Deficiencies in the Current Tax System

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Abstract

International mobility of capital and competitive pressures are challenging Australian governments to reduce taxes, especially on capital, while conflicting demands, from deregulation, concerns about national savings, and pressures to reform indirect taxes, heighten the need for higher revenues and more progressive taxes.

We risk becoming a society of 'rational fools', where citizens value government services, but governments lack revenue to fund them. Taxpayers see the system as unfair and see others dodge taxes; tax resistance increases, and the revenue base further declines. Rational behaviour from an individual viewpoint is foolish from a communal perspective.

Deficiencies in the tax system must be remedied to break the cycle. The inability to raise adequate revenue is fundamental. Federal/state financial imbalance is intrinsic to the problem and must be addressed. Removing opportunities for 'tax shirking', and addressing major inequities and concessions in direct taxes would improve prospects for indirect tax reform. Increasing overall progressivity by asset or inheritance taxes would balance regressive effects of indirect taxes.

'Would you tell me please, which way I ought to go from here?'

'That depends a good deal on where you want to get to', said the Cat.

(Lewis Carroll, Alice in Wonderland)

1. Introduction

The problem posed by the current tax debate is where, if anywhere, to go on tax reform. The answer depends not just on where we want to go but also on where we are, and have been.

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The future poses a number of challenges for taxation policy. Deregulation of capital, product and labour markets has created new needs for tax revenues to ameliorate unacceptable distributional outcomes from market forces.

At the same time, greater mobility of capital is increasing competitive pressures on governments to reduce taxes on business or investment, and eroding the tax base. Ownership of capital is concentrated among high income earners, further testing governments' ability to use progressive taxation as the means of achieving distributive goals. With sub-national and increasingly national governments competing along the 'least common denominator' principle of business taxation, and pervasive problems of income tax avoidance and evasion, the taxation burden risks being substantially passed from capital, which is internationally mobile, to labour, which is not (Graetz 1985: 414).

Furthermore, emerging pressures on the environment require collective action to prevent further environmental degradation and pollution and to encourage frugal use or conservation of natural resources including land, water, air, minerals and energy, forests and fisheries, and habitats.

The present tax system appears inadequate to meet the challenges of revenue raising and achieving Australia's social and environmental objectives in a global economy.

The current taxation system has many deficiencies, but the most important is an increasing inability to provide revenue. Traditional revenue sources are diminishing or stagnating, amidst growing concern about rising government deficits and declining national savings. Declining public saving is at the heart of the national savings problem. Yet public opinion seems to rule out the most obvious options for increasing tax revenues – a GST, or raising personal income tax rates.

The problem is not that we are taxed too much. Nearly all other developed countries have a higher ratio of taxation to national income than Australia, while facing similar competitive pressures. The problem is one of structure, design and public perceptions of taxation in Australia.

In this paper I suggest how we might make progress in reducing deficiencies, despite the apparent deadlock in the tax reform debate. Based on the research for my book on Australian tax policy history, I draw on a broad historical perspective on how we have arrived at the current situation and how the terms of Australia's 'fiscal contract' have been drawn up. By trying to understand what has brought us here, and where we stand, I hope to make clearer where we might go.

The first section briefly outlines how we got where we are, and what lessons we might draw from that. It argues that continuing inequities in our tax system and the unbalanced revenue allocation across federal, state or local government, along with perceived inequities of reform, create a deadlock on moves to reform indirect taxes. The subsequent section identifies key deficiencies in the existing system, deficiencies that must be remedied for progress to be made on a broader tax reform front.

2. Background

'I have with me two gods, Persuasion and Compulsion',
Themistocles 514-449 BC

Taxation reform proposals since the 1980s have been closely linked to improving Australia's savings performance. According to Australia's national savings and fiscal guru, Vince Fitzgerald,

> the long term decline in national savings is predominantly (although not solely) due to a structural decline in public savings, ie reduced surpluses/increased deficits on current transactions (1993).

For the last two decades, taxes as a percentage of GDP have been relatively stable, or even declining [Table 1]. However, substantial rises in public expenditures for health, education and social security were not matched by increased revenues.

Our tax gods lost the powers of both persuasion and compulsion.

As a result, the previous revenue surpluses of the Commonwealth government turned to deficits. The Commonwealth government, which collects 80 per cent of the nation's tax revenues, passed the buck to state governments, which have major spending responsibilities, but little revenue earning capabilities. As a result, the deficit problem spread.

