

Out of the Tax Wilderness

The rule of law is collapsing in the Australian tax system. **Geoffrey de Q. Walker** suggests some ways to re-build it.

The Australian tax system displays a range of symptoms suggesting a virtual collapse of the rule of law. There is a flourishing cash economy which, as Mark Latham points out, at an estimated 15% of GDP is one of the developed world's largest and equivalent to New Zealand's entire economy.¹ An underground economy of that magnitude requires the involvement not only of many businesses, but also of millions of consumers, who apparently believe that the greater spending power they can achieve through cash discounts is worth more than the duty to comply with a law they obviously consider unworthy of respect.

Another symptom is the growing irrelevance of the law and its institutions. Tax advisers struggle to cope with a body of law that the Federal Court's Justice Hill, then a leading tax barrister, in 1987 described as 'unintelligible'.²

Normal legal advice is problematic because otherwise lawful arrangements can be overridden through the semi-subjective appraisals of purpose creeping into the application of Part IVA of the *Income Tax Assessment Act 1936* (Cth). The High Court now seldom grants leave to appeal in federal tax cases, as if it had given up hope of keeping the tax system subject to legal principle and normal adjudication methods.

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The present state of the rule of law in the federal tax arena stems from a number of immediate causes. These causes can also be viewed as symptoms because, as general systems theory tells us, effects have a tendency to feed back into the causation process.³

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Symptoms and causes

1. Tax legislation: volume and uncertainty

The sheer quantity and ever-changing content of tax legislation is undermining its ability to command general obedience. That is partly because of the practical difficulty of knowing what the law is and what it means. Before the High Court in the 1942 *First Uniform Tax Case* gave the Commonwealth a monopoly (at first *de jure*, later *de facto*) of income taxation, the relevant federal legislation occupied 81 pages in the statute book. Now it has exploded to 8,500 pages, or 13,500 pages if one includes fringe benefits, capital gains and superannuation provisions.

Behind the vast volume of actual legislation looms an equally massive bulk of Australian Taxation Office (ATO) public determinations, public rulings, bulletins, interpretative decisions, policy papers, circulars, administrative guidelines and practice statements. In generating this mountain of administrative norms the ATO may be doing little more than trying to make an unworkable law work, but the net result is to add to the system's unfathomable obscurity. This makes predictable interpretation and reliable advice next to impossible.

Uncertainty in the law is a major factor in undermining the rule of law, and tax is riddled with it. As Lord Oliver has pointed out, where

there are legal rules in an area without a clear moral imperative, the rules must be clear.⁴ On the question of tax law's moral content Justice Learned Hand was blunter: '[N]obody owes any public duty to pay more than the law demands. Taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant'.⁵ Whatever moral force the legislation may have is undermined when its complexity and ambiguity make outcomes depend, not on working out the right answer, but on inside knowledge, administrative concessions or luck.

The attitude of many taxpayers (other than the wretched conscripts of the PAYE army) is increasingly to treat the law and the courts as irrelevant. Legal advice leaves them unmoved. All they really want is an ATO ruling that will protect them from penalties or prosecution. Many just surrender and let the government have its way. 'A common comment by corporates now', observes KPMG's Michael Evans, 'is, "I know I'm not getting it right but if the Tax Office wants to come out and go through everything and tell me where I've underpaid, I'll pay it because that is cheaper than putting a process in place to comply with it."⁶

2. Statutory discretions: wagging the dog?

A further symptom of the law's growing irrelevance in the tax field is the swelling number of wide statutory discretions granted to the commissioner. The ultimate grant of discretionary power is Part IVA, enacted in 1981 and to which the rest of the Act is subject. Australia has placed more reliance on the general anti-avoidance rule ('GAAR') than any other Western democracy,⁷ and Part IVA's supporters argue that it may strengthen the rule of law by increasing compliance with tax legislation.⁸ The problem, however, is that it seeks to encourage compliance by means that compromise the rule of law, for example by depending on discretion and opinion.

