costs by tax type revealed that VAT constituted the second largest category of compliance costs next to business profit tax, highlighting the existence of complexities in the VAT system. In terms of the in-house costs of compliance by type of compliance activity, the results showed that

activities associated with filing and paying taxes absorbed the highest share of taxpayers' time in compliance (compared to pre-filing and post-filing activities).

Fourth, as the regression analysis revealed the use of a cash register machine (mandatory in Ethiopia for most large businesses) was found to be associated with higher compliance costs. Consistent with the findings of nearly all prior studies into tax compliance costs, this paper reported not only the existence of a positive and statistically significant relationship between tax compliance costs and the size of businesses, but also regressivity in that the ratio of tax compliance costs to turnover was significantly higher for smaller businesses than larger ones.

Finally, taxpayers using computers in their tax accounting systems were found to incur higher costs of tax compliance than the others. Businesses engaged in the service (trade) and other services sectors were also found to have lower tax compliance costs than those engaged in the manufacturing and other sectors.

6.2 Recommendations

In order to reduce the tax compliance burden on smaller businesses in Ethiopia and also encourage formalisation, further simplification of the tax regime for micro (category C) enterprises is worth considering. As presented in section five, the tax regime for micro (category C) businesses is complex, time-consuming and costly.

The practice of taxing micro businesses in Ethiopia coupled with the tax compliance burden as revealed by the relatively high tax compliance costs of smaller businesses necessitated the review of the business tax system (for category C businesses) in light of international experience and the reality in the country and replacement of the regime by a more simplified and more objective system.

The fact that about half of the businesses that are registered for VAT are outsourcing at least some of the tax compliance burden suggests that the complexity is more than many Ethiopian businesses can currently handle on their own. The relatively high compliance costs associated with VAT also suggest that the burden is onerous for smaller businesses. It is recommended that the frequency of VAT filing be reduced (e.g., make it quarterly) for relatively smaller businesses. The VAT threshold also needs to be adjusted periodically for inflation, and is usually set at the lower turnover level for a 'medium' sized business (taking into account also the capacity for the necessary bookkeeping for VAT compliance). The current threshold, ETB 500,000 (at about the equivalent of USD 25,000), is quite low by international standards.

In addition, it might be helpful to eliminate legally-mandated registration requirements for certain sectors for VAT. In particular, reviewing these requirements may be important in reducing the burden of tax compliance on affected taxpayers operating in regional states, as the volume of business in regions outside Addis Ababa is likely to be relatively lower and is therefore likely in most cases to stay below an annual turnover of ETB 500,000.

Businesses in Ethiopia typically visit tax offices regularly, and this is more so for category A and B taxpayers. Furthermore, the in-house cost of compliance for filing taxes is higher than that of pre-filing and post-filing activities. It is, therefore, recommended that voluntary electronic filing (e-filing) of tax reports and payments, and mobile phone payments should make it possible to considerably reduce the time costs and the overall tax compliance costs for many businesses. It is known that the

tax authority has launched e-filing for larger businesses (and medium business to some extent) in Addis Ababa. Extending the e-filing system on a voluntary basis to those taxpayers who are able to use the system is worth considering. Furthermore, for the e-filing system to be effective in reducing the compliance costs of taxpayers, it should be supplemented by electronic payment (e-payment) or payment through the banking system. Payment using mobile phone is also recommended to be considered as one option in reducing the compliance costs burden, especially on smaller businesses.

Tax compliance costs in Ethiopia are the highest for business profit tax. ToT and VAT also contribute a lot to compliance costs, depending on the size category considered. We also find that the total compliance costs as a share of turnover are relatively high for Ethiopia, and especially so for the smallest businesses. Thus, total compliance costs could probably be reduced through continuing taxpayer education and awareness creation programs.

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Retrospective tax law: Has Pandora's Box opened never to be shut again?

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Abstract

The recent *Chevron* case¹ raised the issue of retrospectivity of legislation. While this issue is not new, it has been argued in the past that there are limits on when governments can resort to enacting retrospective laws. These limits centre on the ability of government to protect the revenue in the public interest. This paper explores the history of retrospective taxation legislation in Australia, and analyses whether such legislation was justified in the circumstances to achieve this goal. The authors argue that the *Chevron* case not only entrenches the right of governments to enact retrospectively with respect to taxation laws, but unjustifiably extends that right in the name of 'protecting the revenue'. This will have serious implications for taxation practitioners and their clients. The authors contend that retrospective legislation should only be considered in the most egregious circumstances, and that it is incumbent upon governments to acknowledge deficiencies in legislation promptly, and amend such legislation quickly, in order to provide certainty and maintain public confidence in the taxation system.

Key words: Retrospective laws; taxation; *Chevron* case

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¹ *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [No 4] [2015] FCA 1092 ('*Chevron*'). See also below n 7.

1. INTRODUCTION

James Popple, in his article 'The Right to Protection from Retroactive Criminal Law',² considered that the right to protection from retroactive criminal law has been accepted without argument although literature to justify this is scarce. The principle has been enunciated in various declarations of human rights from 1789 until the present.³ His article discusses retroactive criminal laws — the Nuremburg trials and Australia's own 'Bottom of the Harbour' legislation.⁴ The paper discusses both sides of the argument regarding when retroactive legislation is appropriate. Although the paper concentrates on criminal law, two maxims arise which bear consideration. The first is that there can be a penalty with a law imposing that penalty and secondly that a person cannot be prosecuted for doing something which is not prohibited by law.

He goes on to discuss two further principles — that penal laws should be accessible and intelligible and that ignorance of the law is no excuse because the laws are accessible and intelligible.⁵

Retrospectivity means that even a person well-informed about the law will be ignorant of the illegality of her or his acts because those acts are not deemed illegal until the retroactive law is made. So, it can be seen that retroactive laws are at odds with the principle that ignorance of the law is no excuse.⁶

Senator Don Chipp commented on retrospective tax law in the debates on legislation following the Bottom of the Harbour schemes:

Good heavens; give politicians the chance to legislate retrospectively and we will open a Pandora's Box. I find that quite frightening. On this occasion a Pandora's Box is opened in the excuse of catching the filthy people who cheat on tax. It is done for a noble purpose, one might say, and I agree. But I have never been one to subscribe to the view that the end justifies the means. That sort of proposition leads one down a track which is fraught with disaster. That is the track that every tyrant in history has gone down; that is, to make illegal today something which was legal last year.⁷

The Federal Court issued its much anticipated decision in *Chevron* on 23 October 2015.⁸ The case was extremely complex involving multiple facets of tax law, in particular, transfer pricing. However, one of the matters discussed in *Chevron* was the

² James Popple, 'The Right to Protection from Retroactive Criminal Law' (1989) 13(4) *Criminal Law Journal* 251 <<http://users.cecs.anu.edu.au/~James.Popple/publications/articles/retroactive/>>.

³ Ibid 251.

⁴ Ibid 256 to 257; 259 to 260.

⁵ Ibid.

⁶ Ibid.

⁷ Commonwealth, *Parliamentary Debates*, Senate, 1982, Vol S96 2594.

⁸ The focus of this paper is the decision of the Federal Court of Australia in *Chevron* at first instance. The authors note here that the taxpayer appealed that decision to the Full Federal Court, which dismissed the appeal on 21 April 2017 (*Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [2017] FCAFC 62). The issue raised in the appeal did not concern the retrospectivity aspect of the first instance judgment, but rather the transfer pricing provisions of pt III div 13 of the *Income Tax Assessment Act 1936* (Cth) ('ITAA 1936') and sub-div 815-A of the *Income Tax Assessment Act 1997* (Cth) ('ITAA 1997'). Chevron Australia has since advised it will seek special leave to appeal the decision of the Full Federal Court to the High Court of Australia (<http://www.theaustralian.com.au/business/chevron-to-appeal-340m-ato-bill/news-story/40879c8cc9bf0514644377efecd96fea>).

validity of retrospective taxation legislation. It is in light of this aspect of the judgment that the focus of this paper is directed towards a discussion of the principle of retrospectivity and governments' ability to enact retrospectively in order to 'protect the revenue'. This article is structured in three sections. First, a general overview of the principle of retrospectivity will be presented. Second, the history of retrospectivity in relation to taxation will be discussed and analysed against the requirement that the revenue be protected. As part of this analysis, consideration will be given to the possibility that the same practical outcome could have been achieved without enacting legislation with a retrospective operation. Third, the decision in *Chevron* will be analysed with a view to summarising its impact on the ability of governments to enact retrospective tax legislation. With reference to Senator Chipp's Pandora's Box the authors consider that the Box has been opened never to be shut again, much to the dismay of tax practitioners and taxpayers. On this basis, the ability for governments to enact retrospectively should be reconsidered and limited to circumstances in which the threat to the revenue is so blatant or egregious that there is no other alternative than retrospective action in the public interest.

2. RETROSPECTIVITY OF LEGISLATION — GENERAL OVERVIEW

The principle underlying retrospectivity of legislation is that the common law presumes that legislation acts *prospectively* but not *retrospectively*.⁹ As noted by Pearce and Geddes, the courts have frequently declared that, in the absence of some clear statement to the contrary, an Act will be assumed not to have retrospective operation.¹⁰ The leading case on this question in Australia is *Maxwell v Murphy* where Dixon CJ summarised the approach of the courts thus:

The general rule of the common law is that a statute changing the law, ought not, unless the intention appears with reasonable certainty, to be understood as applying to facts or events that have already occurred in such a way as to confer or impose or otherwise affect rights or liabilities which the law had defined by reference to the past events.¹¹

Another frequently cited statement of the principle is from Fullagar J in *Fisher v Hebburn Ltd*:

There can be no doubt that the general rule is that an amending enactment — or, for that matter, any enactment — is *prima facie* to be construed as having a prospective operation only. That is to say, it is *prima facie* to be construed

⁹ As noted by Susan Franks <www.charteredaccountants.com.au>, in his *Commentaries on the Laws of England* (Book 1) first published in 1765, Sir William Blackstone describes retrospective legislation as unreasonable since it is impossible for a person, at the time of taking an action, to foresee that his or her action would become illegal by a subsequent law. Blackstone states: 'There is still a more unreasonable method than this, which is called making of laws *ex post facto*; when after an action (indifferent in itself) is committed, the legislator then for the first time declares it to have been a crime, and inflicts a punishment upon the person who has committed it. Here it is impossible that the party could foresee that an action, innocent when it was done, should be afterwards converted to guilt by a subsequent law; he had therefore no cause to abstain from it; and all punishment for not abstaining must of consequence be cruel and unjust. All laws should be therefore made to commence *in futuro*, and be notified before their commencement.' Lon Fuller, in his *Morality of Law* (1964), laid down eight fundamental requirements for a purported law to be genuine, one of which was that it be prospective.