With Australian governments spending more than their revenues, the national savings rate declined. Services provided by state governments, especially health, and education were cut and the quality of public services diminished.

Taxes are 'the dues that we pay for the privileges of membership in an organised society'. In other words, taxes are one element in a fiscal 'contract' between Australians and their governments.

The Australian public in numerous surveys has shown it is prepared to pay higher taxes to fund government services that it values. For example, a recent survey for EPAC showed strong willingness to pay more taxes for improving the environment, roads, police and education services (EPAC 1994).

The EPAC survey also showed the community has no overall desire to reduce their own tax bill in exchange for reduced government service

Table 1: Taxation as a per cent of Gross Domestic Product, 1949–1991

	Commonwealth	State[a]	Total
1948–49	22	3	25
1958–59	17	4	21
1968–69	20	3	23
1976–77	23	6	29
1984–85	25	6	31
1988–89	25	6	31
1990–91	25	7	32

Note: [a] excludes state semi-government authorities
Source: See Smith 1993, *Taxing Popularity*, p 133.

provision. Consumers are aware of the need for collective provision of certain goods and services and understand that the quality and level of provision of such goods and services depends on direct and indirect tax contributions of all citizens.

The tax side of the 'contract' is contingent on citizens perceiving individual and community benefits from paying tax, such as access to valued public goods and services (Levi 1988). Looking at Australian tax history, it is clear public acceptability of taxation hinged on it being linked – in the public mind or by 'earmarking' revenues – to popular programs, whether they be support for orphans, public education, old age pensions, war veterans, child endowment, widows pensions and unemployment benefits and other social security, or our public health system (Smith 1993).

As such linkages fade from public memory, it is no surprise to find the public resists higher taxes as it perceives declining value for money in what governments, especially state and local governments (whose activities are very visible in the community), give back.

Public support for taxation also has hinged historically on it being perceived as fair, as well as properly requited by government services. 'Fair' generally meant based on 'ability to pay'. The balance between Australia's direct and indirect taxes is similar to other countries.

However land, estate and gift taxes – 4 per cent of national taxes in the 1950s – were eroded or abolished after inflation undermined their fairness from the 1950s. We came to rely disproportionately on the income tax to maintain tax progressivity. The search for 'revenue with equity', led Australia- to a single tax, the federal income tax. Accounting for just over 40 cents in every dollar of tax collected in the late 1950s, income tax represents nearly 60c of every dollar in the 1990s [Tables 2 and 3].

Inflation, tax avoidance and income tax concessions also eroded the progressivity of income tax since the 1960s. It increasingly fell to low and moderate income PAYE taxpayers to finance Australian's fiscal 'contract'.

Meanwhile, the contribution to revenue of major indirect taxes, wholesale sales tax, customs and excise duties, dwindled to 21 per cent of national revenues compared to 34 per cent in the late 1950s.

Table 2: Taxation 1958–59

	Commonwealth		State and Local		Total	
	$mill	%	$mill	%	$mill	%
Customs and Excise Duties	616	27	0	0	616	23
Sales Tax	287	13	0	0	287	11
Income taxes	1,214	54	0	0	1,214	44
Estate and Gift Duties	31	1	54	12	85	3
Stamp Duties, nei	0	0	57	12	57	2
Land Taxes	na	0	31	7	31	1
Other taxes	117	5	323	69	440	16
(Payroll)		(4)		na		
(Motor taxes)		na		(18)		
Total	2,265	100	465	100	2,730	100

Source: See Smith 1993, *Taxing Popularity* p 82.

Table 3: Taxation 1990–91

	Commonwealth		State and Local		Total	
	$mill	%	$mill	%	$mill	%
Customs and Excise Duties	14,924	16	0	0	14,924	13
Sales Tax	9,365	10	0	0	9,365	8
Income taxes	66,377	71	0	0	66,377	56
Estate and Gift Duties	0	0	0	0	0	0
Stamp Duties, nei	229	0	3,983	15	4,212	4
Land Taxes	0	0	1,602	6	1,602	1
Other taxes	2,428	3	20,373	78	22,801	19
(Payroll)		na		(22)		
(Motor taxes)		na		(9)		
(Gambling)		na		(7)		
(Business franchise)		na		(10)		
Total	93,323	100	25,958	100	119,281	100

Notes: Until 1988–89 the ACT was included in the Commonwealth sector, and from 1989–90 it was included in the state and local sector. Land taxes excludes local government rates.
Source: See Smith 1993, *Taxing Popularity*, p 115.

