Tax Reform: Lessons from the 1980s

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Abstract

The 1980s was a decade in which federal governments tackled the problem of massive tax avoidance by corporations. Taxation Reforms have reduced tax avoidance but have not been totally successful. This paper develops five propositions designed to bring about a tight and economically efficient system.

Introduction

At the beginning of the 1980s John Head ran a conference on tax reform at Monash University[1]. Fresh from the Bottom of the Harbour era we sought to articulate a vision for a new tax system, a Camelot rising from the ashes of the 1970s carnage. The operational outcome of that romantic vision was more solid than any of us dared to expect back in those dark days just after the Australian tax avoidance Dunkirk. Before the 1980s round of reform Australia lagged 30 - 40 years behind the USA. That gap has largely been closed and, arguably in some areas, we have moved ahead of the USA. But I have formally, and with due gravity, to report to you that Camelot is still proving illusive.

At that conference, as the token lawyer amongst a haggle of economists, I pushed an alternative model of tax reform. The model was built on a single unifying theme. The theme was that technical and institutional issues dominate the real world dynamic of the Australian Tax System and that our strategic stance should be constructed accordingly. It drew on the well

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1 Head, *Taxation Issues of the 80s* (1983, Australian Tax Research Foundation).

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known aphorism of Kay and King[2]. **The ways in which actual tax systems differ from shining ideals is often of far greater economic significance than the way various ideal systems differ from each other.** Ultimately, it is the minutiae of deductions and enforcement and the timing of income which dominate the outcomes of our tax system. Because not insignificant amounts of cold hard cash are involved, the shrewd and the powerful will probe the limits of our tax legislation, and the tax base is no stronger than its weakest link. Any strategist who concentrates on the big picture to the exclusion of what is happening on the ground is doomed to win a series of victories, possibly victories widely applauded by the gathered multitudes, but victories which will nevertheless prove to be pyrrhic . The measure of a politician's commitment to micro-economic effectiveness, to fairness in the Tax System and to enduring tax reform is not to be measured by grandstanding on sweeping substantive measures. It is to be measured by the resources committed to the hard graft of unspectacular battles, the mental toughness to stand up to the rhetoric of the paper shufflers and the practical outcomes of the tax system on the ground.

What I want to do in this paper is to revisit these fundamental arguments with the benefit of a decade of hindsight. Unfortunately, as my practical examples will demonstrate, it *is* still necessary to reassert basic propositions. In this decade, having cracked the nut of the blatant, mass produced, paper tax avoidance scheme, we have been required to address the tougher issues and look at the strategies for long term maintenance and renovation of the Tax System. The issues currently pre-occupying tax reformers in Australia are Modernization and Simplification and the ability of complex audits to penetrate the continuing tax avoidance schemes of the big players (typically going under the euphemisms of "tax based financing" or "international corporate structuring"). What these current tax reform projects have in common is that they take institutional issues seriously.

Modernization is an attempt to bring the Australian Tax System up to date with proper computer equipment and a large range of correlative shifts in institutional settings. In the case of so-called "Simplification" (I prefer to use the terms "coherence" and "efficiency"), the job is to fixate on transaction costs and the brutal imperatives of a mass decision-making tax system. A preliminary report has gone to the Government. It will doubtless involve an attempt to move to with-holding taxes, to wash out a lot of the fine tuning which cannot be cost justified, to improve the effectiveness of

2 Kay and King, *The British Tax System* (1978), 1

communication and the techniques for effective delegation in the mass decision-making process.

Extensive anti-avoidance provisions, covering off-shore tax haven schemes (the Controlled Corporations measures) have just been released in "final" legislative form. The question is whether, for the big players who can afford to hire good professional advice to move profits around the world and to gear out profits in Australia, those impressive substantive reforms are, at long last, to make their taxes into something more than a voluntary contribution to the consolidated fund. The question for analysis in complex audit, and particularly the large case program operating on the major companies, is whether the current success in generating near half a billion dollars annually from the big players is going to continue and be extended as it gets hot in the kitchen and whether politicians from both sides are really serious about a tight and economically efficient tax system.

The propositions I shall advance are:

1. **The development of reform strategies must be fully informed, *right from the earliest stages of strategic planning*, by political and administrative constraints.** I intend to elaborate this argument in the familiar context of the capital gains tax debate.

2. **Reformers who operate at a high level of generality and do not properly integrate feedback from hard technical problems into strategic planning are liable to gloss over the critical issues which should drive real world tax policy decisions.** I intend to develop this proposition by drawing briefly on the debate over fringe benefits tax. But, more importantly, I intend to fully exploit the luxury of hindsight to critically analyse the argument used by Treasury to oppose intervention to limit deductions for company takeovers. Now that the dust is starting to settle, this issue provides a unique context for evaluating arguments typical of those mobilized by economists in the tax debate during the last decade.

3. **Much of the generalized economic rhetoric used in public debate is useful to sell tax policy to the electorate. It is useful for that purpose alone. If that rhetoric is taken seriously as the foundation of a tax reform strategy, it is likely to cause policy makers to paper over the critical factors which should drive hard policy choices.** I intend to elaborate this proposition in the context of the indirect tax debate.

4. One of the great dangers for any discipline is to start to believe one's own rhetoric. This can very quickly blunt the ability to evaluate policy choices critically.

5. The main determinant of outcomes in our Tax System is the design and quality of our institutions. This requires the commitment of appropriate human resources, effective deployment of those resources and proper incentives to get the best out of them. The effectiveness of our Tax System will be determined by the extent to which we can penetrate crude deregulation rhetoric and revisit these institutional issues. We need to look squarely at hard practical questions about attracting and retaining human resources in a competitive market, at the extreme limits on the projection of administrative resources and at what compromises we must make to accommodate these realities.

2. Proposition One

The development of reform strategies must be fully informed, *right from the earliest stages of strategic planning*, by political and administrative constraints.

The ideology driving tax reform through the 1980s was the comprehensive tax base, immortalized in Keating's colourful rhetoric as "the even playing field". As operational rhetoric it was extremely useful. It allowed both the US and Australian governments to break a terrible log-jam, a vast raft of pork barrels accumulated over many years, which was choking the mainstream of economic forces. But the outcomes of this operational rhetoric have not been wholly satisfying.

Take the important area of capital gains. We have ameliorated the tax bias in favour of the paper tax avoider who found an infinite regression of means to convert an income stream into a tax free capital profit[3]. But the downside is that we now have, albeit in somewhat diluted form, institutionalized the very same bias in the tax system. There is still a substantial tax shelter for capital profits. Much more seriously, we have simply moved the discrimination between taxable income and tax free capital gains to a new bright line. We have created a serious tax bias in favour of owner occupier

3 This is easy because capital is the present market value of a future income stream and, by definition, one can always be arbitraged into the other.

housing. In the result, we are channelling a heavy percentage of Australia's already inadequate savings into ever more elaborate extensions and pools in homes in the Eastern suburbs of Sydney.