¹⁰ Dennis Pearce and Robert Geddes, *Statutory Interpretation in Australia* (LexisNexis, 2011) 322.

¹¹ (1957) 96 CLR 261, 267.

as not attaching new legal consequences to facts, or events which occurred before its commencement.¹²

As discussed in *Attorney-General of New South Wales v World Best Holdings Ltd*,¹³ the presumption is strongest if 'palpable injustice' will result from retrospective operation, for example, legislation creating retrospective criminal offences. By contrast, the presumption will be weaker if the retrospective operation of legislation actually has a beneficial operation, or causes some injustice to one party but rectifies injustice to others.

Naturally, the operation of the presumption does not mean that Parliament is forbidden from passing legislation that has a retrospective operation. Parliament *can* legislate retrospectively and may do so for a variety of reasons, for example, to:

- overcome court decisions (including interpretations which Parliament does not like); or
- close loopholes in tax or other legislation; or
- validate past actions.

As noted by the Australian Law Reform Commission, the general justification for laws that interfere with vested property interests is that the interference is necessary and in the public interest.¹⁴ However, if government of free individuals is justified upon the basis that protection of private property can only be achieved by public authority,¹⁵ then retrospectivity presents a challenge. Yet, as alluded to by Higgins J in *R v Kidman*,¹⁶ while there are plenty of passages that can be cited showing the inexpediency, and the injustice, in most cases, of legislating for the past, of interfering with vested rights, and of making acts unlawful which were lawful when done, such passages do not raise any doubt as to the power of the legislature to pass retrospective legislation, if it sees fit. In such cases, the presumption against retrospectivity should be excluded by a direct statement to the contrary in the relevant Act.¹⁷ This requires a statement of 'necessary intendment' that the Act is to operate retrospectively. As Pearce and Geddes point out,¹⁸ the closest one can perhaps come to a working rule is provided by *Worrall v Commercial Banking Co of Sydney Ltd*:

Necessary intendment only means that the force of the language in its surroundings carries such strength of impression in one direction, that to entertain the opposite view appears wholly unreasonable.¹⁹

It is important when considering the question of retrospectivity to draw a distinction between legislation having a prior effect on past events and legislation basing future action on past events. The presumption is against having a prior effect on past events, it is not against having a future effect based on those same past events. Jordan CJ contrasted these circumstances in *Coleman v Shell Co of Australia Ltd*:

¹² (1960) 105 CLR 188, 194.

¹³ (2005) 63 NSWLR 557, 568 to 574.

¹⁴ Australian Law Reform Commission, *Traditional Rights and Freedoms — Encroachments by Commonwealth Law*, Interim Report 127, 7.136.

¹⁵ See John Locke, *Two Treatises of Government* (Cambridge University Press, 2nd ed, 1967) 289.

¹⁶ (1915) 20 CLR 425, 451.

¹⁷ Pearce and Geddes, above n 10, 330.

¹⁸ Ibid 330.

¹⁹ (1917) 24 CLR 28, 32 (Barton J).

[A]s regards any matter or transaction, if events have occurred prior to the passing of the Act which have brought into existence particular rights or liabilities in respect of that matter or transaction, it would be giving a retrospective operation to the Act to treat it as intended to alter those rights or liabilities, but it would not be giving it a retrospective operation to treat it as governing the future operation of the matter or transaction as regards the creation of further particular rights or liabilities.²⁰

An illustration of the operation of this distinction can be found in *La Macchia v Minister for Primary Industry*.²¹ In that case the holder of a fisherman's licence was convicted of an offence that at the time of conviction could not result in the cancellation of his licence. Subsequently, the relevant Act was amended to permit licence cancellation on the basis of such offences and his licence was cancelled. The Full Federal Court upheld the validity of a cancellation based on the conviction before the Act was amended, on the basis that this was held *not* to infringe the presumption, since the new law only operated into the future, in that it permitted licence cancellation in the future on the basis of past events. In other words, it did not create a new offence but created a new penalty that operated into the future.

The presumption against retrospectivity only arises where so to read the legislation would impinge on a person's accrued rights or duties.²² It does not apply to legislation that merely regulates procedure.²³ For example, in a criminal trial, the law to be applied at trial will be that at the time of the offence, however, the procedure for the trial (eg, rules of evidence) will be governed by the law of procedure, evidence etc, at the time of the trial.²⁴ In other words, rules which are directed to governing or regulating the mode or conduct of court proceedings are procedural and all other provisions or rules are to be classified as substantive.²⁵

3. RETROSPECTIVITY OF TAX LEGISLATION

As noted by Pearce and Geddes, there is, in general, no reason why any different approach should be followed in determining whether a tax Act is to operate retrospectively than is applicable to other legislation.²⁶ However, the fact that taxpayers will have organised their affairs to comply with existing legislation strengthens the argument that the legislative intention to remove existing rights should appear clearly: *Commissioner of Stamps (Qld) v Weinholt*,²⁷ followed in *Perpetual Trustees (Australia) Ltd v Valuer-General*.²⁸ In fact, the introduction of retrospective tax legislation is not done lightly. It is generally only done where there is a significant risk to revenue that is inconsistent with the Parliament's intention.²⁹ However, as we will see, there is now a significant history in Australia of governments acting retrospectively in the name of countering risks to their revenue base. Yet, the

²⁰ (1943) 45 SR (NSW) 27, 31.

²¹ (1986) 72 ALR 23.

²² Pearce and Geddes, above n 10, 326.

²³ *Maxwell v Murphy* (1957) 96 CLR 261.

²⁴ *Rodway v R* (1990) 169 CLR 515.

²⁵ Pearce and Geddes, above n 10, 337.

²⁶ *Ibid* 316.

²⁷ (1915) 20 CLR 531, 541.

²⁸ (1999) 102 LGERA 324, 337.

²⁹ Explanatory Memorandum, Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No 1) 2012.

operation of such legislation, in fact, appears to go beyond the 'noble purpose',³⁰ as Senator Chipp put it, of punishing tax cheats and seems to be becoming, as one commentator has noted, a 'fact of life'.³¹

As noted by the Australian Law Reform Commission, concerns about the scope of retrospective taxation laws have been widely expressed.³² For example, in 2012, the Tax Institute of Australia made a submission to Treasury in which it noted an 'extremely concerning trend in recent months of the government announcing retrospective changes to the tax law'.³³ The Tax Institute warned that retrospective changes in tax law are likely to 'interfere with bargains struck between taxpayers who have made every effort to comply with the prevailing law at the time of their agreement'.³⁴ The Tax Institute accepted that retrospective tax laws are justified in the case of:

1. concessional announcements, where it is proposed that a person should have a benefit from a given date but the legislative programme does not allow for immediate enactment; and
2. strengthening of tax laws, where an issue has come to the attention of the Commissioner requiring prompt attention (subject again to the legislative programme).

Therefore, it appears that some retrospective legislation is necessary, yet the question then becomes in what circumstances. The above cases cited by the Tax Institute could be considered as a broad guide as to the appropriateness of retrospective legislation, yet in this paper we are engaging in a more specific analysis. In other words, would it be possible for the legislature to achieve the same result (for example, strengthening the tax laws) without acting retrospectively? Which situations would pose a 'significant risk to the revenue'³⁵ so as to render retrospective legislation appropriate? Is the retrospective action warranted in the public interest? We now turn our analysis to various instances in the past in which retrospective legislation has been applied and assess whether that application was warranted in the circumstances, taking into account these considerations.

4. HISTORY OF RETROSPECTIVE TAX LAWS

4.1 Bottom of the Harbour schemes

As recounted by Lidia Xynas in her article³⁶ the 1970s and 1980s were decades in which the tax avoidance industry in Australia evolved and flourished. While prices rose by 54.6 per cent and wages by 116.6 per cent, income tax collections rose by

³⁰ Commonwealth, *Parliamentary Debates*, Senate, 1982, Vol S96 2594.

³¹ See John Eager, 'CGT, Retrospectivity and All That ... Some Hard Lessons Learned!' 33 *Butterworths Weekly Tax Bulletin*, 605.

³² Australian Law Reform Commission, above n 14, 9.76.

³³ Tax Institute, 2012–13 Federal Budget Submission, 2012, 2.

³⁴ *Ibid* 2.

³⁵ Above n 29.

³⁶ Lidia Xynas, 'Tax Planning, Avoidance and Evasion in Australia 1970–2010: The Regulatory Responses and Taxpayer Compliance' (2011) 20(1) *Revenue Law Journal* who cited these figures from the Asprey Report: W Asprey and R Parsons, 'Taxation Review Committee' (University of Sydney Library, 1975) ch 11, [11.1].

332.14 per cent.³⁷ It was the disproportionate increase in tax collections which drove the tax avoidance industry at the time.

One method used to avoid tax was to strip a company of its assets and accumulated profits before tax was payable and transfer those assets to another company which would continue the business operations. The stripped company would be sent 'to the bottom of Sydney Harbour'³⁸ often with its records. This meant that the company was transferred to the ownership of someone who did not have the means to pay the tax and was also disinterested in the activities of the company.