As inflation and cuts to top marginal tax rates turned our progressive income tax into an approximate flat rate income tax, horizontal equity became another casualty. Tax allowances for children, set at a total value of around 12 per cent of male earnings in the 1950s, were cashed out, paid to mothers, labelled 'middle class welfare' and means tested in the 1980s. Taxation no longer recognises the reduced ability to pay tax of those with children.

What seemed to be sensible social reforms, to allow more to be paid, directly, to those who needed it, became a means to shift the tax burden to those with children.[1] At the same time, a range of child related payments conditional on women's choices between paid and unpaid work or study, and how couples arranged their financial assets gave effect to an unspoken strategy of 'divide and rule' 'one income' and 'two income families'. A sterile 'one income/two income' policy debate ignored the complex reality of women's lives and the economic value of unpaid work, while denying the aspirations of the nine out of ten mothers who prefer part time employment when their children are young.

The income tax is highly visible politically. So much so that it was vaunted as a tax on extravagance because of its visibility when introduced in Victoria in 1895. With high income tax rates on 'middle Australia', Australians were told this was a high tax country, when it wasn't (OECD, 1994).

Also very visible is income tax avoidance. Australians resisted further tax increases because of the perception and reality that the existing system was unfair, that it did not reflect ability to pay, and that it was PAYE taxpayers who were left with the main burden.

But the revolt was against unfair taxes, not taxes *per se*. Attempts from the late 1970s to introduce first a retail tax and then a value added tax (GST) to reduce the income tax burden failed when advocates could not convince Australians of the equity of the move.

Proponents of reform also failed to assure them that compensation would be more than temporary, and that compensation would travel from the trouser pocket to the shopping purse. It failed to convince that the move was not motivated by an ideological desire to reduce the overall progressivity of taxation under the banner of 'changing the tax mix'.

And it failed to convince others, attracted to the strong revenue base afforded by consumption tax, that reform was not motivated by an ideological desire to force cuts in valued government services, as was occurring in New Zealand and attempted less successfully elsewhere (Evans 1988). Indeed the New Zealand example showed that the risks to low and moderate income earners of eroded compensation and increased vulnerability to social security and family assistance cutbacks were very real (Smith 1993a).[2]

Public support for taxation and perceptions of its fairness, also means no 'free riders' – tax dodging (Levi 1988). Tax avoidance, ineffective or half-hearted tax enforcement, and policies allowing special privileges to sectional interests have done untold damage to our community's attitude to taxation and to tax compliance, especially the income tax. As Seligman pointed out in *Essays in Taxation*,

> The honest taxpayer would willingly bear his fair share of the burden, but even he cannot concede his obligation to pay other men's taxes. (1900: 31)

As any system of income taxation relies to a considerable extent on the honesty of the taxpayer, it is highly vulnerable to changes in 'tax morality'. According to an early parliamentary opponent of income tax in New South Wales, it would place them under irresistible pressure to cheat:

> If the Devil Himself had sent a representative here to institute a means of destroying the morality of the people, he could have found no better instrument than an income tax. (1886, NSW Parliamentary Debates, quoted in Mills 1925: 66)

Although some damage was undone in the 1980s, the attitude of our community leaders, judges and politicians, to tax obligations of citizens have validated 'tax dodging' or 'tax-shopping' as a legitimate activity. Rather than fixing problems of equity and tax avoidance and evasion, the mythology of an 'income tax revolt' was created.

It has been said that the lone honest taxpayer in a country of shirkers is a fool not a moral paragon (Scholz, 21). Since everyone benefits from public expenditures whether or not they pay, the rational player will avoid paying and free ride on others, ensuring that everybody is worse off, as valued public goods and services can not be provided.

Australia's approach to tax compliance and the predominant tax morality increasingly reflects the attitudes of these 'rational fools'. The approach to paying taxes emphasises deterrence and fear, rather than the benefits and obligations of citizenship and social security. Narrowly targetting Australia's social security programs further reduced public support as the middle class feel excluded from the benefits of taxes.

If some can opt out of paying tax, as it seems they can, the very basis of our tax system is threatened because a viable tax system requires the voluntary cooperation of taxpayers. This will only be forthcoming if all are perceived to pay their 'fair share'. As an American scholar Pedrick commented on the ludicrous decision to abolish rather than reform federal estate and gift duties in 1976,

> Revenue acts are not the acts of a hostile enemy of occupation. They are the means by which the community maintains itself as a community responding to the needs of its members.