I do not want to be misunderstood. I think that the Liberal Party policy in the last election, to transform the capital gains tax into a short term capital gains tax, was economically short sighted. Any policy maker seriously interested in an economy which is driven by the creators of real wealth and jobs rather than the paper shufflers and those sitting on unproductive dollars locked in bloated housing stock, would support a gradual move to, if not an even playing field, then at least a playing field in which the hollows are more intelligently deployed. The relative after tax return from various activities are absolutely critical in giving the right signals to capital markets and the current signals still leave much to be desired.

But, having said all this, more thought might have indicated that a gradualist reform strategy, on the model pursued in superannuation reform, would have produced better economic bottom lines. Such a strategy would target the worst excesses and gradually move to closer approximations of the ideal.

If the rhetoric of the even playing field was gradually replaced by more explicit and better targeted economic policy intervention, a more disciplined policy agenda could be constructed. This would gradually close down unjustified and economically counter-productive tax shelters. The great advantage of this strategy is that it gives a natural order of priorities to the reform agenda and that second best distortions are appropriately managed. To that end, the decision of the High Court in *FCT v Myer Emporium Ltd*[4] is very significant because it sets a clear path to redefinition of the common law income concept with a promise that the better approximation to a comprehensive tax base might be a realistic longer term objective[5].

Please do not respond with the familiar cliche that government should butt out of these issues and leave it to the market. The point I develop later in the paper is that the status quo and all the options currently on the political agenda involve distortions of the market. **The question is not whether government intervenes in the market place but how it intervenes.**

It should be stressed that the significance of these problems goes well beyond tax lawyer's talk about the integrity of the tax base. They have extremely significant economic consequences. Investors are extremely

4 (1987) 163 CLR 199.

5 Fully analysed in Grbich, New Concepts Drive the Australian Income Tax (1989) 2 CBLJ 1.

sensitive to relative after tax returns from available investments. Any political party seriously interested in mobilizing the modest pool of Australian savings more effectively would have these "technical" distortions very high on its agenda. This should be our pre-occupation.

3. Proposition Two

Reformers who operate at a high level of generality and do not properly integrate feedback from hard technical problems into strategic planning are liable to gloss over the critical issues which should drive real world tax decisions.

As part of its Tax Summit reform package, Government introduced a Fringe Benefits Tax. This is a tax collected at the employer level. At the time, this measure was attacked by the economic purists on the basis that perks should be valued at the employee level because it was the employee who enjoyed the increase in spending power. Similarly, the disallowance of entertainment expenses was attacked as completely contrary to principle.

While both of these arguments can be supported at a high level of generality, both miss the essential point. Given the cost and realities of enforcement, such measures had not been and were not realistically capable of enforcement. In particular, how is it possible, either in principle or in practice, to distinguish between the genuine business meal and the perk given as part of a compensation package? Do we have a tax inspector at every meal a taxpayer eats with professional colleagues? Do we count the minutes spent on personal and business conversation? Do we distinguish between business friends and those one tolerates to do business? While the abuses were kept within manageable bounds, it was possible to turn a blind eye to occasional stretching of the expense account. But as executives began to pour a substantial part of the tax base through the remuneration package loophole, the cost became intolerable.

The narrow inference to be drawn is this. If you put up substantive rules which are, practically speaking, incapable of being policed or if you don't put in enough resources to police them, you create open season on the tax base. **In the real world of limited resources and civil liberty constraints, arbitrary solutions are inevitable and much of the criticism of arbitrariness in the literature and in leading cases is based on the most basic misunderstanding of the choices facing real world policy makers. The only question worth asking is which of the inevitably crude and arbitrary solutions is the least distortionary.**

Where the fringe benefit rules did fail was this. Because they were not pushed through with sufficient rigour, they failed to wash out the tax advantage for perks. By buckling to pressure and giving favourable valuations and treatment to many benefits[6], instead of achieving the objective of getting employee perks cashed out and taxed under the mainstream tax base, the government ensured that perks would last for ever, with all the attendant transaction costs and tax driven distortions of employee choice.

The broader inferences are two. First, as a tax legislator sometimes you have to be tough to be good to people. Second, if the policy maker is too grand to get down to the hard enforcement and technical detail, more often than not she is going to miss the main game.

The argument for full deductibility of interest on amounts spent to finance company takeovers was articulated in a 1986 Treasury Economic Paper[7]. That paper comes up with the clear conclusion that "strong arguments would be needed to justify action to restrict high gearing"[8] for company takeovers. In particular, the argument advanced for allowing full deductibility floated right over the technical legal and accounting details which are the key dynamic in this problem[9]. But first let us get right back to basics.

The essential question in this area is not whether company takeovers are, on balance, desirable or not. It is whether they generate enough economic benefits to justify the present tax treatment, with its foregone revenue, distortion of the tax system and other costs (including the balance of payments problems). The question is not whether all deductions should be disallowed but whether we should do more to ensure that expenditures are only deductible to the extent they can be matched to income taxed in the same year, at the same rate and subject to similar rules.

As we go into the arguments it is necessary to keep another cluster of issues in mind. Does such a tax subsidy operate to give an *artificial* advantage to the take-over predator who makes his greenmail or speculative profit from exploiting his tax advantage? Does it encourage corporate instability by creating strategic hollows in the playing field for the predator? Does it encourage the potential target to go into artificially high debt/equity ratios to bolster its defence against takeover? Does it provide an artificial,

6 Most particularly, the "temporary" asymmetry between top marginal rates and the company rate.

7 Treasury Economic Paper No 12 (1986), "Some Economic Aspects of Takeovers", 8ff.

8 What they really mean, of course, is that we should not partially disallow *deductions* for high gearing.

9 The argument in this part of the paper is a shorter version of arguments advanced in a forthcoming paper from the Taxation of Corporate Debt intensive weekend workshop entitled Grbich, *Interest on Debt Financing; With Particular Reference to Deductability,* soon to be published by Longmans

tax driven, incentive to seek cheap[10] overseas debt capital without producing demonstrable *real* productive investment to show for it?

Takeover tax schemes rely on the familiar device of high or negative gearing. Highly leveraged takeovers set off expenditure for interest paid to buy the target company against the income generated by the target company after the takeover. The profit from the target company is typically less than the interest expenditure to service takeover costs and the resultant tax loss can be set off against income flows from profitable operations of the predator. In the result, the front end tax benefit in the deduction is used to subsidise holding costs, with the ultimate payoff normally coming as a tax sheltered capital profit (either implicit in a tax bounty for establishing a future cash cow or explicit in a realized capital profit). In the result, this method arbitrages the income of the predator into sheltered capital gains (realized or unrealized) in the target company. It is a strong inducement to heavy gearing and it is made all the more attractive in an inflationary economy because, if the investment is even half decent, nominal gains are virtually assured in the longer term. This is attractive because our Tax System makes no attempt to approximate the discounted value of future cash flows. Nor does the case law make any attempt to allocate expenditures to separate baskets of present, future, exempt and sheltered profits. It must not be forgotten that much of the domestic problem lies in the precise design of capital gains tax rules, since the predator will often take out profits in this form[11].