At the time there was no consensus as to the legality of these schemes. There was debate as to whether they constituted tax avoidance which was legal or tax evasion which was illegal. Without a decision as to the interpretation of these schemes many taxpayers who had faced significant increases in taxation liabilities engaged in these schemes. It was estimated that this engagement in these schemes cost the Australian economy dearly. Grabosky and Braithwaite quoted from Treasury's 1985 Draft White Paper which estimated revenue losses of \$3 billion per year from tax fraud.³⁹ Section 260 of the *ITAA 1936*, the general anti-avoidance section was found to be ineffective. Taxpayers continued to use schemes which saved them tax while the Commissioner had no effective method of countering them.

A number of reviews and reports at the time highlighted the growing inequality between taxpayers who could and couldn't access these schemes and the effect that this was having on the collection of tax.⁴⁰ By this time the Australian public was aware that many hundreds of companies had paid no tax because they had taken part in these schemes.⁴¹ The government finally had to take action due to the loss to the revenue and the effect on the taxpaying public which could not benefit from such schemes. It took action in two ways — firstly to criminalise participation in those schemes and secondly to allow the retrospective collection of tax which had been avoided under the schemes from 1 January 1972 – 4 December 1980.

The *Crimes (Taxation Offences) Act 1980* was enacted in 1980 and made it a criminal act to have taken part in the schemes in the 1970s. It was in the debate on this legislation that Senator Don Chipp made the comments quoted at the start of this paper. There was considerable reluctance to pass this legislation, however, the damage which had been done to the collection of revenue eventually persuaded members to vote in favour of it.

The second piece of legislation was the *Taxation (Unpaid Company Tax) Assessment Act 1982* ('*TUCT*'). It applied to schemes entered into on or after 1 January 1972 and before 4 December 1980. At that date the *Crimes (Taxation Offences) Act 1980* became operative. The *TUCT* legislation allowed the Commissioner to recover the tax which had been avoided using the schemes. Some additional legislation was also introduced at this time to make some actions criminal and to confiscate 'tainted' property. The large scale use of schemes and the huge effect on the revenue allowed

³⁷ Xynas, above n 36.

³⁸ Above n 2, 259.

³⁹ Peter Grabosky and John Braithwaite, *Of Manners Gentle: Enforcement Strategies of Australian Business Regulatory Agencies* (Oxford University Press, 1986).

⁴⁰ See, eg, the Asprey Review (1975), McCabe-La Franchi Report (1979–83), and Costigan Royal Commission (1984).

⁴¹ Grabosky and Braithwaite, above n 39.

the retrospective nature of this legislation to pass. In the circumstances, the retrospectivity here was warranted in the public interest, given the threat to the revenue and the ineffectiveness of the legislation at the time to combat these schemes.⁴² It could be argued that the scale of the mischief was such that it warranted and almost required the retrospective change to the legislation.

The following two areas we will discuss have shown the willingness of governments to enact retrospectively not solely to protect the revenue or to give better effect to Parliament's legislative intent. In other words, the ability of governments to enact retrospectively is being extended beyond what could be considered to be in the public interest, thus seeing an 'opening up' of the Pandora's Box that those such as Senator Chipp feared would occur.

4.2 Capital gains tax

Prior to the introduction of capital gains tax (CGT) many comments were made that it would only operate on capital gains arising after its introduction. These included comments made by the then Treasurer, Mr Paul Keating. Yet, the legislation taxed the gain which arose on the giving of a lease on a property which a taxpayer had owned prior to the introduction of the tax. The matter was raised in *Gray v FCT*⁴³ and effectively endorsed the taxation of such lease premiums and the grant of an easement. While the Treasurer made a statement to Parliament on 19 September 1985 and in the second reading speech on 22 May 1986 the Court held that it was the legislation as enacted which must be interpreted.

The need for retrospective legislation in the aftermath of the Bottom of the Harbour schemes was obvious to Parliament and approved by the public, notwithstanding the reservation of Senator Chipp, among others. However, this cannot be said of the 'retrospective' operation of the CGT provisions to properties which had been owned prior to the introduction of the tax, but attracted CGT when lease premiums were received when such properties were leased. John Eager commented after the *Gray* case that 'retrospectivity appears to be a fact of life and not just to put down tax avoidance schemes or to punish "tax cheats"'.⁴⁴ We should not accept this as *de rigueur*. Taxpayers and their advisors need certainty when engaging in business or investment activities. Legislators must write sound and clear legislation on which taxpayers can rely. Legislation which does not achieve its aims or contains provisions which are easily avoided must be amended in order to protect the revenue. The government must move quickly to overcome these deficiencies but will have to bear the cost of inadequate legislation, rather than impose retrospective legislation on law-abiding taxpayers.

4.3 Transfer pricing

Transfer pricing legislation is the area which has seen recently the deliberate use of retrospective legislation to ensure that the government's intention in respect of the legislation was made possible; and this was the subject of the *Chevron* case.

⁴² As discussed by Xynas, above n 36, Grabosky and Braithwaite, above n 39 and the reports cited in above n 40.

⁴³ (1989) 20 ATR 649 ('*Gray*').

⁴⁴ Eager, above n 31.

The initial legislation was introduced in 1982 in div 13 of the *ITAA 1936*. Division 13 was introduced to address emerging concerns about cross-border profit shifting. Each of Australia's tax treaties also contains articles that deal with transfer pricing. The Commissioner of Taxation has long held and publicly expressed a view that the treaty transfer pricing rules, as enacted, provide an alternate basis to div 13 for transfer pricing adjustments.⁴⁵ It was tested in *Commissioner of Taxation v SNF (Australia) Pty Ltd*⁴⁶ and as a consequence of the decision it was decided that the legislation required amendment and strengthening. Consequently sub-div 815-A of the *ITAA 1997* was enacted to operate retrospectively so as to ensure that treaty rules in relation to transfer pricing have separate application to div 13. This subdivision applies to transactions entered into on or after 1 July 2004 but was enacted on 8 September 2012. While it was observed in the Explanatory Memorandum that this retrospective application of the legislation had not been entered into lightly, there was a perceived significant risk to the revenue which could only be protected with retrospective legislation. In fact, the *SNF* case was considered on the basis on div 13 alone and no reference was made to the relevant treaty. It was considered, however, that div 13 'may not adequately reflect the contributions of the Australian operations to multinational groups, and as such in some income cases treaty transfer pricing rules may produce a more robust outcome'.⁴⁷ This reflects inadequacy or errors in the drafting rather than the intention of the Parliament.⁴⁸

The Australian Law Reform Commission in its Interim Report 127 *Traditional Rights and Freedoms — Encroachments by Commonwealth Law* commented as follows in respect of the proposed changes to transfer pricing laws as a consequence of this case:

In introducing the legislation, it was explained that this would 'ensure the Parliament's view as to the way in which treaty transfer pricing rules operate is effective, that the Australian revenue is not compromised, and that International consistency is maintained with our tax treaty partners'.⁴⁹

Further, the Explanatory Memorandum stated:

There are strong arguments ... for concluding that under the current income tax law, treaty transfer pricing rules apply alternatively to Division 13. If this is the case, these amendments constitute a mere rewrite of those rules. To the extent that some deficiency exists in the current law, these amendments ensure the law can operate as the Parliament intended.⁵⁰

This analysis has been criticised. The Law Council, for example, submitted to the Senate Economics Legislation Committee that the provisions of the Bill cannot be regarded as merely 'clarifying' the law:

To the contrary, the Bill introduces a new test for interpretation. This test requires taxpayers and the Court to read relevant provisions of the tax

⁴⁵ Ibid.

⁴⁶ [2011] FCAFC 74; 193 FCR 149 ('*SNF*').

⁴⁷ Above n 29, 7.

⁴⁸ Australian Law Reform Commission, above n 14.

⁴⁹ Ibid 9.71–9.74.

⁵⁰ Above n 29, 7.

treaties 'consistently' with OECD guidance, fundamentally changing the interpretation and application of the law.⁵¹

In a submission to this Australian Law Reform Commission inquiry, the Law Council argued that these retrospective laws were not justified for two reasons. First, it could not be said that the amendments merely restored a prior understanding of the law, as differing views and questions had been raised by the courts. Second, there was no evidence of avoidance behaviour.⁵² Again, there were no egregious circumstances existing to justify enactment of retrospective laws. The arguments advanced by the Law Council, as outlined above, formed the basis of one of the key issues raised in the *Chevron* case.

5. THE *CHEVRON* DECISION⁵³

This case involved the application of the transfer pricing provisions to some loans between Chevron Australian Holdings Pty Ltd (CAHPL) and Chevron Texaco Funding Corporation (CFC). The two entities were related by having a common parent — Chevron Corporation (CVX). Whilst the case is significant for many reasons, given its significance in the context of transfer pricing legislation both in Australia and internationally, and the OECD's current BEPS work, it was also the first case to consider the validity of the transfer pricing rules in sub-div 815-A of the *ITAA 1997* because of their retrospective nature. These rules operated concurrently with existing transfer pricing rules in div 13 of the *ITAA 1936*. From 1 July 2013, both div 13 and sub-div 815-A were replaced with sub-div 815-B of the *ITAA 1997*.

Amended assessments were issued on 20 May 2010 for each of the years ended 31 December 2003–07. These were made as a result of earlier determinations made against the taxpayer on the basis of s 136AD of the *ITAA 1936*. On 24 October 2012 the Commissioner made determinations under s 815-30 of the *ITAA 1997* for the years ended 31 December 2005–07 (ie the 2006–08 tax years). On 26 October 2012 amended assessments were issued for those years. The determinations were based on sub-div 815-30.

One of the grounds of the taxpayer's appeal was that the retrospective nature of sub-div 815-A made it invalid. In addition to other claims, the taxpayer claimed that

the provisions applied to taxpayers over a period during which the criteria for liability were neither specified nor ascertainable, in view of both the terms of the provisions and the reasoning in decisions of the Federal Court to the effect that relevant double taxation treaties did not by themselves confer a power of taxation ...⁵⁴

Further, the taxpayer submitted that sub-div 815-A was retroactive and, as applied by s 815-1 of the *Income Tax (Transitional Provisions) Act 1997* to the income years commencing on or after 1 July 2004, ss 815-10–815-30 of the *ITAA 1997* were invalid because they imposed an arbitrary exaction and therefore did not answer the

⁵¹ Law Council of Australia, Submission to Senate Economics Legislation Committee, Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No 1) 2012, 2.