3. Major Deficiencies in Australia's Taxation System

The most fundamental deficiency in our tax system is its apparent inability to raise adequate revenue, the basic function of taxation.

Deregulation of product and labour markets and privatisation of government enterprises increases the burden on the tax system to ameliorate unacceptable income and wealth inequalities produced by market forces (Nevile 1995).

While using wage or industrial regulation to indirectly achieve distributive goals may reduce economic efficiency, benefits of deregulation must be weighed against economic efficiency costs of raising taxes to achieve such social goals directly.

As global pressures tend to reduce the overall progressivity of taxation, it is critical to fully exploit all available opportunities for raising revenue that improve progressivity. To maintain international competitiveness and job opportunities, and minimise incentives to reduce, misdirect or waste scarce investment capital, revenue-raising must also prioritise taxing economic rents, less mobile assets, and the most costly gaps in the consumption, income or assets tax base. Revenue should also be best raised from sources which discourage socially costly or environmentally-damaging activities.

Federal Tax Sharing and Tax Competition

Deregulation of financial markets has increased the difficulty of taxing capital, as capital becomes more mobile. This risks worsening the current imbalance of taxation resources between commonwealth, state and local governments. While the federal government collects around 80 per cent of taxes, state and local governments provide more than 50 per cent of public services, 75 per cent of the public sector workforce, and 80 per cent of essential economic and social infrastructure (Walsh 1991: 4).

While Australia needs to maintain a fiscal environment giving a reasonable balance to international competitive pressures, this should not blind governments or businesses to the advantages which public provision of goods and services along with social cohesiveness and political stability, provides to business and investors.

This increasingly applies to the Commonwealth as well as state governments, which have in the past indulged in a tax competition for investment and development which has produced little or no net gain for the Australian community. Ad hoc concessions to multinational companies establishing headquarters in Australia is one example of the former. The erosion of state land taxes, payroll taxes and more recently gambling taxes, are examples of the latter.

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Tax concessions are sometimes granted to keep Australian taxes below neighbouring states or countries, without due regard to the benefits to businesses and investors of a skilled, educated and healthy workforce, public transport and other infrastructure, a publicly-financed social security net, or political stability and investment security.

The basic challenge is to find ways to strengthen the national tax base in ways which at least maintain the overall progressivity of taxation, promote an efficient use of available investment capital, and distribute revenues between the three levels of government more in line with their expenditure responsibilities.

Public Perceptions and the Visibility of Taxes

Australia is a low tax country by OECD standards (OECD 1994). Increasing overall levels of Australian general government revenue to the OECD average – (39 per cent of GDP), or the New Zealand level (36 per cent of GDP), would increase Australia's national revenue by more than $15 billion.

The balance of taxation between indirect and direct taxes is also comparable with other countries. However, because the burden of progressivity is not shared by general assets taxes, the direct taxation that Australia does levy is more concentrated on income taxation. As income taxes are very visible to taxpayers, this creates perceptions that income taxes are high.

Unlike other countries, and with the exception of the Medicare levy, Australia does not attribute any of its income-type taxes on employees or employers to social security or social insurance. This makes Australian income taxes appear higher compared to other OECD countries which have social security taxes on incomes or payrolls. It also means Australia's taxation is also less directly linked with valued public expenditures.

However, this has not always been the case. For example, federal land taxes and customs and excise duties were originally linked with introducing the 1909 federal age pension, payroll taxes with child endowment, and post war expansion of income tax to ordinary wage earners with new social security measures such as unemployment and widows pensions. The introduction of the Medicare levy and various earmarked petrol taxes continued the tradition.

Australia's taxation is also more burdensome to businesses and individuals than is apparent from OECD data because Australian governments' taxation powers are used to compel billions of dollars of payments annually to private superannuation funds, rather than to the public purse. Compulsory superannuation payments are not counted as taxes by OECD definitions, as

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the proceeds do not go to governments. 'Tax room' that might otherwise be available to strengthen the nation's public finances is thus wasted.

Federal financial imbalance also reduces the linkage between taxes people pay and their perceived benefits of those taxes (Walsh 1990).

Taxation of Assets

With the abolition of taxes on the transfer of wealth – estate and gift duties – in the 1970s, Australia forgoes around $4 billion of revenue annually. We thus miss an important opportunity to both enhance tax progressivity and maintain revenue.

Concerns may be raised about incentives to accumulate. However, like old age, such taxes may be preferable to the alternative – raising other taxes, such as income taxes or WST or state government taxes to replace lost revenue, may be much more damaging to productive effort, capital accumulation and thrift. No doubt it was for such reasons that the Fitzgerald Report on National Saving reminded the Labor Government of this option.