Traditionally, governments have been tolerant of such a tax shelter because, in the classic analysis, it encourages successful companies with high profits to channel those profits into new investment. By gearing up with debt capital, the entrepreneurs of Australia mobilize national resources to create wealth and jobs. The loopholes admittedly compromise horizontal equity but they do so in order to pursue the over-riding objective of growth in the Australian economy. It is a back door way of subsidizing investors in the corporate sector and shifting the tax burden on to the middle classes.

Since there is a substantial revenue cost, and since the argument for deducting much of this cost on normal matching principles cannot be sustained, it is clear that the onus for maintaining open ended deductibility lies squarely on the shoulders of those advocating it. We would want clear evidence, not just that firms taken over are more productive, but that the

10 This refers not so much to lower overseas interest rates as to the generous tax treatment of overseas debt (often limited to 10% or even zero "witholding tax".

11 Bryan, "Leveraged Buyouts and Tax Policy" (1987) 65 North Carolina LR 1039.

direct tax costs of negative gearing and of the hard-core schemes are justified by the tangible economic benefits. Imagine a proposal for the Federal Government to pay Alan Bond or John Elliott half a billion dollars as subsidy to encourage them to take over a few companies. It would be laughed out of parliament in any normal budget context. It is too open-ended and badly targeted. Yet, once we take away the technical window dressing, this is precisely the outcome produced under the operation of the current law. The detailed legal aspects of the problems are fully analysed in a forthcoming paper[12].

The schemes under review are typically based on a crude illusion. It involves the creation of a single, indivisible expenditure which achieves two objectives, typically the derivation of assessable income in the current year and profits which are taken in tax sheltered or postponed form. It then involves setting up the structure and documentation to give that composite expenditure a plausible nexus to one only of those objects, that object being the production of assessable income in the current tax year.

The purpose of the scheme is to smuggle the whole of the composite package past the sentinel at the central gateway of the main deduction provision in s51 and to get the whole of the expenditure into the promised land of deductible status. The taxpayer does this by secreting the suspect part of the expenditure in a suitably bland and commercial looking package. The expenditure is treated as if it was spent to earn assessable income of the same year because the decision maker finds it altogether too hard to handle the evidential and conceptual difficulties in unravelling the package or finds it too difficult to sell the process by which second best solutions (which usually involve apportionment and some degree of arbitrariness) might be sold.

The issues move to a qualitatively different level when the negative gearing is used in combination with a technical device to facilitate double dipping or blatant arbitraging. By artificially manipulating deductible expenditures within a company group or to a tax exempt or tax sheltered institution, the group can get the benefit of full deductibility for interest *plus* the full tax rebate for dividends paid from company to company (under s46). Generations of schemes exploit these devices to punch through the tax base. **Loophole closing is always a question of closing a long line of stable doors after horses have bolted. The only effective long term strategy is to**

12 Taxation of Corporate Debt intensive weekend workshop entitled Grbich, *Interest on Debt Financing; With Particular Reference to Deductibility*, soon to be published by Longmans.

address the pathologies in fundamental concepts and in decision-making paradigms which support such schemes.

Treasury argued that the deductibility of interest on corporate takeovers is no more than a reflection of fundamental design features of the Australian tax system[13]. and that "the tax system is operating as intended" in the case of the deduction for corporate takeover. It is clear that this argument[14] falls into the trap of *assuming* that the matching principle is operating properly in this context. This is the main issue for analysis.

The essence of a tax driven corporate takeover is to mobilize the imprecisions and rigidity of the law, to use the grey area to wring out the best results for a client. Far from reflecting Dixon's ideal[15] of *matching* income and the expenditure incurred in producing it, the *sine qua non* of this strategy is based on creating and exploiting *asymmetry*. Tax deductibility for these composite expenditures operates to generate a subsidy, a "tax expenditure" (to use the technical term in an extended sense) for the activity in question.

The crucial assumption by Treasury is that deductibility is an all or nothing matter. This superficial assumption uncritically accepts the outcome of various schemes which deliberately fudge expenditure to produce various categories of profit, some taxable from the same income basket and some not taxable or taxed in various privileged ways. It makes no attempt to analyse what the tax system "intended". To assert that "commercial judgments on factors other than tax are involved and will frequently dominate" is to gloss over the systematic, structural tax advantages which dominate the dynamics of most of the tax driven takeovers which are falling to pieces in the current economic downturn. The question is not whether there are important non-tax issues driving takeovers. Clearly there are. It is whether the sort of tax based structural advantages of debt financed takeovers have created a systematic bias in favour of the predator and whether such bias can be justified on the basis of over-riding economic outcomes.

Treasury, from on high, also argues that measures to restrict deductibility of interest on money borrowed to fund takeovers are unlikely to be made to

13 At 9. While this argument was directed mainly at the inherent bias involved in the double level of taxation involved in the old, classical system of company taxation (an argument which is vigorously attacked by Andrews, "Tax Neutrality between Debt and Equity" (1984) 30 Wayne LR 1057), it is also based on wider assumptions.

14 at 10; See the way the argument is constructed simply glosses over the critical question in all its assumptions and the way in which the later analysis of imputation (correct in itself) simply glosses over the tax arbitrage potential of debt deductibility.

15 Dixon CJ in *Commissioner of Taxes (South Australia) v Executor Trustee Co (Carden)* (1938) 63 CLR 108, 152.

work effectively[16]. It is argued that restrictions on takeovers could be circumvented in friendly takeovers by the purchase of assets rather than shares[17] and that it would be difficult to trace takeover funds in large corporations.

Because of cash flow problems and debt servicing costs, as a matter of practicalities, it is by no means as easy as Treasury assumes to fudge the linkage between borrowing a couple of billion dollars and the production of income. Since the backlash against legalism in the 1970s, the Courts have become much less formalistic about searching for the *real* purposes of an expenditure. They are willing to infer causal linkages from the whole context of a scheme. In *FCT v Hunter Douglas*[18] the Federal Court was able to penetrate beyond the immediate income earning destination of borrowed funds and look at the ultimate, capital, purpose of a $2 million loan. With the introduction of intensive audit, it is possible to monitor the real use to which funds are put. Needless to add, the Australian authorities have avoided the temptation to engage in mindless application of tracing rules to ensure that the actual dollars spent find their way into the same pool as assessable income. This is one of the positive outcomes of the legalism aberration. Everybody now understands that formalistic attempts to match expenditure and the income it produces will invite excessive pedantry and the breakdown of the practical workability of the matching principle.

One of the basic problems in the Treasury position is its reliance on the fungibility argument. The argument assumes that, because a company which borrows cash is indifferent as to the destination of that money, so should the Tax System.

The linkage between expenditure and the production of assessable income is fundamental under Australian income tax law. It is the operational arm of the matching principle which is the bed-rock on which the whole law of deductions, and indeed the Australian concept of assessable income, rests. While it can be conceded that it is possible for well advised taxpayers, by judicious juggling of borrowed and other funds, to artificially construct a plausible causal linkage, it is a far step from this proposition to the further proposition that, because cash is fungible, any attempt to apportion expenditures and relate them to the income they generate should be abandoned. On the basis of this sort of argument, to take

16 LR 1039, 1041.

17 This is hardly an argument, since we would want to apply the same critical analysis to geared purchases of assets.

18 (1983) 14 ATR 629.