⁵² Australian Law Reform Commission, above n 14.

⁵³ *Chevron* [2015] FCA 1092.

⁵⁴ *Ibid* [531].

description of a law with respect to taxation for the purposes of s 51(ii) of the *Constitution*. Chevron's primary submission was that the arbitrariness of the exaction imposed by the retroactive operation of sub-div 815-A flowed from the absence of ascertainable criteria with sufficiently general application as to whether an entity had received a transfer pricing benefit. Alternatively, Chevron submitted, an unduly retrospective exaction could, in the circumstances of its imposition, be arbitrary in character and thus beyond legislative power. Informing its arbitrariness was the inability of a taxpayer to comply with its criteria because they remained unknown during the course of ordinary commercial discourse: they could not be pointed to at the time when the events, which subsequently gave rise to purported liability, were entered into. Nor could they be identified when a tax return was prepared by a taxpayer. Subdivision 815-A was unduly retrospective and thus arbitrary.⁵⁵

One of the Commissioner's responses was that 'a law was not retrospective ... merely because it attached new consequences to past events'.⁵⁶ The Commissioner at paragraph 552 argued that Chevron's argument proceeded from a misapprehension of the relationship between taxing Acts and assessment Acts. The amount payable by force of s 4-10 of the *ITAA 1997* for each tax year was assessed by the Commissioner, subject to appeal or review, under relevant provisions of the *ITAA 1936* which defined 'this Act' to include, amongst others, the *ITAA 1997*: see s 6(1) of the *ITAA 1936*. The insertion of a new taxing provision into the *ITAA 1997*, expressed to apply in respect of a particular tax year, changed the amount of income tax payable under s 4-10 for that year and income tax in that amount was imposed by the *Income Tax Act 1936* (Cth). That Act operated in an ambulatory fashion but it did not impose tax for a particular year only during the course of that year and in accordance with the assessment Acts as they stood during that year. There was no need, in the case of a new taxing provision applicable to past tax years, for an additional provision retrospectively incorporating the assessment Act as amended into the *Income Tax Act*. Any additional liability created by the insertion of a new taxing provision became 'due and payable' in accordance with the former s 204 of the *ITAA 1936* and s 5-5(7) of the *ITAA 1997*.⁵⁷

The Court found for the Commissioner. For the purposes of the subject at hand, Robertson J dismissed Chevron's position that the retrospective transfer pricing rules in sub-div 815-A (introduced in 2012) are not constitutionally valid, although it was held that art 9 of the *Double Taxation Agreement* between Australia and the USA does not provide a separate taxing right independently from the domestic transfer pricing rules. Specifically, Robertson J opined:

In my opinion, the contentions on behalf of the applicant in this respect misconceived the nature of the amendments made by s 815-1 of the *Income Tax (Transitional Provisions) Act*. The provision had the effect, according to its terms, that Subdiv 815-A of the *ITAA 1997* applied to income years starting on or after 1 July 2004. I accept the respondent's submission that the *Income Tax Act* did not impose tax only for the particular year in which it was enacted and did not impose tax limited to the form of the Assessment Act as it stood at the time the *Income Tax Act* was enacted. Section 7 of the *Income Tax Act* provided that the tax imposed by s 5(1) 'is levied, and shall

⁵⁵ Ibid [529].

⁵⁶ Ibid [537].

⁵⁷ Ibid [552].

be paid, for the financial year commencing on 1 July 1986 and for all subsequent financial years until the Parliament otherwise provides'.⁵⁸

From this, it appears quite clear that the ability of Parliament to legislate retrospectively in matters of taxation was confirmed by the Court. The general principle against retrospectivity advanced by Chevron, namely, the inability of a taxpayer to comply with a law that did not exist at the time of a particular transaction, was dismissed by the Court. It appears that, maybe, as Senator Chipp feared, the end of protecting the revenue does justify the means of the enacting of retrospective laws, irrespective of the actual purpose of those laws.

6. HOW TO AVOID OR LIMIT THE NEED FOR RETROSPECTIVE LEGISLATION

In light of the discussion in the previous sections of our paper, this section will consider action that could be taken by government to:

1. reduce the need for retrospective legislation; and
2. explain why retrospective legislation is necessary in some circumstances.

Good interaction between the ATO and practitioners will go a long way to ensuring that legislation is better drafted to prevent deficiencies in legislation arising in the first place, so as to avoid the reliance, so to speak, on retrospective action by governments. It is incumbent upon the ATO and Treasury to engage with the public in explaining the above public interest test and to work with practitioners before legislation is provided in draft form for comment and during the public consultation period.

The government and the ATO also need to explain more clearly when retrospective legislation is justified. The recent reaction to the proposed changes to non-concessional superannuation contributions announced in the 2016–17 Federal Budget, offers a useful contemporary case study. While the proposed changes were not overtly retrospective, they appeared to have a retrospective element with regard to non-concessional contributions.⁵⁹ Was this approach necessary in the circumstances? In other words, was the law on these contributions, as it stood, posing a serious threat to the revenue? The view of the Treasury was that the changes would only adversely affect around 1 per cent of fund members.⁶⁰ Further, a Tax Institute submission on the proposed changes noted that a similar outcome could have been achieved without the implied retrospective nature of the changes.⁶¹ These considerations suggest that the retrospective approach was not justified in the circumstances, and, in fact, will no longer be introduced into law.

The government and the ATO must show the public generally that both tax avoidance and evasion are in fact stealing from the public. Such practices go beyond the realm of intelligent tax planning, but it disadvantages the public at large, thus eroding public confidence in the taxation system. It also encourages smaller taxpayers to take measures to avoid or reduce their tax liabilities. Currently about 95 per cent of

⁵⁸ Ibid [553].

⁵⁹ Commonwealth of Australia, *Budget 2016–17* <http://budget.gov.au/2016-17/content/glossies/tax_super/html/>.

⁶⁰ Commonwealth of Australia, *The Treasury* <<https://treasury.gov.au/superannuation-reforms/#lifetime>>.

⁶¹ Tax Institute, 2016–17 Federal Budget Submission.

taxpayers pay their tax voluntarily. Significant actions by large or sophisticated taxpayers to reduce their tax payable with 'artificial' measures or misuse of existing law will eventually see a reduction in this level of voluntary payment.

Perhaps more importantly, the issue of retrospectivity should be specifically addressed during the legislative process itself, from policy consideration and approval through to the drafting stage. Presently, the *Legislation Handbook* (the Handbook), published by the Department of the Prime Minister and Cabinet,⁶² provides guidance on the requirements of the legislation process. With regard to retrospective legislation, paragraphs 5.19 and 5.20 of the Handbook provide, relevantly:

5.19 Provisions that have a retrospective operation adversely affecting rights or imposing liabilities are to be included only in exceptional circumstances and on explicit policy authority (see paragraphs 3.7(i) and 3.19(b) and also paragraphs 3.26 to 3.29 concerning announcement of legislation to operate from the date of announcement).

5.20 Departments need to be aware that the Senate Standing Committee for the Scrutiny of Bills and the Parliamentary Joint Committee on Human Rights, which scrutinise all bills, expect that an explanation and justification for any retrospective provisions will be included in the explanatory memorandum and statement of compatibility with human rights (see paragraphs 7.20 and 7.29(c) to 7.29(d)).

Paragraphs 3.7 and 3.19 provide, in summary, that a justification for retrospective legislation must be included in any policy approval as well as an explanation of any adverse impact.

Paragraph 7.29(c) states that an explanatory memorandum '*must set out whether, and why, retrospective application of the Act would adversely affect any person other than the Commonwealth and, if applicable, include an assurance that no person would be disadvantaged by the retrospective application of the Act*' (emphasis added).

Whilst the government may still enact retrospective legislation, the only 'safeguard' here, as it were, is that the proposed legislation does not adversely affect any person and no person must be disadvantaged by it. This appears to be a quite broad, almost ambiguous, statement. The Handbook does not specifically prescribe that any retrospective legislative proposal must demonstrate that it is in the public interest, and, as far as taxation legislation is concerned, whether the proposal is designed to counter a real and serious threat to the revenue, the nature of that threat, and therefore a justification for retrospective action in the circumstances. If, as Lon Fuller suggests, a genuine law is one that operates prospectively, an 'explanation and justification for any retrospective provisions'⁶³ should include a 'statement of compatibility with the public interest' (similar to the 'statement of compatibility with human rights'⁶⁴), outlining that, in the circumstances, the retrospective approach is warranted, given the threat to the revenue and the ineffectiveness of the legislation presently in force to combat the threat. Such a requirement may render more credible and transparent any claims of the necessity of retrospective action on the part of the government of the day.

⁶² Commonwealth of Australia, *Department of the Prime Minister and Cabinet* (February 2017) <<https://www.dpmc.gov.au/resource-centre/government/legislation-handbook>>.

⁶³ Ibid.

⁶⁴ Ibid.

7. CONCLUSION

Having started with the premise in 1789 that laws should not be retrospective as it does not allow taxpayers to fully appreciate the implications of their actions, the decision in *Chevron* relating to the retrospective nature of the transfer pricing legislation appears to have finally put to rest this premise. In fact the previously long held view, as enunciated in cases such as *Commissioner of Stamps (Qld) v Weinholt*⁶⁵ and *Perpetual Trustees (Australia) Ltd v Valuer-General*⁶⁶ that taxpayers will have organised their affairs to comply with existing legislation no longer appears to hold sway. Indeed, retrospective legislation now seems to be 'a fact of life'. This should cause practitioners great concern particularly at a time when the government is proposing new legislation concerning transparency and international transactions, not to mention the proposed changes to superannuation contributions announced in the 2016–17 Federal Budget, which appear to have a retrospective element with regard to non-concessional contributions.⁶⁷

Practitioners should not accept retrospective legislation as a 'fact of life', and must resist this trend — we should insist on governments responding with alacrity and effectively to perceived deficiencies in legislation. Retrospective legislation should only be countenanced in the most egregious circumstances in order to truly protect the revenue in the public interest, rather than simply to render past events no longer legitimate, which is now the trend in this area. This could be addressed via amendments to the Handbook, wherein it should be prescribed that any retrospective legislative proposal (and ensuing explanatory memorandum) must demonstrate that it is in the public interest, and, as far as taxation legislation is concerned, whether the proposed legislation is designed to counter a real and serious threat to the revenue, the nature of that threat, and therefore a justification for retrospective action in the circumstances, rather than an assurance that the proposed legislation does not adversely affect any person. Such an approach would enhance the transparency of the process.