Australia's most prominent tax economists maintain that wealth taxes must be an important element of any shift from income to consumption taxation (Mathews 1983: 8-9, Groenewegen 1985: 211; Head 1991: 40).

In advocating a shift of taxation towards goods and services in 1975, the Asprey Review of the Taxation System (530) saw some form of capital taxation as essential to its strategy, to maintain progressivity and offset windfall gains to high income earners from expanding indirect taxation.

Excluding wealth from assessment of capacity to pay in the tax system contrasts starkly with assets-testing applicants for family assistance. Assets are considered a factor in receiving social security, so why not in determining ability to pay tax? A fair tax system would ask a taxpayer with $70,000 of income and meagre assets to pay less tax than one with the same income but $2 million of assets. As the Commonwealth Treasury told the Asprey Taxation Committee in the early 1970s (1974: 3)

> Some form of a tax on assets [is] an essential component of the tax system to recognise the advantages which accrue from the ownership of wealth.

As ownership of assets is concentrated among high income earners, including wealth or assets in the tax base also increases the progressivity of taxation and therefore improves vertical equity.

It may also help tax enforcement, for example in identifying assets transferred to avoid income taxation. And like GST, it helps ensure that taxability left untouched by the income tax due to evasion, avoidance or loopholes can be reached to at least to some extent by the tax system.

While imposing a wealth tax raises some significant issues of administration and valuation, these are not insuperable. The OECD Committee on Fiscal Affairs concluded after reviewing member countries that 'no country with a net wealth tax considered it more difficult to administer than income tax and some specified that it was less so' (OECD 1979: 127).

By not including a reformed capital transfer or inheritance tax regime in the 1985 and 1993 tax packages, the efficiency burden of other taxes was necessarily higher, tax progressivity was lower, and the chance of an acceptable package of indirect taxation reform was reduced.

Income Tax Expenditures

The scope of the income tax is limited by tax concessions, tax dodging, and weak tax enforcement for some groups of individual taxpayers or taxable entities.

There are a number of conceptual and measurement issues surrounding tax expenditure cost estimates (Butler and Smith 1992). However, as Feldstein commented,

> calculating the revenue implications of different features of the tax law is clearly a necessary first step in the process of evaluating alternative tax policies. The fact that experts disagree about which provisions should be considered tax expenditures does not reduce the usefulness of any estimates of particular tax subsidies (Feldstein 1980: 103).

A **partial** revenue cost estimate for existing tax concessions by the Commonwealth Treasury is $18 billion a year, about 15 per cent of Commonwealth government outlays. By far the largest items are tax concessions for superannuation contributions, fund income and payouts at around $8 billion, with industry assistance and development accounting for $2.8 billion [Table 4].

These estimates understate revenue costs, excluding items arguably included as part of the 'benchmark' (eg capital gains tax on a realisation not accruals basis and concessions for multinational companies based in Australia). Also the cost of other tax expenditures, such as certain exemptions from capital gains tax, income tax are not calculated.[3] As noted below, the 1995 Treasury estimates also understate the large current potential cost of concessions on private borrowing for infrastructure projects.

That such heavy demands on the public revenue are made outside the visible and accountable public processes of the annual budget is unacceptable from the viewpoint of democratic decision making – as well as because of the major equity and efficiency implications of these substantial public subsidies.

Had the present $8 billion subsidy to superannuation contributions by high income earners been subject to the usual public and bureaucratic scrutiny of social security expenditures it is unthinkable that such expenditures would have been approved. Representing a huge net drain on public saving for at least 25 years, and directing $800 billion of savings to superannuation funds over the next 25 years, the present superannuation scheme is postulated to increase national savings by just 4 per cent of GDP. By comparison, increasing economic activity and federal budget measures is estimated to achieve the same thing in four years from 1993 (Davidson and McClelland, 1996: 85). With a more transparent decisionmaking process, claims that tax subsidies will be effective in increasing private savings would have been publicly tested against international empirical evidence that they are not (OECD 1994b).