Part IVA enables the ATO to alter the scope of the tax law, to impose what amounts to a tax by analogy where none was imposed by the statute. It can declare after the event how much tax is to be paid without saying it in advance. The ATO's

exercise of its discretions may be reviewable by a court but, quite apart from the difficulty of persuading a court to overrule a discretionary ATO decision when the burden of proof is reversed as in Part IVA appeals, vesting a wide discretion in a court is no great improvement on vesting it in an executive official.

Judicial review serves the rule of law when courts apply known rules and principles, not when their decisions may turn on their opinion about someone's purposes or on policy questions, and when the result may be to disapply explicit statutory provisions. Neither Britain nor the United States has a GAAR, and practitioners from those countries aver that the rule of law has survived relatively well in their tax systems.

The grant of wide discretions has two main consequences for the rule of law. First, it conflicts with both the principle of legal certainty and the principle of equality before the law. It becomes harder for citizens to plan ahead if they have no sure way of ascertaining what their future tax liability will be (subject to the rulings system, of which more in a moment), while the discretions are so wide that there is no assurance that similar cases will be treated in a similar way.

Second, broad discretions threaten the constitutional principle that no tax should ever be laid that has not been specifically authorised by parliament. That principle was established by John Hampden in his resistance to paying ship-money in 1637 and later reasserted, in different ways, in both the French and American revolutions. In Edmund Burke's words, 'Would 20 shillings have ruined Mr Hampden's fortune? No! But the payment of half 20 shillings, on the principle it was demanded, would have made him a slave'.⁹

3. *The rise of the ATO as deciding authority*

A third symptom is the growing ascendancy of the Australian Taxation Office as the final authority, combining aspects of the executive, judicial and even legislative roles. Only the largest corporations and wealthiest taxpayers can now afford to challenge an ATO decision in court or otherwise seek judicial review. For most

citizens today, the best source of 'legal' certainty is an ATO ruling.

Under the system of self-assessment, itself made necessary by the inability of tax assessors to keep up with the flood of amendments and case-law, some form of binding ruling procedure was essential if any reliable predictions of tax liability were to be possible. Hence the introduction in 1992 of the present public and private rulings regime, embodying dispensing powers of such scope as to make a James II sob with envy.

Useful though it is in present conditions, the rulings system has adverse consequences. One is that it weakens the separation of powers. A central tenet of that doctrine is that it must not be possible to change the law at the point of application. That ensures that the judicial function determines the citizen's rights by reference to previously enunciated legal rules and principles rather than by personal opinions or extraneous policy considerations.

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The system of binding rulings puts the ATO in the position of giving effectively final determinations, thereby intruding into the judicial function and making the ATO judge in its own cause. At the same time it overlaps into the legislative role, as in the system of internal directives described above, or when we see the ATO laying down what look very much like statutory rules, as in the case of limited recourse loans in *Firth*.¹⁰

If those separation lines become blurred, as they have following the expansion of the ATO's role, other consequences will start to appear. Under such a system, Professor Waincymer points out, 'There is also no guarantee that the administrator will be impartial, fair or would

appropriately balance the interests of taxpayers against the interests of revenue collection'.¹¹ On the contrary, there is good reason to fear that constant government pressure on the ATO to maximise collections will have the opposite effect. It may weaken the principle of even-handed enforcement which, like equality before the law, is an important element of the rule of law.

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The dynamics of deadlock

The Commonwealth's approach to avoidance and the underground economy has been to attack selected symptoms. The PAYG system and the GST have set off in pursuit of part of the cash services sector. Discretionary powers and Part IVA lie in wait for those who do not cleave to the spirit of the law. But for all that the frontline has not moved far. Increasing the authorities' enforcement zeal may be counterproductive if it fails simultaneously to deal with underlying causes.

The symptom-oriented approach will only ensure that the problems of evasion, avoidance and pathological administration will reappear in some other form, such as emigration, leisure substitution and the storming of remaining shelters, such as negative gearing. That will follow inevitably if reform disregards the basic dynamic of federal taxation in Australia today. That dynamic is the irreconcilable confrontation between the two opposing forces of (1) revenue raising and (2) resistance.

1. Revenue raising

Formerly, economists and political scientists interpreted the revenue-raising process through

the 'benevolent despot' model, under which the institutions of power were assumed to act in the 'public interest'. Government was seen as raising revenue to the extent needed to pay for a suitable list of public goods. If citizens conscientiously paid their tax and a surplus resulted, government would reward them with a tax cut.