The question now is, how do we provide advice to our clients, secure in the knowledge that we have adhered to the law as it exists at the time they enter into transactions when we don't have a functioning 'crystal ball' to tell the client that the advice we provide currently may be illegal or even criminal, in the future? If this is the case, not only should clients be concerned but also practitioners, in that they may face the Pandora's Box governments have opened and will have to explain and defend this new view to their law-breaking or indeed criminal clients.

⁶⁵ (1915) 20 CLR 531.

⁶⁶ (1999) 102 LGERA 324.

⁶⁷ Commonwealth of Australia, 'Budget 2016–17', above n 59.

Risks of IFRS-based taxation: The application of section 24JB by authorised users to hedged relationships

Pieter van der Zwan¹

Abstract

Section 24JB of the *Income Tax Act 1962* introduced IFRS-based taxation in South Africa. This research aimed to identify risks of IFRS-based taxation by performing a conceptual analysis of the application of section 24JB to hedging relationships of authorised users. The analysis identified a number of timing mismatches that arise and interpretation uncertainty when section 24JB is applied to such hedging relationships. The findings suggest that for IFRS to be an appropriate basis for taxation, its use as a tax base should be limited to specific narrowly-defined transactions as opposed to classes of instruments or persons. For such transactions, all elements of IFRS that are relevant to the transaction should be incorporated into the tax base to avoid mismatches.

Key words: Financial instruments, hedged relationship, IFRS-based taxation

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1. INTRODUCTION

The South African National Treasury introduced section 24JB into the *Income Tax Act 1962* (Act No 58 of 1962) (the Act)² with effect from years of assessment ending on or after 1 January 2014 (*Taxation Laws Amendment Act 2013* (Act No 31 of 2013)). This provision was a first for South African tax legislation as it introduced International Financial Reporting Standards (IFRS) into the Act as a basis for determining the amount to be subject to income tax for certain financial instruments.³ This amendment was introduced to simplify compliance by eliminating the need for complex adjustments to determine taxable income as well as enforcement by the tax authorities by requiring that certain entities determine their income for tax purposes in respect of specific financial instruments in accordance with the rules applied for financial reporting purposes (National Treasury, 2013).

The application of section 24JB is mostly limited to financial institutions, as opposed to taxpayers in general. It does however also apply to certain non-banking institutions that are authorised users as defined in section 1 of the *Financial Markets Act 2012* (Act No 19 of 2012) (FMA). These entities include commodity traders as well as entities licensed to buy or sell certain listed securities using the Johannesburg Securities Exchange (JSE) trading system. These securities may include commodity derivatives, the entities' own publicly traded debt instruments traded for market making purposes or interest rate instruments held for their own account. The derivative instruments in respect of which a person is an authorised user are often traded for the purposes of hedging certain risk exposures of the authorised person. The scope of section 24JB was further narrowed by amendments at the end of 2016 to exclude companies whose principal trading activities constitute a treasury operation.

A hedging relationship involves two elements, namely an underlying transaction or exposure to a risk and an instrument used to hedge some or all of the risks arising from the exposure. Where a hedge has been entered into to cover an exposure to a risk arising from the hedged transaction, the entity should no longer be economically exposed to the effects of the particular risk to the extent that the hedge is successful (Correia et al., 2003; PWC, 2014). Any exposure to losses, but also the potential for gains, resulting from the hedged risk is neutralised.

Maroun (2015) found that the use of IFRS as a basis of taxation in terms of section 24JB may have certain problematic outcomes, with hedge accounting being one such area. As section 24JB only applies to certain financial instruments, the risk exists that the two elements of a hedging relationship do not fall within the scope of this provision. It is posited that section 24JB, in particular prior to its amendment in 2016, may in some instances not fully recognise the hedged relationship and result in tax consequences that do not reflect the economic transaction that has been entered into to hedge the risks.

The research question that is considered in this article is whether section 24JB, prior to the amendment in 2016,⁴ succeeded in reflecting the economic outcome of such

² Any reference to a section in this article refers to a section of the Act unless indicated otherwise.

³ The Act contains other references to IFRS as part of the criteria to determine how a transaction or event should be treated or classified from a tax perspective but not as a basis to determine the amount to be taxed.

⁴ Any reference to section 24JB in the remainder of this article refers to the provision prior to the amendment in 2016.

hedged relationships in the taxable income of authorised users to which it applies. The research reflects the findings of a conceptual analysis of the alignment between the treatment required by section 24JB and the hedge accounting principles in IFRS. The intended contribution of the research is to highlight to a broader global audience some of the specific risks that IFRS-based taxation may pose, using the application of section 24JB to hedging relationships as an illustration. In light of this objective of the research, the contribution of the research is not affected by the amendments to section 24JB that were made at the end of 2016. It is submitted that the need for these amendments confirm the validity of some of the risks of IFRS-based taxation, as identified in this research, that may be of relevance to a global audience.

The discussion in this article commences by considering profitability measures used for tax and financial reporting purposes and the possible overlap of these measures. The provisions of section 24JB in the context of hedged relationships are then considered. This is followed by a discussion of the principles of hedge accounting contained in IFRS. A conceptual analysis is performed to determine whether the use of IFRS as a basis for taxing financial instruments in accordance with section 24JB reflects the economic outcome of the hedged relationship in an entity's taxable income. The article concludes by presenting the specific risks of IFRS-based taxation, as identified from the conceptual analysis, which would be of relevance to any tax authority that considers using IFRS as a basis for taxation.

2. CONCEPTUAL ANALYSIS OF PROFITABILITY MEASURES

Section 24JB of the Act uses a profit measure determined in terms of accounting standards as a basis for taxation. This part of the article considers the objective of information prepared for financial reporting purposes and compares this to the objective of a measure of profits for purposes of taxation.

2.1 Financial reporting

Financial statements are prepared with the aim of providing information that can be used for economic decision-making by a broad range of users. These users include existing or potential investors, lenders and creditors (International Accounting Standards Board, 2015a). Traditionally, the purpose of information reported in financial statements was to provide information to business owners who were separated from those who managed and operated the business on a day-to-day basis. The information reported fulfilled a stewardship function as managers reported historic results of the businesses that they were entrusted to operate (Whittington, 2008). This purpose has evolved and a much greater focus is now placed on financial reporting that provides users with an indication of the current value of the reporting entity. This includes the use of forward-looking estimates and the measurement of balance sheet items at fair value rather than on a historical cost basis (Ball, 2006). Earnings reported in profit or loss for accounting purposes reflect not only historic and realised earnings, but also a measure of anticipated future earnings that may be relevant to stakeholders interested in valuation (Atwood et al., 2011). The balance sheet and earnings therefore reflect information that does not directly show the real net cash flows of an entity due to the fact that unrealised fair value gains or losses are also reflected. In contrast with historical cost accounting, which reported realised profits following exchange events, the use of a combination of historical cost and fair value as a reporting basis provides investors with relevant information about unrealised risk

exposures of a firm that may affect such investors in future (Nutter, 2010; Linsmeier, 2011).

2.2 Corporate tax base

Corporate tax is a direct taxation imposed on realised creations of wealth and payments (Harris, 2013). Manzon and Plesko (2001) describe the primary objective of tax law in defining taxable income or taxable profits as providing a framework to determine efficient and equitable tax liabilities in order to collect revenues to fund government expenditure. This basis for collecting taxes generally requires that income should only be taxed once such income has been severed from the capital that produced it, hence the development of the important distinction between income and capital for the purposes of determining taxable income (Holmes, 2001). If the historic or current value capital were to be taxed before realisation of the value to be derived from it, the risk exists that a taxpayer would have to dispose of some of this capital that will produce further income to be able to pay the tax. In the long run this will result in a shrinking tax base.

2.3 Differences and overlap between these profit measures

A comparison of the profitability measures for financial reporting and as a base for corporate tax highlights certain fundamental differences between the objectives of the respective profit measures. Users of financial statements may be interested in not only historical reporting but also a measure of forward-looking information which is provided by estimates and fair value accounting. Tax authorities, on the other hand, should ideally collect a share of wealth generated by taxpayers without requiring taxpayers to find cash to pay tax on gains not yet realised. Shevlin (2002) suggests that it is unlikely that a single set of rules can serve investors, lenders and other users as well as provide governments with a basis to fund social and economic objectives, while managing political interests at the same time.

Accrual or fair value based tax has been proposed by numerous authors. The main criticisms raised against a tax being imposed on accrual of value rather than on the realisation of value are based on problems arising from valuation and liquidity (Shakow, 1985). Concerns regarding liquidity to pay tax on unrealised gains in light of the need to preserve the tax base, as raised by Holmes (2001), are arguably closely related. The use of accounting profits, in particular accounting profits that include fair value measures, may therefore pose liquidity risks. In the long run this may require disposals of capital assets that may have an unrealised fair value to pay taxes. This would in turn gradually reduce the capital bases that produce income to be taxed, thereby causing a shrinking tax base. The liquidity impact of linking the tax base to an IFRS-based measure of profit was considered by the South African National Treasury when section 24JB was introduced. These concerns were mitigated by the fact that the scope of the provision is limited to instruments measured at fair value with movements in profit or loss. These instruments would generally be more liquid instruments held with a short-term or trading intention (National Treasury, 2013; Maroun, 2015). Given the short duration of the instruments, the effect of taxing unrealised gains is unlikely to be significant. In addition, specific items that could have caused liquidity problems are excluded from the scope of the provision in section 24JB (2).