Table 4: Major Income Tax Expenditures 1994–95

	$mill
Superannuation	7275
Industry assistance and development	2800
(FBT concessions for company cars)	(1000)
(Exemption from IWT for public and widely spread issues)	(672)
(Accelerated depreciation allowances)	(640)
(150% R&D allowance)	(630)

Source: Treasury 1995

'Things which are Caesar's'

> Render therefore unto Caesar the things which are Caesar's; and unto God the things which are God's. (Matthew, 22: 21)

Deficiencies in the scope or application of income taxation create pervasive problems of equity. High income earners and the wealthy are the main beneficiaries of existing tax concessions for superannuation, ownership of shares and property. High income earners also benefit most from the $1 billion fringe benefits tax concession for company cars, a concession which is equally objectionable on environmental grounds because of the incentive for extravagant personal use of motor vehicles.

As Head has pointed out (1995: 28), mostly high-income shareholders received around a net $4 billion from dividend imputation and cuts to the company tax rate, yet misalignment of the company and personal tax rate means we now get few benefits of an imputation system. Misalignment of rates continues opportunities for high income earners to avoid tax through incorporating their services or investment income and paying the lower, company tax rate on their own or their spouses' incomes. Tax avoidance through incorporation is facilitated by the absence of measures such as the former Division 7 provisions for taxing retained/passive income of private companies.

There is large scale tax avoidance and loss of revenue from design deficiencies in capital gains tax (Krever 1995; Head 1995). Instead of a 'valuation day' basis of capital gains taxation for pre 1985 assets, we have an enormously inefficient 'lock-in' of all pre-existing assets. Similar 'lock-in' problems arise from allowing rollover of capital gains on transfer of deceased estates. The exemption for all principal residences is an unwarranted concession to millionaire home owners in Sydney and Melbourne.

Allowing capital gains to be adjusted for inflation, but permitting deductions of nominal interest payments, opens up opportunities for tax avoidance and senseless subsidy of borrowing-based speculation. Major avoidance of capital gains tax also occurs through levying it on a realisation rather than accrual basis, as this permits taxable income to be converted into unrealised, and therefore presently untaxed capital gains.

Avoidance mechanisms such as negative gearing, income splitting, and the tax treatment of trusts and incorporated companies are unfair to personal taxpayers who do not have the same opportunities to avoid taxation. Such devices are particularly objectionable because they are mainly available mainly to the well-off, thus offending vertical equity, and reducing the progressivity of income tax.

Legislation and administrative practices regarding tax avoidance are also inadequate (Krever 1995). Income tax law and practice lacks effective anti-income splitting provisions. In some cases, eg laws on assignment of assets, income tax law even facilitates this form of tax avoidance. Provisions permitting negative gearing are considerably more generous than overseas, and prejudice productive business activities while favouring borrowing and speculation in property.

Detection and legislative action of emerging technical loopholes in tax law is too slow, if it occurs at all. Anti-avoidance activity is largely ineffective against widespread avoidance as it is based on administrative action from a limited number of audits combined with use of ineffectual general anti-avoidance provisions.

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Taxable Capacity of Parents

One of the most notable problems of horizontal equity is the lack of recognition of fluctuation in income and ability to pay tax during the childraising years, and the very high effective marginal tax rates on second earners in families.[4]

This is a key issue facing those advocating a move to GST, as compensation provided through the social security system increases the number of families with children who are forced to rely on social security and child payments for a decent standard of living. As the compensation paid increases benefit levels and replacement rates, it is vulnerable to being cut in future budgets to improve work incentives, as New Zealand experience shows (Smith 1993a).

High effective marginal tax rates from various family income and assets tests, rates far higher than appears acceptable for any high income taxpayer, especially affects women as the second potential earner in many families.

Indirect Taxes

> The best taxes are such as are levied on consumptions, especially those on luxury; because such taxes are least felt by the people. They seem in some measure, voluntary; since a man may chuse how far he will use the commodity which is taxed. They are paid gradually, and unsensibly: They naturally produce sobriety and frugality if judiciously imposed: And being confounded with the natural price of the commodity, they are scarcely perceived by the consumers. (David Hume 1752)

The indirect tax base (wholesale sales tax, petrol, tobacco and alcohol taxes, state franchise taxes etc) is diminishing for a number of reasons, as others will cover in more detail. For example, the policy priorities given to tariff reductions, constitutional challenges to state indirect taxes, and the changing structure of consumption and relative prices, along with introduction of new technologies erode indirect tax revenues, while exacerbating the inefficiencies associated with levying high rates of taxation on a narrow base (Warren 1995).

However, a shift to GST is not a panacea, especially for savings. Comparing a theoretical income tax with a theoretical consumption tax produces hypothetical savings increases. But in reality, significant saving improvement comes only by reducing progressivity, and denying households and businesses transitional relief such as for consumption from existing capital (Aaron and Gale 1996).