That perspective was first questioned by the Norwegian scholar Knut Wicksell, who complained that it 'seem[ed] to have retained the assumptions of its infancy, in the 17th and 18th centuries, when absolute power ruled almost all Europe'. It was also criticised as being 'unmotivated', and thus unconvincing: it offered no reason why governments or rulers would be motivated to use their power to advance the public interest rather than their own.¹²

A model that would explain public finance in the context of a modern mass democracy was thus needed. It was supplied by public choice theory, which is essentially the application of economics to political science, and which posits that politicians and bureaucrats act from the same motives of self-interest as everyone else. 'The State is not the agency that nobly and conveniently steps in to correct the supposed deficiencies of the free market', writes Professor Gary Anderson, 'but a giant rent-seeking machine that provides coercive wealth transfers to the highest bidder'.¹³

Public choice economics has replaced the benevolent despot theory with the model of government as a Leviathan that spends up to the limit of its revenue-raising capacity. This view offers a much better explanation of contemporary reality and has annihilated the old benevolent despot view, at least among economists.¹⁴

The public choice perspective also points out that normal electoral processes are insufficient to restrain self-seeking governments and bureaucracies. The authors note that the tax revolt in the United States began in 1979 with Proposition 13, a California citizen initiated referendum (CIR) measure. It emerged from outside the normal parliamentary processes and interparty competition, in the face of opposition from most of the political and media establishment.¹⁵

2. Resistance

There will always be some people who will break even the fairest tax laws. Those Sydney barristers who omitted ever to lodge a return did so even in the 1960s, when they would have paid a marginal rate of only 25%. But today's trench warfare between non-compliance and government arbitrariness is a comparatively recent phenomenon that dates only from the 1970s. The 1950s and 1960s, one perplexed commentator observes, were marked by an 'almost sheep-like taxpayer compliance' that mysteriously broke down in the next decade.¹⁶ This account overlooks the crucial development that transformed taxpayer attitudes—the ravaging inflation unleashed by Frank Crean's 1973 and 1974 federal budgets which distorted the established tax scales out of recognition and vastly increased the burden of government on the people. Those distorted scales remain substantially uncorrected to this day.

Until the massive bracket creep of the 1970s, most people complied with the tax laws, partly because they considered them reasonably fair, and partly because non-compliance did not pay—the relatively minor savings obtainable did not warrant the costs and risks involved. Thus, taxpayer compliance was rewarded with reasonable tax laws; or, more accurately, reasonable tax laws were rewarded with taxpayer compliance.

Australians have never voted for income taxes at the present rates and would have defeated any government that proposed them. The current situation is the result of bracket creep and failure to reform, and its results have been a decline in taxpayer morality: people do not regard working in the cash economy as cheating because they believe they are paying too much.¹⁷ Government must increasingly rely on withholding or reporting at source. While the cash economy has been called the tax avoidance of the masses, even the masses have been venturing into sophisticated forms of tax avoidance, with construction workers, Melbourne tram drivers and Sydney bicycle couriers being notionally employed by their own service companies and people of moderate means negatively gearing a second property.

Under our unreformed system, perverse incentives abound. At the lower levels, the growing tax burden is driving onto the welfare rolls people who could support themselves if taxes were lower.¹⁸ The low tax-free threshold of \$6,000 gives them every incentive to stay on welfare, as they face effective marginal rates of up to 70% if they resume work and thereupon lose welfare payments. At the higher levels, a tax-driven brain drain is developing. Robert Gottliebsehn warns: 'Many [expatriates] intend to return but discover the 48% tax rate cutting in at ridiculously low levels means they can't afford to move home until they've made their fortune offshore. It's then too late . . .'.¹⁹ Australia's diaspora now numbers over one million, a high proportion for a young country of 20 million which is in other respects regarded as a good place to live.