Despite the differences in the objectives of the two profit measures, a degree of overlap exists between accounting profits and taxable profit. As a result, accounting profits are used as a basis for taxation in practice (Harris, 2013). However, a corporate tax base that mirrors accounting profits is an extreme that does not exist to any identifiable extent in practice. Some jurisdictions use certain elements of IFRS to determine taxable income. Harris (2013) found that the vast majority of countries recognise the relationship between accounting profits and taxable profit by requiring the use of accounting profits as a starting point for the calculation of taxable income. Shevlin (2002) suggests that this approach may reduce the ability of firms to shelter reported income from being subject to tax, as companies would generally not understate information reported in their financial statements for various reasons, including potential violation of loan covenants and negative impacts on management compensation. In South Africa, the Act prescribes a specific framework to be followed to determine taxable income. This framework is generally not linked to accounting profits. Some information contained in the financial statements, mostly historic information about transactions concluded during the period, is relevant to the tax authorities. The corporate tax return (ITR14) acknowledges this relationship between financial reporting information and taxable income as it requires profit before tax to be reconciled to taxable income (South African Revenue Service, 2016). The South African National Treasury advanced that one of the main reasons for implementing IFRS-based taxation in section 24JB was the fact that adjustments between tax and accounting profits for entities to which section 24JB apply became so divergent that it was prone to inaccuracies (National Treasury, 2013).

3. AN OVERVIEW OF SECTION 24JB AND TAX PROVISIONS RELEVANT TO HEDGED RELATIONSHIPS

3.1 Section 24JB

3.1.1 Scope of section 24JB

Section 24JB was introduced to simplify the adjustments required between accounting and taxation for large volumes of financial instruments (National Treasury, 2013). As such, it is not a provision that was intended to apply to all taxpayers. The narrow scope of the provision is reflected in its application to covered persons, a term defined in section 24JB(1). It is submitted that the persons included in this definition can be separated into two categories.

Firstly, it includes financial institutions. The definition lists the South African Reserve Bank, any bank, branch, branch of a bank or controlling company as defined in the *Banks Act 1990* (Act No 94 of 1990) (Banks Act). It also includes any company or trust forming part of a banking group as defined in the Banks Act. It does not include insurance companies or subsidiaries of insurance companies.

The second category is any authorised user as defined in section 1 of the FMA. An authorised user is defined in the FMA as a ‘person authorised by a licensed exchange to perform one or more securities services in terms of the exchange rules, and includes an external authorised user, where appropriate’. Security services include the buying or selling of securities for a person’s own account or on behalf of another person as a business, as part of a business or incidental to conducting a business, as well as the use of the trading system or infrastructure of an exchange to buy or sell listed securities.

Securities, in turn, include listed and unlisted shares, debentures, bonds, derivative instruments, notes and certain participatory interests in collective investment schemes. These authorised users are members of the JSE, as published on its website (JSE, 2017). Unlike the entities in the first category, they are not necessarily involved in the business of banking. They would rather deal with the instruments in respect of which they are authorised users in their course of their businesses. This category includes various commodity brokers and traders as members in relation to commodity derivatives. It also includes state-owned entities, such as Eskom SOC Ltd (the South African electricity utility), Telkom SOC Ltd (the South African telecommunications entity), as well as the Trans-Caledon Tunnel Authority and Transnet SOC Ltd (both involved in transport infrastructure in South Africa), that are members in relation to interest rate instruments (bonds) and certain equity derivatives.⁵ These state-owned entities are involved in significant infrastructure development (Fourie, 2001). The focus of this article, in particular the analysis in part 5, is on the application of section 24JB to authorised users, rather than banks and financial institutions.

3.1.2 *The charging provisions of section 24JB*

The charging provisions of section 24JB override the application of the normal principles that determine the timing of taxation of income or deductibility of expenditure (section 24JB(3)). Instead, section 24JB(2) determines that a covered person must include or deduct from income:

all amounts in respect of financial assets and financial liabilities of that covered person that are recognised in profit or loss in the statement of comprehensive income in respect of financial assets and financial liabilities of that covered person that are recognised at fair value in profit or loss in terms of International Accounting Standard 39 of IFRS or any other standard that replaces that standard...

This would include specific instruments and amounts that would disturb the neutrality of the corporate tax system or pose a risk to the tax base. Exclusions exist for these items. The first such exclusion is for certain listed items that are financial assets that were designated upon initial recognition in terms of International Accounting Standard (IAS) 39 *Financial Instruments: Recognition and Measurement* of IFRS (IAS 39) (International Accounting Standards Board, 2015d) by the covered person to be accounted for at fair value through profit or loss because that financial asset is managed and its performance is evaluated on a fair value basis (section 24JB(2)(a)). The second exclusion is for any dividend or foreign dividend received in respect of an instrument measured at fair value that was recognised in profit or loss. These amounts should remain exempt as taxing dividends would disturb the exemption of dividend income at the shareholder level that is available to other taxpayers, which was not the intention with section 24JB (section 24JB(2)(b)).

Section 24JB(2) is the provision that results in amounts recognised in terms of IFRS in respect of the instruments listed in that section being used as the basis for taxing those amounts. The use of IFRS as a basis for taxation is limited to *amounts in respect of*

⁵ These entities may arguably fall outside the scope of section 24JB following the amendments in 2016. This would however depend on the purposes of their trading activities, which depend on the circumstances of each particular entity. In light of the broader objective of this article, as set out in part 1, it is beyond the scope of this article to consider the effect of the 2016 amendments on each such entity.

financial assets and financial liabilities that are *recognised in profit or loss* in the statement of comprehensive income in respect of financial assets and financial liabilities of that covered person that *are recognised at fair value in profit or loss*. Instruments that are not measured at fair value are not affected by section 24JB. This would typically be loans and receivables that are carried at amortised cost (PWC, 2014). Section 24JB therefore does not apply IFRS as the overall tax base, but rather applies it selectively to certain elements, an approach also suggested by Harris (2013) in part 2.3 above.

An anti-avoidance rule exists for agreements entered into between a covered person and a person that is not a covered person with the sole or main purpose of abusing the timing differences that arise between the normal tax base for non-covered persons and the tax base applied by section 24JB (section 24JB(4)).

The remainder of section 24JB deals with transitional provisions upon the initial implementation of section 24JB and the treatment should an entity cease to fall within the scope of this provision. These provisions are beyond the scope of this article and are therefore not considered in further detail.

3.1.3 Application of section 24JB to hedged relationships

Neither section 24JB nor the explanatory memorandum that was issued when section 24JB was introduced (National Treasury, 2013) explicitly state whether the provision applies to or excludes hedging relationships. de Jager et al. (2012) identified the uncertainty in this regard as one of the criticisms against the initial draft version of the provision. Maroun (2015) found the final provisions of section 24JB to be ambiguous as far as hedge accounting is concerned.

The definition of a financial asset for the purposes of section 24JB has been drafted to specifically include 'a commodity taken into account in terms of IFRS at fair value less cost to sell in profit or loss in the statement of comprehensive income'. IAS 2 *Inventories* (IAS 2), the accounting standard that deals with inventory, generally requires inventory to be measured at cost or net realisable value, if this is lower than cost (International Accounting Standards Board, 2015b). It contains an exception for broker-traders who may measure their stock at fair value less cost to sell (International Accounting Standards Board, 2015b). A broker-trader is a person who buys commodities for others or on their own account with the purpose of selling them in the near future and generating a profit from fluctuations in price or broker-traders' margins. The definition of a financial asset in section 24JB refers to this exception in IAS 2. Section 24JB(2) requires that the income of a covered person should include or be reduced by amounts recognised in profit or loss in the statement of comprehensive income in respect of such commodities measured at fair value less cost to sell in profit or loss in terms of IFRS. No specific explanation for the inclusion of these inventory items into the scope of section 24JB was provided in the explanatory memorandum (National Treasury, 2013). It is, however, submitted that these items may often be hedged by commodity forward contracts or commodity futures that fall within the scope of IAS 39 and therefore also within the scope of section 24JB. Failure to include both elements into the tax base would arguably have resulted in a timing mismatch between the gains and losses recognised in respect of an economically hedged commodity carried by the entity (de Jager et al., 2012). This would suggest that the provisions of section 24JB were intended to apply to such relationships.

In addition, as further elaborated in part 4 below, hedge accounting requires measurement of the hedging instrument at fair value. Changes in this fair value are recognised in profit or loss. The timing of the recognition of these amounts in profit or loss depends on the type of hedge and when the hedged item impacts on profit or loss. IAS 39 uses very specific terminology. This includes a category of financial instruments for *financial assets or financial liabilities at fair value through profit or loss*. This category of financial instruments specifically excludes instruments that form part of a hedging relationship. The wording of section 24JB(2) does not require a financial asset or financial liability to fall into this category to be within the scope of section 24JB(2). Section 24JB(2) refers to ‘amounts in respect of ... financial assets and financial liabilities of that covered person that are recognised at fair value *in* profit or loss’ (emphasis added). In the exclusions to section 24JB(2), specific reference is made in paragraph (a) to instruments designated as ‘at fair value *through* profit or loss’ (emphasis added). Given that section 24JB refers to the correct terminology in accordance with IAS 39 elsewhere in the provision, this suggests that it would be correct to conclude that the scope of section 24JB is wider than merely those amounts relating to instruments that strictly fall within the fair value *through* profit or loss category in IAS 39. Similar views on the scope of section 24JB(2) are held by Maroun (2015).

The above approach to interpreting the wording of the legislation by considering the actual wording (in this case, the word ‘in’ as opposed to ‘through’) is supported by the views expressed in *R Koster & Son (Pty) Ltd & another v CIR* 47 SATC 23, 1985 (2) SA 834 (A) that:

in construing a provision of an Act of Parliament the plain meaning of its language must be adopted unless it leads to some absurdity, inconsistency, hardship or anomaly which from a consideration of the enactment as a whole a court of law is satisfied the Legislature could not have intended.