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just one example, we would also abandon any attempt to assert a jurisdiction to tax based on residence and source. The causal link in all of these cases can be similarly constructed and there is frequently no more "economic rationale" for the locus of profits in transnational companies than there is for attaching borrowing to take-overs.

By refusing to carry out this causal analysis for interest deductions, as the sorry US history demonstrates clearly[19], is simply to transform a discussion of causality into an equally artificial discussion of definitions of "interest". It is fundamentally wrong to imagine we can abandon all attempt to link expenditure and receipts and the US conceded as much in the very same year the Treasury paper appeared. This is not to say, of course, that, in the case of composite expenditures, an arbitrary apportionment based on objective rules might not provide the most suitable second best. It is to say that to take your marbles and go home because this issue is too tough is to concede the main game. To repeat, the tax base is no more secure than its weakest point.

But most damning of all is Treasury's argument that, in any event, a distinction attempting to trace various forms of interest expenditure can not be supported "because, in principle, attributing interest expenses to particular revenue items has no economic rationale. It is simply not possible, on economic grounds, to say that a particular interest expense relates to a particular item of income."[20]

This elevates the fungibility argument from a practical constraint into a theoretical imperative. Causal constructs are never completely adequate. But they thread through every part of income tax law[21] and indeed through every other part of civil and criminal law. This form of argument, typical of so much economic argument in the media and public decision-making during the 1980s, demonstrates the danger of a discipline which overreaches its area of comparative expertise. Application of the same argument in the general context of deductions[22] would undermine any sustainable position and that alone is sufficient to discredit the argument[23].

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19 Historically the US gave an open-ended deduction for interest. This merely pushed the inevitable definitional problem to the issue of whether an expenditure was "interest" and the artificial problems involved were just as severe. After much criticism, this attempt was finally abandoned in, ironically, 1986 when the US moved largely into line with Australia.

20 At 17.

21 eg residence, source, all manner of deduction items (whether spending was for income earning property), attribution of income from labour.

22 For example, apply it to questions of whether money spent on books or education or travel or amounts spent on defending employees is deductible. Acceptance of this silly

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The Treasury argument which can be taken seriously is that which insists that the disallowance of deductions for takeovers would put Australian business at a relative economic disadvantage in takeover battles for Australian companies against foreign predators and at a relative disadvantage against defenders in the target company. It is thus unfair and counter productive to act selectively against our own corporate predators.

A number of points should be made. If we accept that behaviour ought not to be proscribed because off-shore competitors or white-knights can do it, we lay ourselves open to the lowest common denominator on all issues from prohibitions on child labour, minimum wages, to leaving our tax base at the mercy of those who engage in various schemes. This might be a reason for examining the utility of our own rules or it might be a reason for being more circumscribed and more conscious of the downsides before getting too settled on the international deregulation bandwagon. It might be a reason for doing some lateral thinking about better targeted measures to proscribe the evil at hand rather than generating very large tax expenditures, putting an enormous hole in the tax base and distorting the tax system in quite fundamental ways. In any event, after its own 1986 changes, the US has retreated from its position on this matter and the cogency of this argument recedes.

Treasury explicitly supports its position with a wider policy argument. It is asserted that disallowing deductibility "may be quite contrary to basic economic or social objectives", so that a "solution" which yields the highest revenue may not be the best solution[24]. Presumably this is bureaucratese for saying that the Government ought to accept this open-ended tax welfare benefit to our corporate raiders because of the wider economic payoffs generated by takeovers.

Putting the case at its most generous, the empirical support for the cost-effectiveness of this large and undisciplined tax expenditure is uneasy. The basic reason for supporting the tax expenditure is it disciplines the company sector to ensure that assets are used effectively. If there is a group

argument would make most of the case law on deductions and capital/income issues otiose.

23 See the detailed refutation of the argument by the eminent economist Richard Bird, "Comment on Tax Arbitrage" (1984) 30 Wayne LR 1016. He analyses the different objectives of income definitions used by various policy makes and notes "there is no reason at all why what is done for one purpose has anything to do with what is, or should be done for another". More specifically, the fact that "interest flows are unrelated to the production of income" is no more relevant for interest than it is for rent, transfer or capital gains. In other words, this is the elementary error of the first year law student.

24 At 9.

of paper entrepreneurs waiting to take over under-performing companies, this will provide a potent incentive for effective performance.

Even blatant greenmail by a practiced elite of corporate raiders, according to Treasury, "may serve a useful economic function"[25]. It provides an economic signal to management that existing resources are under-utilised. Whatever the wider benefits of potential coup d'etats on encumbant management as a form of economic discipline, this argument does not explain how it benefits the wider economy to transfer the economic rent from the under-utilized assets to the predator or how the economy benefits from another class of un-productive paper shufflers. Perhaps such carnage and misallocation of resources, including the massive transaction costs and management effort and vision consumed in the game, is justified because there is no more efficient regulatory mechanism for making management accountable than this grossly expensive and strategically flawed method of regulation. Give me the massive cash earned by the greenmailers during the last decade and I will come up with a more effective regulatory mechanism.

When all the downsides of this "regulatory" regime is coupled with the insight that *artificial* advantages flow to the tax driven greenmailer or other predator, the position changes qualitatively. It is even worse when the predator enjoys the blatant contrived and artificial advantages of the *Palvestments* type or on the basis of other schemes which double dip on the benefits. The predator translates the artificial tax driven advantages described earlier into an unfair advantage over an otherwise economically efficient management. **The tax system builds in a decisive advantage for the paper shuffler over the genuine productive manager.** The exploitation of this insight puts the predator at a critical strategic advantage over a prudent management. It encourages the target company management to crowd out this advantage by gearing beyond a prudent or commercially rational level. By failing to remove the basis of these schemes we stimulate a share market game in which reality, in the form of rational capital mobilization for real wealth creation, recedes in favour of outcomes driven by strategic paper advantages generated by the schemes I have described. Does this promote the sort of playing field the Treasurer has been selling? Was this a major contributor to the economic instability suffered in Australia during the 1980s?

Treasury advances the argument that "there is no indication that [high gearing] has been a source of instability to business overall or that there is

25 At 22.

reason for general concern in this regard"[26]. This argument can be contrasted with statements to the opposite effect in the US[27]. The argument is an embarrassing Albatross. Having regard to subsequent events, it is difficult to imagine anyone who would want to support this argument in 1990. Few would now doubt the damage generated by the failure of highly geared conglomerates in the recent economic downturn. They threaten the stability of the Australian banking system, impose balance of payment pressures, have contributed to unusually high interest rates, compromised Australia's reputation among overseas investors and undermined the economic health of the nation, not to mention the disastrous substantive consequences in particular industries, with particular reference to the media industry.