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The potential for real reform

The rule of law is thus being steadily undermined by increasing resistance by the population, which is met by ever-increasing arbitrariness by the authorities. The two sides are deadlocked in a downward spiral of dysfunctionality. Indeed, on current indications the chasm between Australian federal taxation and the rule of law is likely to widen. The Integrated Tax Design concept currently being trialled by the ATO for possible general adoption contemplates that the law should no longer attempt to deal with complex situations. These would instead be

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directly regulated through administrative rulings. Specific anti-avoidance provisions binding on all taxpayers would be replaced by 'compliance strategies' targeted to the 'risk profile' of various 'users'.²⁰ It does not take much legal imagination to see where that approach is likely to lead.

Tinkering with tax legislation and procedures will not revive the rule of law or restore government institutions to their proper roles. Curtailing discretionary powers, rewriting the legislation or other symptom-oriented solutions that do not tackle the underlying revenue-raising and enforcement versus resistance dynamic will only cause the confronting pressures to break out elsewhere in the system. True reform will need to be substantial enough to change the pattern of incentives so that, as in the 1950s and 1960s, most people will voluntarily meet their obligations and enforcement pressure is needed only to deal with the greedy few. The rule of law can operate only where most people are willing to obey the law voluntarily most of the time.

To be effective, any programme to restore the rule of law in the tax field must therefore start from these propositions:

Reversing negative incentives will entail substantial tax rate cuts

To have any significant impact on the present morass of disincentives, distortions and non-cooperation, effective reform must include substantial reductions in the personal income tax burden. The modest cuts delivered so far are too small to affect incentives. A good place to start would be the tax-free threshold (TFT) or zero rate step. At present, liability to income

tax begins at an income of \$6,000 per annum. That is less than half the annual dole of \$12,370 (including rent assistance for a single person) or just over a quarter of the federal minimum wage of \$22,400. In 1980 the TFT was \$4,441, which in today's dollars would be \$14,000. For comparison, the French TFT today is 15,000 euros (\$25,000).

Next, the rate structure must be overhauled. It must be hard for citizens to feel any respect for a system under which, as now, a worker on close to the average weekly wage pays a marginal rate of 42%. And with the next step starting at \$62,500, an absurdly low figure by world standards, such modestly remunerated people as schoolteachers and nurses are joining Kerry Packer in the top bracket, which now catches one taxpayer in five.

To reverse the brain drain, promote growth and restore the ethic of compliance, the top marginal rate should be cut to 30% and should commence at a much higher level than the present \$62,500. Corresponding adjustments to the other rates would be needed. A top rate of 30% would match the company tax rate and would permit substantial administrative simplification. It would make the nation competitive in the race for internationally mobile capital and skilled labour, as a 2002 IMF assessment of the Australian economy argued.²¹ It would also help to reduce Australia's high tax enforcement and collection costs.

Large cuts need not cause revenue loss

Experience shows that such large reductions need not cause a loss of revenue and usually lead to increased collections (as has happened in Australia following the substantial cut in the company tax rate). A spectacular recent example is Russia, which in 2001 abandoned its 'progressive' rates and adopted a 13% flat tax on personal income. The lower rate, limited deductions and simpler system have produced vastly more revenue, with a 50% real increase in the first two years and overall economic growth of 10%. Over three years, income tax collections as a percentage of GDP have increased from 9% to 16%. Small business has a choice of either paying a 6% flat tax on their revenues or a 15% flat tax on their profits. Russia now has a budget surplus and

the best tax laws in Europe.²² It is ironical that Vladimir Putin, a former head of the KGB, has given Russia a liberal, incentive-building revenue law while Australia still suffers under a tax regime based on class warfare ideology.

Tax indexation must be restored

A vital part of any reform programme must be the immediate restoration of tax indexation, the lack of which is the main cause of our current misfortunes. Even the present cumulative inflation rate of 3%, while low by the standards of recent decades, is high by those of history and, if not compensated for in tax scale adjustments, will over time effect a substantial transfer of resources from the people to the government. Leviathan must not be allowed to profit from his own wrong, silently debasing the currency so as to drive lower-paid workers into higher brackets. This reform also has the advantages of having little immediate impact on budgeting and of being almost impossible for the opposition in the Senate to reject.

Tax indexation should be a statutory, automatic mechanism similar to that introduced by the Fraser government, rather than a 'manual' process as in the United Kingdom, where thresholds are raised each year in the budget as a matter of practice and convention.