The intention of the Legislature with section 24JB in the context of a hedged relationship would therefore be important. The wording of section 24JB(2) was specifically amended from the initial Bill where section 24JB appeared for the first time. The initial version of section 24JB would have applied to financial instruments recognised *through* profit or loss. Similarly to the final version, it contained certain exclusions. The exclusions however only applied to unhedged positions (*Taxation Laws Amendment Act 2012* (Act No 22 of 2012)). At the time, the National Treasury explained this carve out from the exclusion, which effectively brought hedged positions within the scope of section 24JB, on the basis that the hedged items would also fall under the mark-to-market system. In light of this, the application of section 24JB to a hedged position would not cause any liquidity concerns that may otherwise arise from the items excluded from section 24JB (National Treasury, 2012). This explanation implies that it was intended that items that form part of a hedged relationship should fall within the IFRS-based tax treatment. The broadening of the scope of section 24JB to instruments measured at fair value in profit or loss, as opposed to strictly only those that fall into the IAS 39 category of financial instruments measured at fair value *through* profit or loss, supports the argument that section 24JB applies to hedged relationships where the components are measured at fair value with changes recognised *in* profit or loss, even though these items do not fall into the IAS 39 category of instruments at fair value *through* profit or loss.

A strong argument therefore exists for the view that section 24JB does in fact apply to instruments to which hedge accounting is applied. This conclusion is in line with the views of de Jager et al. (2012) who also came to the conclusion that it appears as though the intention of the Legislature was to tax all value changes from hedged items under section 24JB.

3.2 Other provisions of the Act related to hedged relationships

The Act does not contain any provision that is exclusively aimed at governing the taxation of hedged relationships. The tax implications of the hedged item or transaction and those of the hedging instrument, which is often a derivative instrument, will be determined separately in terms of the provisions generally applicable to the transaction or instrument in an unhedged position. Provisions of the Act that may be relevant to the item being hedged may include section 24J, which deals with interest, and section 24I, which deals with exchange differences, in the case of a loan. Similarly, the Act contains certain provisions applicable to derivatives irrespective of whether they form part of a hedged relationship or not, for example, section 24K and 24L that deal with interest rate agreements and options respectively (Rudnicki, 2003; Masondo, 2009).

In addition to the above, certain subsections of section 24I are aimed at instruments entered into to hedge exchange risk exposure. In the context of forward exchange contracts (FEC) and foreign currency option contracts (FCOC) section 24I contains specific timing provisions in relation to affected contracts to ensure that any exchange gain or loss in respect of a FEC or FCOC is only taken into account when determining taxable income once the debt which is hedged by such an instrument has come into existence during the year. This will to some extent ensure that the gain or loss on the hedging instrument is matched from a timing perspective with the corresponding loss or gain, as the case may be, on the hedged debt (de Koker & Williams, 2016). Furthermore, section 24I(7) determines that where a debt has been used to fund the acquisition of certain assets that have not yet been brought into use in the taxpayer's trade, the exchange differences arising on such a loan should only be taken into account by the taxpayer once the asset is brought into use. Sections 24I(7)(b) and (c) state that an exchange gain or loss on an instrument (FEC or FCOC) entered into to hedge such a loan will follow the same deferral treatment as the exchange differences on the loan.

Other than the above provisions of section 24I, which make explicit reference to a hedged relationship, the normal principles contained in the definition of gross income in section 1(1) and the deduction in section 11(a) of the Act will govern the tax treatment and timing of such implications of derivatives used for hedging purposes (Brincker, 2010). The intention and motive of the taxpayer for entering into the derivative instrument is of importance. In the case of a hedged relationship this intention will be more closely linked to the hedged transaction than to trade or speculate with the derivative instrument (Kruger, 2015).

4. AN OVERVIEW OF HEDGE ACCOUNTING PRINCIPLES

From an accounting perspective, the objective of hedge accounting is to ensure matching of the treatment of the components to the hedged relationship, being the hedged item and the hedging instrument. This primarily includes matching from a

timing perspective, but also matching as far as the element of the financial statements where such gains or losses are recognised (i.e. in profit or loss or other comprehensive income) is concerned (PWC, 2014). IAS 39 prescribes rules for hedge accounting. Hedge accounting treatment overrides the ordinary treatment of the hedged instrument, and in some instances, the hedged item. The definition of a financial asset or financial liability at fair value through profit or loss excludes derivative instruments that are designated and effective hedging instruments from being classified as held for trading, and consequently from being categorised as financial instruments at fair value through profit or loss (definitions in IAS 39.9).

In order to qualify for hedge accounting, IAS 39 requires that certain criteria be met. These include that the hedged relationship must have been formally designated and documented at inception (IAS 39.88(a)). The hedge must be expected to be highly effective in offsetting the changes in the fair value or cash flow attributable to the hedged risk (IAS 39.88(b)). IAS 39.88(d) and (e) furthermore require that the effectiveness of the hedged relationship must be reliably measurable and that the hedge must have been determined to actually be effective throughout the periods designated. This is the so-called retrospective effectiveness test. These requirements are amended by IFRS 9 *Financial Instruments* (IFRS 9) (International Accounting Standards Board, 2015e) to more closely reflect the commercial realities of hedged relationships. As this standard only becomes effective on a compulsory basis for annual periods beginning on or after 1 January 2018 (IFRS 9.7.1.1.), the changes to hedge accounting have not been taken into account for the purposes of this research.

IAS 39 distinguishes between three types of hedged relationships. Only two are relevant for the purposes of this discussion. These are fair value and cash flow hedge relationships.

A fair value hedge is described in IAS 39.86(a) as ‘a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss’. Where such a hedged relationship exists, IAS 39.89 requires that the gain or loss from the remeasurement of the hedging instrument at fair value in the case of a derivative hedging instrument be recognised in profit or loss. In order to achieve matching and reflect the hedged relationship in the reporting entity’s profit or loss, it requires that the gain or loss on the hedged item attributable to the hedged risk (i.e. a change in fair value of the item due to identified risks) also be recognised in profit or loss. This is the case irrespective of whether such an item would otherwise have been measured on another basis in the absence of hedge accounting.

An aspect of fair value hedge accounting that is of particular relevance for this research is the inclusion of hedges of exposure arising from unrecognised firm commitments. IAS 39 defines a firm commitment as ‘a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates’. Accounting matching is achieved by recognising an asset or liability for the gain or loss made on the unrecognised firm commitment, with the corresponding entry being recorded in profit or loss (IAS 39.93). This effect in profit or loss offsets the gains or losses on the hedging instrument. When the firm commitment realises and the entity acquires an asset or assumes a liability, this asset or liability contemplated in IAS 39.93 should be set off against the initial carrying

amount of the asset or liability that results from the firm commitment in accordance with IAS 39.94.

Cash flow hedge accounting on the other hand does not affect the accounting treatment of the hedged item that gives rise to the cash flow to expose the reporting entity to a particular risk. IAS 39.95 requires that the portion of the gain or loss on the hedging instrument that is an effective hedge in terms of IAS 39.88 be recognised in other comprehensive income (hedging reserve). IAS 39.88 views a cash flow hedge as effective if the changes in the fair value of the hedging instrument offset the changes in the cash flow resulting from the hedged risk. Unless the relationship involves hedging of risks from forecast transactions, IAS 39.100 requires the amounts recognised in the hedging reserve in respect of the hedging instrument to be reclassified to profit or loss when the hedged forecast cash flow affects profit or loss. In this manner, the effects of the hedged transaction and hedging instrument are taken into account in profit or loss at the same time.

5. MISMATCHES CAUSED BY SECTION 24JB IN THE CONTEXT OF HEDGED RELATIONSHIPS

This section of the article highlights mismatches that arise when section 24JB is applied to certain types of hedged relationships by authorised users. These scenarios considered arise from practice and the tax implications thereof under section 24JB have not previously been documented in literature.

5.1 Authorised users involved in infrastructure development

South African entities involved in infrastructure development are likely to be exposed to risks arising from the arrangements entered into to fund these developments. These risks are likely to be exchange risk and interest rate risk. An interest-bearing loan from an external funder will be measured at amortised cost in terms of IAS 39. The interest on the loan will be recognised in profit or loss in accordance with the effective interest rate method, while any exchange differences arising on the instrument and the accrued interest will be accounted for in terms of IAS 21 *The Effects of Changes in Foreign Exchange Rates* (IAS 21) (International Accounting Standards Board, 2015c). This standard specifies how exchange differences should be determined and recognised in profit or loss (IAS 39.AG83). The loan, interest and related exchange differences are therefore not accounted for at fair value. If the loan is designated as a fair value hedge, one may however be able to argue that IAS 39.89(b) changes this treatment as it requires the gain or loss on the hedged item to be recognised in profit or loss.

The hedging instrument is always measured at fair value (refer to the discussion in part 4). In the case of a fair value hedge, the timing of the recognition of any gain or loss on the hedging instrument is matched with the timing of the gain or loss on the hedged item. In the case of a cash flow hedge, the recognition of the fair value movements on the hedging instrument is deferred until the hedged cash flow affects profit or loss. Under both fair value and cash flow hedge accounting, the neutral hedged position (i.e. neutral from the perspective of economic gains or loss in respect of the hedged risk) will ultimately be reflected in profit or loss.

From a tax perspective however, section 24JB will only apply to elements of the hedged relationship that are financial assets or liabilities measured at fair value and for which amounts are recognised in profit or loss. This will be the hedging instrument, which in the case of exchange and interest risk exposure is likely to include FEC, interest rate derivatives or cross currency swaps. In the case of a fair value hedge, this fair value gain or loss is taken to profit or loss immediately. In the case of a cash flow hedge, the gain or loss is initially deferred but will ultimately be recognised in profit or loss and should therefore be within the scope of section 24JB. The effect of the application of section 24JB is that the gains or losses on these instruments will be included or deducted, as the case may be, from taxable income when such gains or losses are recognised in profit or loss for accounting purposes.