A vigorously argued case against the interest deduction for takeovers is advanced by Professor Bale in a 1981 attack on similar proposals in Canada[28]. He refers to such a deduction as a "welfare tax subsidy". It is unnecessary to repeat his arguments at length here. Among his reasons back at that stage were the arguments against corporate concentration, the adverse balance of payments effects, and the diversion of scarce capital (including bank credit). It is not as if Treasury was unaware of these arguments when it commited billions of dollars of taxpayer funds.

The primary factor to weigh against any advantages of economic discipline by takeovers is its tendency to increase aggregate corporate concentration. Government sponsors a half hearted Trades Practices policy which vainly attempts to halt the tide of monopolistic forces generated by takeovers with a minimalist strategy which intervenes, if at all, only when the last of the majors in an industry are gobbled up, while simultaneously advocating a tax policy which creates structural biases strongly signalling corporate concentration to the (anything but free) market. Regulatory policy can only operate at the margin to proscribe the most flagrant behaviour and can never operate effectively if other fundamental policy parameters are out of step.

The recent research study by the Bureau of Industry Economics on Mergers and Acquisitions found that "mergers may not produce all the efficiency benefits expected" and ironically, it was international competition which was an important determinant of efficiency. Takeovers merely acted

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26 At 19.

27 See analysis in Bryan, "Leveraged Buyouts and Tax Policy" (1987) 65 North Carolina, LR 1039, 1041.

28 G. Bale, "The Interest Deduction to Acquire Shares in other Corporations: An Unfortunate Welfare Subsidy: [1983] *Canadian Taxation* 189.

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to accelerate inevitable changes in industry structure. On the other hand, the mergers did not appear to have the feared impact on competition.

4. Proposition Three

Much of the generalized economic rhetoric used in public debate is useful to sell tax policy to the electorate. It is useful for that purpose alone. If that rhetoric is taken seriously as the foundation of a tax reform strategy, it is likely to lead policy makers to paper over the critical factors which should drive hard policy choices.

Let me address some points which it has not been fashionable to articulate publicly in recent years. Let us assume for the purpose of argument that in a market economy which is not generating enough investment it is sometimes necessary to trade off fairness in the distribution of the tax burden, to compromise the even playing field so convincingly modelled by the Canadian Royal Commission, in the larger cause of promoting economic productivity. Let us accept that, notwithstanding the comprehensive tax base rhetoric, one of the methods by which subsidies are delivered is by building structural biases into the tax system, such as a capital gains shelter, a comprehensive deduction for all interest, a superannuation tax shelter or a sharp move to indirect taxes (thus exempting all savings from tax). Let us further assume that it is the job of economists and lawyers to legitimate such necessary asymmetries.

But to assume the proposition that these structural biases in the tax system are justified, is not to assume the further proposition that any given means of pursuing them is also justified. We must still establish that those measures can be justified on the basis that the revenue foregone is used cost effectively to generate saving and investment. One can readily accept that a market economy, lacking the mechanisms to command investment, can only achieve adequate levels of investment by building in financial carrots to save and invest. Unfortunately, by definition, the only ones with substantial capital to invest are rich persons and institutions. It is very easy to confuse basic national investment policy with the short term self-interest of this constituency. It hardly needs to be spelt out that the interests of this constituency does not at all times and in all circumstances coincide with the wider national interest.

The problem with the old capital gains tax shelter was not so much that it shifted the tax burden from the poor to the rich. The nub of the problem was that this largesse was squandered and worse because it gave the wrong signals to the market. It was a badly targeted and counter-productive investment incentive. It encouraged the paper shuffler who did not mobilize capital effectively and it put the genuine investor, that dying breed who generates real wealth and real income flows, at a relative disadvantage. It sacrificed both tax revenue and *effective* investment.

The trouble is, of course, that the media and the gathered multitudes cannot handle such "subtlety". They would rather have easy to measure but wrong outcomes rather than hard to measure but right ones. Since it is difficult to measure the quality of investment, politicians design their policy to maximise crude investment numbers and receive the brownie points of the Canberra press gallery when these Mickey Mouse figures look good. The mere fact that much of the investment happens to be the sort of highly geared and ultimately sterile paper television investment of Bond or Skase, borrowed dollars creating illusory capital "value", does not show in the figures. How does it assist the economy to bid up a television station to a value which bears no resemblance to its true worth, as measured by cash flow, and to borrow big to do so? Unfortunately, the sterility of such a strategy is only obvious well down the track when the highly geared "South Sea Bubble" bursts. In Australia today we still continue with the policy stances which encouraged this nonsense.

A sharp move from income tax to indirect tax constitutes a massive tax windfall to those who do not consume all their income in Australia. But is the considerable tax cost well targeted and is it cost justified? Would we be better off frankly acknowledging that the current Australian Tax System is, in fact, a hybrid of income tax and expenditure tax? If we really must have structural biases to encourage saving and investment, we could concentrate on cost-effective strategies for improving the design of tax shelters for saving through superannuation or direct subsidies or carefully disciplined tax shelters in other areas. With careful design we can get a lot more investment bang per government buck.

Now let us move down from the big picture into the detailed design of indirect tax. It is not unusual for academic economists to have love affairs with tidy constructs, and it is not unusual for them sell such constructs to politicians with similar prejudices. Economists carried all of Europe with their obsessive vision of a perfect tax collected at every stage of the production process with *every* business filling in tax forms for *every* transaction and correlating them to *every* invoice. This sort of obsessive computerised record keeping leaves the Australia Card for dead. Far better that every business to spend $10,000 transaction costs on tax collection and to create a dossier on every single transaction than any taxpayer escape $10 of tax. Britain had to go along as the entry fee for joining a greater Europe. But it is more unusual for *Australian* businessmen to get carried away by such obsessive visions. Perhaps there is more to this than meets the eye.

Subsequent events have given me little occasion to revise my views expressed at the 1985 Tax Summit:

"Most of the tax debate leading up to this Summit has focused on the tax mix. This pre-occupation has caused us to lose sight of more critical issues. Treasury is completely correct in its *diagnosis*. The central problem, and we should positively fixate on it at this Summit, is that the long suffering [income] taxpayer has been picking up a steadily increasing tax burden.....

But, on the road to *prognosis* it is very easy to lose sight of this central problem. It is easy to imagine that all our problems can be solved with bold statutory monuments and substantive measures. The path to *enduring* reform is more prosaic, more untidy, less covered in glory.

Let us concede immediately that the shonky indirect tax system (and I do not limit this to Commonwealth Wholesale Sales Tax) is in need of structural [renovation] and base widening. There is a respectable case for diversification of revenue sources, so that no one tax bears a disproportionate share of the tax burden and a respectable case for a moderate bolstering of indirect tax to take up the slack as the crude oil levy runs down. To be fair, that case has been grossly exaggerated because, contrary to popular mythology, neither the share of direct or indirect taxes in the Australian tax mix is significantly out of line with the OECD average. The danger is that a tax reform strategy which elevates a sharp [shift in the tax mix] and a dramatic [change] in indirect tax to its focal point can so easily become a red-herring to divert scarce resources and political attention from the *real* problems which should pre-occupy tax reform strategy."