Welfare reform should accompany tax reform

Controlling public sector growth is a key issue in the tax debate. The largest single head of public spending is social welfare, which accounts for 29% of government outlays, federal, state and local. Federal welfare payments alone swallow 10% of GDP.²³

Since the 1960s the real national wealth, at all levels of income, has doubled. Yet during that period government spending on welfare benefits and services has increased five-fold in real terms, and reliance on welfare support as the sole or principal source of income has increased from 3% to 14%, or one in every seven working-age adults. The welfare state now employs almost one-fifth of the Australian labour force.²⁴

The conditions now exist for a fundamental reappraisal of the welfare system.

Recent scholarly re-evaluation of the concept of poverty, which currently focuses on inequality rather than need, shows great potential and support for slimming the public sector and reducing the tax burden.²⁵ But reform proposals face determined opposition from vested interests, especially the welfare industry. That group is also in denial about the spectacular success of the Clinton administration's 1996 legislation aimed at reducing the number of lone parents living on welfare, which cut numbers on the welfare rolls by 58% in the first three years,²⁶ while the critics' predictions of a humanitarian disaster were falsified.²⁷ The 1996 US legislation stands as one of the few examples of a social reform that has actually achieved its objectives.

Surveys show that a large majority of Australians favour a welfare system that is based on mutual obligation and caters for genuine need, not one based on fallacious, ideologically-driven definitions and assumptions. The potential is there for substantial improvements in Australia's institutional structure and competitive position if the reform process can be shifted from its present narrow focus on purely technical improvements to a broader, more principled perspective.

The beginnings of a public debate about tax are now being heard. There is talk of a higher tax-free threshold, flat rates and abolishing returns for most workers.²⁸ The parliamentary Labor Party is reportedly considering a top rate of 35% as a possible policy option.²⁹ We are hearing less of the notion that Qantas flight attendants earning \$65,000 or Holden night-shift assembly workers on \$72,000 are plutocrats who deserve outright fiscal punishment. 'The incentive system is all wrong,' complains Mark Latham. 'The hard workers are being punished while the rorters are being rewarded . . . For the people who do the right thing in our society, the system is crook'.³⁰ Australia faces a once in a generation opportunity to opt for fairness and growth. It must not be allowed to pass us by.

Endnotes

- ¹ Mark Latham, 'Those Chains are Stifling Spirit', *The Australian* (18 November, 2003), p. 11; The ATO disputes the 15% estimate but offers no