Effect on incentives, investment, economic growth and living standards

> The practical policy question is not so much whether a tax is perfect, but whether it is less perfect than the alternatives (Brennan 1977: 63).

Living standards, past and present are undermined by incentives created by an unbalanced tax and federal financial system.

The federal/state taxation imbalance leaves too much revenue with the Commonwealth, to be spent on less valued services such as defence and general administration, and too little with state and local governments, responsible for producing services people value more, including environmental protection, retraining and education, policing, sports and recreation facilities, and roads (EPAC 1994).

The federal fiscal imbalance may also contribute to sub optimal levels and allocation of public infrastructure investment (Walsh 1993; Smith 1994b). Inadequate public infrastructure inflicts a high cost on business (Allen Consulting Group 1993). Tax concessions subsidising private infrastructure borrowing exacerbate such distortions in national investment priorities, as well as opening up new avenues for tax avoidance by high income earners.[5] The EPAC Task Force on Private Infrastructure found the tax concession for private infrastructure borrowing unjustifiable and recommended its abolition. (1995: 81-84)

We miss numerous opportunities to use taxes to correct undesirable side-effects from activities producing environmental damage (eg air, noise or water pollution, rural land degradation) or with high public or social costs (eg alcohol abuse, gambling, artificial formula feeding of infants). Proposals for a 'carbon tax' are worthy of consideration on similar grounds.

Non-taxation of assets, or economic rents, for example in the mineral and resources sector, also represents missed opportunities for reducing economic costs of taxes, because revenues then must come from more distorting taxes. Existing ad valorem taxes, royalties and levies on non renewable resources result in too rapid or wasteful depletion of resources. Federal/state difficulties have prevented resources rental taxes replacing the current distorting system of royalties, and other exactions on onshore minerals.

Likewise, taxes on certain unearned land value increments such as infrastructure-related betterment taxes, or levies on changes in permitted land use, are likely to be less distorting than raising equivalent revenue through existing taxes on profits or incomes. They may also assist in ensuring more socially efficient and environmentally appropriate use of

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land, and direct investment into genuine enterprise rather than speculation in land or property (Commission of Inquiry into Land Tenures 1973, 1976).

Major income tax concessions, allowances and loopholes distort the after tax return on investments (Pender and Ross 1995), directing savings and investment to socially less productive investments or particular financial intermediaries, for example into particular financial intermediaries such as superannuation funds or into speculation in existing financial or capital assets. Costly subsidies for retirement savings might provide more effective and more equitable incentives for private saving if redirected to removing asset or income tests on age pensions or into tax rebates for long term saving of various kinds.

Investment allowances and accelerated depreciation favour investment in new assets or in capital intensive industries and enterprises. It may be more economically efficient and less discriminatory, however, to put the revenue into maintaining an internationally competitive tax rate on company profits.

Tax-induced distortions to the pattern of national savings or investment direct capital away from small and medium business or innovative ventures, from wealth-producing productive capacity, or from investment in human or social capital. The non-alignment of the company and top personal income tax rate provides incentives for incorporation, distorting the form of business organisation and wasting resources on tax avoidance activities.

Tax revenue shortages and income tax cuts have also resulted in excessive emphasis on 'targeting' family assistance and social security, effectively shifting disincentive effects of high marginal tax rates from higher income earners in the tax system to lower income groups, through the combined effect of taxation and social security income tests. This has a high efficiency cost as it affects lower income earners, such as sole parents and married women, whose labour supply has been shown to be more sensitive to high effective marginal tax rates than higher income taxpayers (eg Killingsworth 1983; Boskin and Sheshinski 1983).

Greater reliance on family income tested social security systems to redistribute income, for example as compensation for increased indirect taxation also makes more acute the issues of dependency and unequal distribution of income within households (Smith 1993a).

4. Summary and Conclusions

Taxation is an important instrument for social cooperation, for making an economy into a society. It plays a crucial role in shaping society to meet collective ideals and aspirations. As the EPAC survey showed

> Australians are willing to pay their proper share of tax to secure the collective and individual benefits of public expenditure, provided that every one else does the same (1994: 39).