My preferred indirect tax strategy is one of gradual base widening, of considerable work to give coherence to the existing wholesale sales tax, of doing deals with the States to rationalise or buy them out of some of the cumbersome taxes which exact heavy transaction costs on business, of retooling sales tax to modify its impact on export and to give a great deal more attention to business and government transaction costs. I have no problem with a gradual and moderate bolstering of indirect tax to take some pressure off income tax. I would support base broadening to bring services into the indirect tax base.

But the argument for running down the existing income tax system and going overboard for a broad based consumption tax makes very little policy sense to me.

We must rigorously separate the case for greater emphasis on indirect taxes from sales tax design issues. If we get carried away with the vision splendid of a brand new tax, it is very easy to paper over more important questions about who wins and who loses, about the wisdom of conceding so much of the existing indirect tax base in the change. Big bang tax changes and the crude rhetoric of neutrality tend to inhibit detailed scrutiny of the precise policy shifts that are predicated by the package of changes. Consider these matters:

First, why would a rational policy maker increase his tax collection points tenfold? The whole trend in tax administration is to dramatically cut down on collection points, to cut a swath through form filling and to lower taxpayer transaction costs. Current costs of sales tax collection are *less than one half of one percent* of taxes collected. Taxpayer transaction costs would be right down at the lower end. In the orgy of public sector bashing in recent years, the media have not given enough weight to a set of numbers for administrative costs which would send shareholders in a comparable private sector service company into paroxysms of joy.

Second, why would a rational policy maker go through the enormous political pain of reform and fritter away most of the revenue gain from the broad based consumption tax by giving a large chunk of it back through reducing higher rates of sales tax? The market has already capitalised these higher rates into the pricing system and such changes would merely result in windfall gains to many undeserving industries in our less than perfect market (does anyone want to argue that point after the recent performance of our banks?). If you really want to recycle a few billion dollars from a broad based sales tax, I am willing to bet we could get better outcomes on key economic variables by redeploying those tax dollars elsewhere. Furthermore, the Labor Government's recent decision to raise the sales tax rate on luxury cars demonstrates that sales tax surcharges can be a useful policy tool, perhaps a more effective strategy for attack on key economic numbers than the indiscriminate carnage of high interest rates. No one seems to argue the *comparative* distortions of high interest rates and other mechanisms for restraining aggregate demand or imports with more explicit policy intervention. To the outside observer, it is a matter of some amusement to observe the selectivity with which neutrality arguments are mobilized. You don't need to be a political science major to understand who wins and who loses and to unscramble these stark bottom lines from the neutrality rhetoric.

Whatever the merits of the go-for-broke scenario, it is clear that the ground rules have changed since 1985. We have had the backlash against the Poll Tax in Britain and an Australian electorate weary of 10 solid years of tax reform. This has exhausted the electorate's tolerance of big bang tax reform. The real danger in the go-for-broke option, as we have seen since the Summit, is that much of the design work is done under pressure and new structural anomalies inevitably creep in as the policy maker buys off pressure groups to maintain momentum.

But, more particularly, the Treasurer's speech of 9 May 1990 was itself a considerable political event. It served notice that the centre of political gravity is shifting. If the Liberals are going to be bloody minded about death duty and a fair capital gains tax regime, Labor has signalled it will play the same game with indirect taxes. **When all is said and done, a shift in the tax burden from the poor and middle class to the rich is fundamental to a shift from an income to a consumption tax base. The whole point of the exercise is to exempt savings from tax and to move the tax burden from higher taxed items to food and services.** If one of the major political parties is willing to blow the whistle on a distributional shift which proponents of the tax had hoped to achieve with a minimum of fuss, the political cost is likely to be heavy. By putting a dollar figure on the costs of compensating welfare beneficiaries *and ordinary taxpayers* in the marginal electorates the undertaker from Bankstown has created the conditions for embalming the broad based consumption tax at the appropriate political moment. Paul Keating has signalled that, in the future, it will be every bit as hard to introduce a broad based consumption tax as it was in the past to introduce a really effective capital gains tax. Instead of the advertisements in the Sydney Morning Herald showing the Commies grabbing your family home, we are going to get advertisements showing the Fascists taking bread from starving children to pay for their Porsches.

My own preferred agenda is to move the focus firmly back to establishing a consensus on detailed sales tax reform. We need to focus on the hard graft of making the existing system into a more effective policy tool and a more efficient collection instrument. There are still important lessons to be learned from overseas structural changes, but, in Australia, the main effort should focus on the detailed processes of renovation. A future agenda might include:

-continuing work to lower both taxpayer and Tax Office transaction costs of collection, with particular reference to increasing computerisation and the associated changes under the Modernization strategy

-structural reforms which remove sales tax on exports

-steady rationalisation and better targeting of the rate structure according to articulated economic and distributional objectives

-gradual broadening of the base to bring in the growing services sector.

-examining the various state indirect and other taxes and generating dialogue about means of bringing them into a more robust and more efficient system coordinating federal and state taxes

-restructuring the dog's breakfast which is sales tax legislation and increasing the coherence of the working rules under which they make decisions; subject to more pressing income tax priorities, a full scale renovation and redrafting of sales tax legislation should in due course flow on from the Simplification initiatives

-continue and sharpen the excellent work of communicating those rules more effectively through a systematic program of industry specific rulings and service so that common problems are monitored and compliance, for the vast bulk of honest taxpayers, is made steadily less difficult

-increase the responsiveness of decision-makers to genuine taxpayer problems and put an emphasis on negotiating rather than litigating disputes.

This strategy is not the stuff of political grand opera, but for those who seriously believe that an efficient tax on spending makes sense, it is probably the optimum strategy in an imperfect world. It deals with the most pressing problems in an orderly way and it gradually transforms the system into something better approximating our ideal.

5. Proposition Four

Rhetoric can be liberally dispensed with a large trowel to convince the gathered multitudes of your wholly self-less motives for hard policy choices, but it must never, never, never be taken seriously. One of the great dangers for any discipline is to start to believe one's own rhetoric. This can very quickly blunt the ability of its communicants to evaluate policy choices critically.

A clear corollary of the previous technical analysis needs to be taken out and separately underscored. As our vehicle, let us revisit the deductibility of interest on corporate takeovers. If my argument is correct, it demonstrates that Treasury's attempt to ride over the top of the question with neutrality rhetoric obscured the hard issues. Issues about deductions for company takeovers do not resolve themselves into an unambiguously clear solution. The issue cannot be resolved by the mobilization of dogma, framed at a high level of generality, about deregulated markets and even playing fields. All options involve distortions. The central argument for Treasury's preferred position, put forward back in 1986, was that it offered neutrality. This argument is bogus. Both of the main options (and any conceivable compromise) generate non-neutralities. Neutrality is the only option not on the table. Essentially, the issue involves, a choice from among evils and a choice which must be resolved in an unsatisfyingly complex second best context. In a system, such as ours, which is such a vast distance from the Haig/Simons ideal (particularly as it relates to the treatment of capital profits and its crude reliance on dollar values which do not incorporate time discounting), arguments based on neutrality can not be taken seriously in any sort of rigorous tax policy debate.