- definite figure of its own: ATO Cash Economy Task Force, *The Cash Economy under the New Tax System*, Report No. 3 (September 2003), ch. 1.
- ² D.G. Hill QC in Robin Woellner, Trevor Vella, Lee Burns, *Australian Taxation Law*, 5th edition (Sydney: CCH, 1994), Foreword to the first edition, p. v.
- ³ Geoffrey Walker, *The Rule of Law: Foundation of Constitutional Democracy* (Melbourne: University Press, 1988), p.66. I refer to this not as 'authority', but to incorporate certain lines of argument by reference for the sake of brevity.
- ⁴ Lord Oliver, 'Judicial Approaches to Revenue Law', in Malcolm Gammie, A. Shipwright (eds.), *Striking the Balance: Tax Administration, Enforcement and Compliance in the 1990s* (London: Institute for Fiscal Studies, 1996), p. 174.
- ⁵ *Commissioner of Internal Revenue v Newman*, 159 F.2d 848, 851 (2d Cir. 1947), J. Hand, dissenting.
- ⁶ 'Push to Simplify Income Tax Rules', *The Australian Financial Review* (3 June, 2003), p.1.
- ⁷ Jeffrey Waincymer, 'The Australian Tax Avoidance Experience and Responses: A Critical Review', in Graeme S. Cooper, *Tax Avoidance and the Rule of Law* (Amsterdam: Tbfd Publications, Australian Tax Foundation, 1997), p. 247.
- ⁸ Cooper, 'Conflicts, Challenges and Choices: The Rule Of Law and Anti-Avoidance Rules', in Cooper, *Tax Avoidance and the Rule of Law*, n. 7 above, p. 49.
- ⁹ Edmund Burke, 'Speech on American Taxation', F. Selby (ed.), *Burke's Speeches* (London, 1930), pp. 12-13.
- ¹⁰ *Federal Commissioner of Taxation v Firth* (2002) 50 ATR 1.
- ¹¹ Waincymer, 'The Australian Tax Avoidance Experience and Responses', p. 304.
- ¹² Knut Wicksell, 'A New Principle of Just Taxation', (first published 1896) in R.A. Musgrave, A.T. Peacock (eds.), *Classics in the Theory of Public Finance* (London: Macmillan, 1958), pp. 72, 82; Gary M. Anderson, 'Referendum, Redistribution and Tax Exemption: A Rent Seeking Theory of Direct Democracy', in Donald P. Rachefer and Richard E. Wagner, *Politics, Taxation and the Rule of Law* (Dordrecht: Kluwer Academic Publishers, 2002), p.81.
- ¹³ Anderson, 'Referendum, Redistribution and Tax Exemption', p.82.
- ¹⁴ As above, p. 81.
- ¹⁵ Alvin Rabushka, Pauline Ryan, *The Tax Revolt* (Stanford: Hoover Press, 1982), pp. 21-26.
- ¹⁶ John G. Head, 'Tax Reform: A Quasi-Constitutional Perspective', in Cooper (ed), *Tax Avoidance and the Rule of Law*, pp. 155, 178-80.
- ¹⁷ 'Experts Warn on Rising Number of Copycat Cheats', *The Sydney Morning Herald* (3 June, 2003), p. 6. When the people have genuine control over the tax laws, as under Switzerland's citizen-initiated referendum system, taxpayers feel more of a moral obligation to comply with them: Mads Qvortrup, *A Comparative Study of Referendums: Government by the People* (Manchester: Manchester University Press, 2002), pp. 66, 139.
- ¹⁸ Peter Saunders and Kayoko Tsumori, *Poverty in Australia: Beyond the Rhetoric* (Sydney: CIS, 2002), pp. 84-5.
- ¹⁹ Robert Gottlieb, 'Taxing Issues of Brains and Ageing', *Australian*, (1 September, 2003), p.31.
- ²⁰ Michael Dirkis, 'Observations on the Development of Australia's Income Tax Policy and Income Tax Law' 56 *Bulletin for International Fiscal Documentation* (2002) pp. 522, 523, 530.
- ²¹ As above, the International Monetary Fund recommendation is in *Staff Report for the 2002 Article IV Consultation*, (9 August, 2002), p.15.
- ²² James Glassman, 'Lessons From Russia', *Policy* (Spring 2002), p.7; Daniel Mitchell, 'Russia's Flat Tax Works', www.nzbr.org.nz; see generally Daniel Mitchell, *The Flat Tax: Freedom, Fairness, Jobs and Growth* (New York: Regnery Publishing, 1996).
- ²³ ABS, *Government Financial Statistics 2001-02*, Cat. 5512-0 (Canberra: ABS, 2002).
- ²⁴ Saunders and Tsumori, *Poverty in Australia*, pp. 4-5, 91.
- ²⁵ See Saunders and Tsumori, *Poverty in Australia* ; Peter Saunders, *A Self-Reliant Australia: Welfare Policy for the 21st Century* (Sydney: CIS, 2003); Peter Saunders, 'Help and Hassle: Do People On Welfare Really Want to Work?', *Policy* (Winter 2003).; Peter Saunders, Kayoko Tsumori, 'The Tender Trap: Reducing Long-Term Welfare Dependency by Reforming the Parenting Payment System', *Issue Analysis* No. 36 (Sydney: CIS, 2003).
- ²⁶ Saunders and Tsumori, *Poverty in Australia*, p. 89.
- ²⁷ Saunders and Tsumori, 'The Tender Trap', p. 6 (see n.25).
- ²⁸ David Stevens, 'Unfinished Business at the Margins', *The Australian* (24 February, 2004), p. 6.
- ²⁹ Cherelle Murphy, 'Labor Plays Down Tax Cuts', *AFR* (13 February, 2004), p. 10.
- ³⁰ Latham, 'Those Chains are Stifling Spirit' (see n. 1).