The increasing international mobility of capital has disturbing implications for national taxation policy (Evans 1988: 40; Graetz 1985: 414). The free flow of international money challenges the ability of citizens to decide the fair distribution of taxes. At the same time, deregulation of labour and product markets increases the need for an effective tax system to offset unacceptable distributional outcomes from market processes. As Mathews wrote in 1994,

> Speculative and self-serving international capital flows, now running at perhaps a trillion dollars a day and swamping commodity trade and productive investment, have virtually made it impossible for governments to govern in the interests of their own people, for example, by successfully pursuing policies of full employment. If the world's government's are to regain control of economic policy from the financial and foreign exchange markets, it is time that they considered what role taxation itself might play to this end. In particular, they might take up the proposal of Nobel Laureate James Tobin for a world-wide, low-rate tax on all foreign exchange transactions (130).

National governments must look also to increased international collaboration on taxation, to ensure that mobile world capital makes a contribution to the world fisc that is commensurate with the benefits capital receives from it and owes as world citizens.

The most fundamental challenge for taxation policy lies in effectively restoring the powers of those twin gods of tax collection – Compulsion and Persuasion – to collect their dues for the common good.

Many who can well afford it do not pay their membership fees: 'dodging the fiscal fiend' remains, if not an honoured pursuit, at least widely tolerated in Australian society.

Australia is far behind comparable countries in our ability to raise revenue. Restoring the revenue base of Australian governments is the most pressing priority for tax reform.

Tax reform in the 1980s failed to produce the Holy Grail of simplicity, an experience shared by other countries (Pechman 1988: 13). Excessive complexity may be undesirable and damaging to the integrity of the tax system. But some concern for a simpler tax system may be in fact a call for a less equitable one. Achieving equity may require some complexity, a point made in the context of the 1964 Social Research Council tax reform proposals:

> The adoption of simplified administrative procedures usually involves a considerable loss of equity. In practice it is therefore necessary to compromise between equity and administrative practicability (Downing et al: 122).

Australia's tax reform debate will remain bogged down in the present morass unless we make taxation fairer, by:

- dealing with the gross imbalance in federal and state and local government revenues, so governments can provide services the public is entitled to and the public perceives value for tax dollars;
- including wealth or assets in taxable capacity, such as through an inheritance tax;
- removing enormously costly tax concessions for superannuation, company cars and capital investment and capital gains;
- recognising the reduced ability to pay tax of those supporting children; and
- addressing problems of tax avoidance and enforcement.

Failure to address these deficiencies as a package of fair tax reforms means economic effort and incentive will remain directed at investments we don't value, and at neglecting activities or depreciating investments which we do.

Failing to address existing deficiencies will also leave us to suffer the inevitable fate of 'rational fools' – declining levels and quality of government services, and an inability to maintain and shape the equitable society that Australians aspire to.

Notes

1. As most, though not all individuals have children at some time during life, and those with children make up a large proportion of total taxpayers, the essential issue is how the tax burden is spread over individuals' lifetimes, rather than how it is distributed between those with children and those without.
2. Introducing GST left many low and moderate income families facing very high effective marginal tax rates on their income because of compensation received under income tested family assistance and social security programs. Accompanying cuts to income taxes for high income earners left a fiscal hole that was later filled by an uncompensated rise in GST and cuts to the level of social security benefits to deal with the problem of unacceptably high wage replacement rates and poverty traps arising in part from the previous GST compensation package.
3. The estimates are partial because of how the benchmark tax system is defined and because some concessions are not costed. The benchmark adopted excludes taxing capital gains on an realisation rather than accrual basis, and exempting from withholding tax certain dividends paid to non-resident sharehold-

ers by Australian resident multinational companies. There are no estimates of revenue losses from exempting imputed housing rents from income tax; dividends or interest paid to various non-residents organisations, businesses and Australian governments from interest or dividend withholding taxes, and for exempting from CGT all pre-1985 assets, all owner-occupied dwellings, and from taxing real rather than nominal capital gains. (Treasury 1995).

4. Lifetime income isgenerally accepted as a better indication of economic income than annual income. Some allowance is made in the tax system for those whose income fluctuates sharply from year to year, eg primary producers. As year to year income averaging arrangements do not extend to those whose income fluctuates due to parenting commitments, parents face higher marginal tax rates when they are in the workforce than may be justified by long-term ability to pay.
5. Although the Tax Expenditures Statement gives a nil revenue cost to the exemption from taxation of interest on borrowings for eligible infrastructure facilities, this grossly understates the current and prospective cost. On 10 September 1996, the Treasurer capped the cost of this concession at $150 million for 1995-96 and $200 million for 1996-97. This followed advice of applications totalling $26 billion (implying an approximate associated revenue cost of around $860 million).

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