Let us revisit a cautionary tale. It is about that eager crop of law graduates from the 1960s. Lawyers stood over the tax policy making process like a colossus. We created a coherent ideology of legalism and that dogma was drummed into the brains of young graduates who genuinely felt their conceptual system gave them a unique ability to understand what policy making was all about. Lawyers had the charismatic authority and they had the appropriate rhetoric to sustain the illusion that they had *the* answers. They even had the wider community believing it. But the story has a punch line. The inadequacy of the dogma became manifest and the love affair with the people gradually faded through the 1970s. By this time lawyers had fooled themselves that high legalism really did describe all the essential elements of the policy universe. The ideology of high legalism over-reached itself and it prevented opinion leaders in the legal profession from responding to the manifest inadequacies of their dogma until it was too late to prevent heavy damage to their credibility. It lead the Australian Tax System down a very costly blind alley, costly in terms of tax dollars, damage to the social fabric and damage to Australia's prospects in the world.

A decade ago I invited economists to learn something from these lessons. But self-conscious re-examination of the operational ideology of economists has not been obvious in recent years. Like high legalism, economics is a discipline characterized by an all-compassing and selective view of reality. It operates at a very high level of generality and relies on a few well understood assumptions for its appeal. Like legalism, the paradigm is so pervasive and all-encompassing that it makes falsification within the accepted framework of discourse well nigh impossible.

Suppose, *purely* for the purposes of argument, and heaven forbid that I should be taken to be advancing this argument in anything but a hypothetical way, but just suppose all the deregulation and floating of the currency was a dreadful mistake. What evidence could one adduce to demonstrate it? How many Bonds and Skases and Pyramids and Connells would it need? Suppose that Tricontinental and Western Australia Inc were not a separate problem but part of the same problem. How would we expose the outdated intellectual baggage? Where would we start to search for new ideas?

We would need to go right back to fundamentals, to the basic idea of a decentralized economic system driven by competition. But, with the accumulating wisdom of recent experience, we would now understand that such a system can operate effectively only if supported by a robust and functional set of cultural understandings, a shared acceptance that business should be evaluated and rewarded by a market system which recognised only real contributions to society's wealth. The necessary underpinning for the operation of the free market will not spring up from the "random" forces of the market itself. Strong institutional foundations would need to be constructed to support and give substance to this construct. We would need to work hard to generate a consensus about the appropriate ground rules used to channel the powerful forces of individual enterprise to the broader economic objectives of the nation. Just as the criminal law has restrained the big and strong from mugging little old ladies to pursue self-interest, we must channel economic self interest. In particular, we would need to make sure that industry was restrained from acting contrary to its own long term self-interest when pursuit of self-interest compromises the foundations which ensure that *productive* competition can be sustained over the longer term. We would need robust mechanisms to forestall the dynamics which, exploiting the very processes of competition and free enterprise, undermine the foundations on which free enterprise can deliver the goods. We would have to find effective mechanisms to stop the paper shuffler from probing the limits of our tax rules and, in a process of attrition, using the mutant rule to generate a decisive advantage over the genuine producer of real goods and services. We would need to construct a set of robust principles in the tax area, analogous to the prohibitions on anti-competitive behaviour in the Trade Practices area, to prevent artificial tax arrangements from undermining the system of rewards allocated by the market.

We have an unhappy alliance in Australia. We have a media and politicians who are altogether too ready to sell the public the bogus idea that the world is a simple place and can be understood with a single media grab. We have an economics profession, altogether disproportionate in its influence in government, the private sector and the media, much of which has an evangelical mission to promote the simplistic idea that, if only we let people do their own thing, if we deregulate all our institutions and run down government so it will be incapable of interfering in our affairs, nirvana will follow. Such a simplistic notion is just as silly as Karl Marx's idea that if you give the proletariat its head then its spontaneous centralized organs will be able to motivate the work force and run a complex modern economy.

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tion is instructive. Even a reluctant Reagan realised that some things positively absolutely must be done by government. The costs of Reagan's one dimensional rhetoric are exacting a heavy price in America and in Australia today. Partly from necessity and partly from historical accident, those service industries which are most vital to the effectiveness of the Australian economy just happen to be located in the public sector. I need hardly underscore the fact that the most critical resource in a high technology economy, research and development of our human resources and the ideas which drive them, quaintly going under the old-fashioned title of "education", is almost wholly reposed in the public sector in Australia. Alan Bond's early efforts to privatise this service industry are hardly auspicious. All our mechanisms for ensuring that the corporate and tax framework operate effectively, our vital economic steering infrastructure, are in the public sector. The plain fact is that it is just straight dumb to run down these vital facilities. In order to cut down on extravagance and waste in a bloated public sector, Reagan shot the navigator. What we need is not destruction of the public sector but much more cogent strategies to ensure that it sticks to the jobs it does well, that it operates efficiently and effectively.

In many ways, the public sector unions have been their own worst enemies. There is a very strong case for ensuring that the public sector is more accountable and better managed. It is sheer crass stupidity to run down this vital infrastructure on the assumption that all of its jobs can be done by the private sector. In the orgy of deregulation, public sector activity was indiscriminately starved of resources and morale was decimated. If the cost of this facile approach has not been sheeted home by the international loss of confidence in our capital markets and the flight into the escapism of paper entrepreneurs, then nothing will drive it home. Where are all the media experts and politicians who promoted this one dimensional nonsense? Are they now standing up to be counted for the loss of international confidence in our stock exchange and the crashes of over-geared paper conglomerates?

If there are not adequate mechanisms for maintaining acceptable norms of market behaviour it is the corporate crook and the paper shuffler who get the decisive advantage. Genuine productive corporate management is left at a relative disadvantage and, in the fierce battle for market share and for the high ground in a takeover, these artificial advantages often prove to be decisive. With the benefit of hindsight we can witness the carnage done to our powerful television industry in the eighties through this sort of policy. We need not get into the US Savings and Loan fiasco or its Australian analogue. In the crunch, it is clear that no major industry is an island and any free market model which assumes that

Effective political systems grow from the interchange of sophisticated ideas, division of powers and creative tensions, not this sort of simplistic dogma.

Now it is hardly the fault of economists that they find themselves in the position where vigorously-sold claims for a free market, through lack of any counter argument, have been taken on board so literally as an all singing, all dancing answer to all the problems of the world. Savings and Loans of the world unite! This skewing of the debate took place because, when the going got tough, when we really had to address scarcity and the death of the warm inner glow, most other social scientists dropped their bundles and could not adapt to the new environment. All the half competent lawyers were out making money by the barrow load and were far too sensible to waste billable hours in endless public policy analysis (unless it was to do some fixing for clients). This one dimensional outcome was accentuated because the centralized political systems, the main models of government intervention, were so demonstrably unable to deliver the economic goods and so slow to adapt to a new world order introduced by rapid technological change and the knowledge society.