As the loan, the hedged item, does not fall within the scope of section 24JB (at least in the case of cash flow hedge accounting), the provisions of section 24J, dealing with interest, and section 24I, dealing with exchange differences will be relevant. These provisions are generally aligned with the accounting treatment which will result in there being no timing mismatch. However, when the asset funded by the hedged loan is still under construction or has not yet been taken into use, section 24I(7) applies (refer to the discussion in part 3.2). The effect of this provision is that any exchange gains or losses are deferred until the asset is taken into use. As a result, the taxpayer may be in a position where the gains or losses on the hedging instruments are taken into account in taxable income when recognised in profit or loss for accounting, while some of the gains or losses attributable to the hedged risk (hedged item) are deferred on the basis of whether the asset is in use or not by a tax provision. This could result in a taxpayer being liable for tax on the gains made on a hedging instrument in times when the underlying risk on the hedged item realises, but the assets funded by the hedged item are not yet in use. This issue may to an extent be eliminated by the 2016 amendments as the entities may be authorised users primarily for treasury activity purposes.

5.2 Commodity brokers and traders who are authorised users

Commodity brokers will enter into hedged relationships in respect of commodities prior to the acquisition of the commodities and while holding the commodities with a view to selling them in the future. In South Africa the risk exposures from these transactions or events are hedged with derivative instruments listed on the JSE SAFEX (Middelberg & Buys, 2012). These derivatives are the instruments in respect of which a commodity broker will be an authorised user (refer to the discussion in part 3.1.1).

In the case of a contract with a producer to acquire the commodity in the future, the commodity broker may enter into a forward contract to sell the commodity at a determined price at a date around the delivery date. In this manner, the commodity broker ensures that it will acquire the commodity to trade in the future but is not exposed to price risk from its arrangement with the producer. The contract entered into with the producer will represent a firm commitment for the purposes of IAS 39. If the commodity broker applies hedge accounting, IAS 39 requires that the gains or losses on the derivative as well as the corresponding losses or gains in respect of the firm commitment be recognised in profit or loss. As indicated in part 4, the amounts recognised in respect of the firm commitment movements will ultimately be treated as an adjustment against the purchase price of the commodity when it is acquired. If the relationship is not accounted for using hedge accounting, IAS 39.5–39.7 may allow

the agreement with the producer to be accounted for as if it was a derivative financial instrument. It is important to note that both of these scenarios are likely to reflect the neutral economically hedged position in the profit or loss of the commodity broker and entities may elect not to apply hedge accounting for this reason. However, section 24JB only applies to financial assets (which includes inventories as discussed in part 3.1.2) and financial liabilities. It does not apply to firm commitments or to items that are accounted for as if they were financial instruments. As such, the commodity broker will be required to include the gains or losses on the hedging instrument in its taxable income on the same basis as financial reporting, while the gains or losses on the hedged item will follow normal tax principles which require realisation of the transaction before its effect is taken into consideration in taxable income. This timing mismatch arises only for purposes of taxation, while accounting reflects the economically neutral position.

Once the commodity trader holds the inventory it will enter into a further derivative that offsets the movements in the value of the commodity held. This can be a SAFEX traded derivative contract (forward sales agreement) or a sales contract with a purchaser to deliver the commodity at a future date. If hedge accounting is applied to this relationship this will be a fair value hedge of the inventory on hand. As such, the changes in fair value of the commodity inventory will be recognised in profit or loss (IAS 39.89(b)) as opposed to IAS 2. The changes in the fair value of the derivative instrument will be recognised in profit or loss in terms of IAS 39.89(a). In this instance, the derivative contract will fall within the scope of section 24JB, while inventory that is not accounted for in terms of IAS 2 will be outside the scope of the provision and any gain or loss will only be reflected once the product is sold. A timing mismatch will again arise.

6. RISKS OF IFRS-BASED TAXATION AS ILLUSTRATED BY THE APPLICATION OF SECTION 24JB TO HEDGING RELATIONSHIPS OF AUTHORISED USERS

IFRS-based taxation may simplify the process of determining taxable income (National Treasury, 2013). However, certain liquidity risks arise when tax is imposed on a basis other than on a realised gain or loss basis. Some of these mismatches are evident from the analysis of the application of section 24JB to hedged relationships in part 5 above. The irony of this finding in the context of the application of section 24JB to hedged relationships is that the impact of the relationship is neutral on accounting for profit or loss but not on taxable income. It is submitted that this finding stems from the fact that in each of the instances considered in part 5 above, one element of the hedged relationship was within the scope of section 24JB (the hedging instrument), while the other (hedged item) was not. Even though Harris (2013) warns against tax provisions that fully mirror IFRS, the scenarios considered illustrate the risk of partially applying certain provisions of IFRS as a basis for taxation. If all the IFRS provisions relevant to a transaction are not included in the tax base, a mixed tax base could apply to a single transaction. This has the potential to cause mismatches such as the ones illustrated in part 5. It is submitted that both the approaches of a tax base that fully mirrors IFRS or a partial or adapted IFRS basis may be problematic. This casts doubt about the appropriateness of IFRS as a basis for taxation.

Although the positions of infrastructure developing entities that are members of the JSE in respect of certain instruments and commodity brokers highlight various mismatches that can arise when using IFRS as a basis for determining taxable income, the ultimate broader finding is similar.

In the context of infrastructure developing entities that are members of the JSE in respect of certain instruments, which are likely to represent a very small part of their overall activities, the question can be posed whether all financial instruments of a certain category should be tainted and possibly be taxed in accordance with IFRS merely by reason of the fact that these entities are members of the JSE in relation to some instruments. The mismatches caused by the wide application of section 24JB to all instruments of a certain class of a covered person, irrespective of whether that is the instrument in respect of which the covered person is a member of the JSE or not, shows the risk of possibly casting the scope of a tax provision, which is motivated mainly by convenience, too wide. As such, it is submitted that the lesson to be taken from this aspect of section 24JB is that where IFRS-based taxation is applied, this should be limited to narrow and well-defined transactions where this may be appropriate as opposed to overall classes of persons and instruments.

In the context of commodity brokers and SAFEX derivatives, the provisions of section 24JB are not necessarily the only cause of the mismatch. As these derivatives (hedging instruments) are marked-to-market and settled on a regular basis, some arguments may exist that these mismatches could have existed previously as well. As such, the use of IFRS, which takes the hedged relationship that the derivative forms part of into account, should be welcomed by the affected taxpayers as a positive development. In light of this it is submitted that the use of IFRS as a basis for taxation will not necessarily be inappropriate, especially in cases where the accounting treatment reflects the economic substance of a transaction. Similarly to the conclusion in relation to infrastructure developing entities, the recommendation in this regard is however that it may be more appropriate to follow IFRS principles for specific well-defined transactions where it may be appropriate, in this instance, hedged relationships entered into by commodity brokers. The views expressed in the context of infrastructure developing entities are also relevant in this context of commodity brokers, as the wide inclusion of instruments based on the nature of the person as an authorised person may include certain trading instruments not used for hedging that the commodity broker may have into the fair value tax net while the person is not an authorised user in respect of all of these instruments.

Where a transaction exists for which IFRS may be an appropriate basis for taxation, it is imperative that *all* the relevant IFRS provisions be used as a basis for taxation to avoid mismatches. It is submitted that section 24JB lacks in this regard as it does not recognise hedging concepts used for accounting purposes, for example, firm commitments. Similarly, it does not apply to inventory remeasured under hedge accounting or hedged items affected by cash flow hedge accounting. As a related point it is submitted that linking tax law to another framework would require the Legislature to be, and constantly remain, up-to-date with any changes to how IFRS may have an impact in any manner on the tax base. The imminent transition to IFRS 9, which contains its own hedging rules, is a good example of this. Maroun (2015) similarly identified the risk that tax law linked to IFRS may no longer be fully within the control of the Legislature, even though this concern would partially be addressed by carve outs in the tax legislation where the accounting treatment may pose a

particular tax risk. However, such carve outs run the risk of causing mismatches. It is submitted that if the use of IFRS as a basis for taxation ends up requiring various complex carve outs, tax law drafted to have a similar outcome to IFRS would be a more feasible alternative.

As a last observation from the analysis in part 3.1.3, it is submitted that when linking one framework (in the case of section 24JB in determining taxable income) to another (elements of IFRS-based profit or loss), the use of accurate terminology is of utmost importance. If the phrase ‘amounts in respect of ... financial assets and financial liabilities of that covered person that are recognised at fair value *in* profit or loss’ (emphasis added) in section 24JB is interpreted as referring to the IAS 39 category of *financial assets or financial liabilities at fair value through profit or loss*, this has a significant effect as this IAS 39 category of financial instruments excludes derivative instruments that form part of a hedged relationship. Uncertainty of this nature does not contribute to the objective of simplification of the taxable income calculation.

7. CONCLUSION AND RECOMMENDATIONS

This article considered whether section 24JB of the Act succeeds in reflecting the economic outcome of such hedging relationships in the taxable income of authorised users who are required to apply this provision. The research however aimed to achieve a broader objective by illustrating some of the risks of IFRS-based taxation from the analysis of section 24JB.

In relation to the detailed provisions of section 24JB, part 5 of this article contains a number of technical concerns that should be considered by the Legislature to ensure that this section has no unintended consequences when it is applied to hedged relationships of authorised users. Some of these concerns may have been addressed by the 2016 amendments to section 24JB. The analysis of the provision prior to its amendment is however useful as it illustrates the risks that IFRS-based taxation may have.

Part 6 of the article provides a broader perspective on risks posed by IFRS-based taxation. It is suggested that IFRS-based taxation may be appropriate in certain instances. The application of this basis of taxation should preferably be limited to specifically identified and narrowly-defined types of transactions rather than broad categories of instruments or persons. The inherent risks of the tax base being linked to an external framework and the interpretation issues that may arise from terminology not being absolutely consistent between the two frameworks should be closely considered if an IFRS-based approach to taxation is followed.

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