One really unfortunate downside to this one dimensional debate stands out. People really started to believe that we could run an efficient economy without the conscious articulation and reinforcement of a set of robust and balanced ideas to drive that system and without effective public institutions to assert these key ideas in public discourse. Like the monetary imperatives institutionalised in the US central bank or the civil liberties entrenched in our Constitution and enforced through the third arm of government, we must guard important economic structural values by entrenching them in our basic institutional structure. We need to ensure that the short-sighted and the greedy do not foul their own nest. Contrary to the popular mythology, greed is not all a good thing.

6. Proposition Five

The main determinant of outcomes in our Tax System is the design and quality of our institutions. This requires the commitment of resources and proper quality control. Above all, the effectiveness of our Tax System will be determined by the extent to which we can replace the one line media grab and the glib deregulation rhetoric with a willingness to look squarely at what jobs must be done by government and how they should be done.

Ronald Reagan made something of a political cult from pointing out the all too obvious shortfalls of government bureaucracy. Of course, this exercise in macho politics never explained how he could consistently support massive public sector military expenditure. Such minor contradictions have never got in the way of a good myth. But the military contradicthe rest of the community is not bearing the cost of the excesses of the "private" paper shufflers is extremely selective.

In the case of tax, as I have consistently maintained over the last decade, the quality of institutional structures and the people who staff them is a more significant determinant of outcomes than grand substantive reforms. In fact, with effective feedbacks, maintenance and redirection of the tax system, periodic orgies of big bang tax reform should not be necessary. With renewed interest in the quality of Australian tax administration we have seen a gradual improvement in the coherence of the Australian Tax System and its responsiveness to real world problems. But severe problems remain. The plain fact is that the bureaucracy (both in Treasury and the Australian Tax Office) must compete in an open market for a relatively inelastic pool of competent higher level tax expertise. It takes not take higher level econometrics to understand that if you pay only 30% - 50% of the going market rate for scarce expertise, in the long term, you are going to get what you pay for. It did not hit the evening news but very recently the Tax Office in Sydney lost one of their best middle level international auditors, part of a steady bleeding of their best and brightest. Virtually all of the Sales Tax divisions of the accounting majors are staffed by Tax Office old boys. It is getting to be a stale joke at the annual Sales Tax Conference run by the Taxation "Business and Investment Law Research Centre.

The cost of this constant drain of this finite pool of human resources is very high. Yet all the bright economists in Treasury and the politicians who have made their reputations on hard nosed understanding of market realities and our trade union leaders (who insist on selectively flexing their muscle to gain restraint in this one easily targeted sector) refuse to see what is blindingly obvious. We must allow public sector salaries to respond to the realities of the market and ensure that public sector executives are paid by performance. We must break the deadening uniformity of public sector salaries so we can get resources to where they are needed. The public sector unions must stop being bloody minded and respond to the real interests of their members. Their own interests and those of their members are not served by a rigid and declining public sector.

Up to now, rigidities in the labour market and the residual warm inner glow of "doing the right thing" have given us much better tax management than we deserve. But the promotion of free market rhetoric by the Treasurer himself and steadily increasing labour mobility is gradually eroding these market imperfections. People who have been told that self interest is the only value worth anythingresent doing professional work for rates which are well below market and they either vote with their feet or, more damagingly, with their lack of commitment. If we accept the basic proposition that all the substantive reform in the world is useless without the educated, skilled and adequately paid personnel to make the system work, the bottom line is stark. Let me state it unambiguously. Politicians who undermine the rigorous enforcement of tax law or fail to pay normal market rates for the tax expertise to support it are making a clear choice. That choice is to allow the erosion of the necessary infrastructure which will ensure that the *private* sector will operate effectively, that it is not dominated by the predator, the inside trader and the paper tax scheme. Arguments about cost are completely spurious because expenditure on such public human infrastructure is demonstrably necessary and, if proper systems of accountability are put in place, demonstrably cost effective in the tax area.

Analysis of public organisations has, over the years, suffered from extreme bias. Who points out the simple fact that the Australian tax system operates at a cost of just over 1% of revenue collected? What are the comparable costs for operating large volume service organisations like insurance or banking? Would we be better off ceasing our fixation with government spending and asking more intelligent questions about whether it is cost-effective to put more resources into this sector? Compare the turnover of the Tax Office (rapidly approaching $100 billion), the responsibilities and effectiveness of the present Tax Commissioner with his private sector counterparts. Then compare the salary of the Commissioner and Tax Office technical experts with, in particular, the salaries of tax experts in the big law and accounting firms. The comparison is high farce. It is about time we saw present attitudes about remuneration in the public sector for what it is. It is a transparent attempt to run down the public sector, not for the good of the nation but to respond to superficial rhetoric by those who have something to gain from a crippled public sector. If trade unions leaders are seriously worried about the shape of the economy, they must stop attacking the soft target of senior public sector salaries, an easy but irrelevant target. The real issueis the failure to develop a comprehensive income policy. So long as company directors and private sector professional advisers can command such bloated remuneration, it is sheer short-sighted bloody mindedness to deny the public sector the right to compete and to slowly bring it to its knees. It would make infinitely more sense to conduct an industrial campaign to peg ordinary workers wages to percentage executive pay rises during the last decade. This would take the wind out of management rhetoric about wage costs and put them to a highly germane election about free markets and restraint.

6. Conclusion

Economists tend to assume that if we construct coherent tax structures and close the obvious loopholes, the rest will take care of itself. The lesson of the 1980s is that this vision is incomplete and fundamentally flawed. Rather, the message of this period is that the paper shufflers are capable of generating their own distortions. They can manipulate substantive tax provisions, however well constructed, and they have the resources to intimidate Elliot Ness for long enough and to muddy our clarity of purpose for long enough to run off with their multimillion dollar returns and to leave major industries in ruins before the stable door is bolted.

Grand visions are essential to coherent tax reform. But effective reform is generated by creative tension between grand visions and a strategy generated from hard analysis of battlefield experience. Political and administrative constraints dominate the construction of effective strategy and they need to be injected into serious tax policy analysis much more systematically than they have in the past. Much of the even playing field rhetoric ends at precisely the point where serious tax reform analysis should start. The real impetus for tax reform must be generated from the technical insights of the enforcers at the grass roots.

A large number of opportunities exist for the operators to manipulate the tax system behind the bland facade of the even playing field. By analysing various examples of such opportunities, this paper sought to demonstrate the practical ways in which the paper shufflers wring such distortion out of the tax system through detailed exploitation of the technical provisions or by reliance on enforcement inertia. It sought to show the way in which the same over-generalised rhetoric, selectively mobilized, continues to be used to paper over the real policy issues in tax reform analysis.

At the end of the 1980s the tax system is still far from coherent and, since the tax system is no stronger than its weakest point, it still sends faulty signals to the market at various critical points. To counter these problems we need be much more sophisticated about issues of conceptual coherence. Conceptual coherence must be redefined to become coherence *after* political and administrative reality is admitted into the conceptual matrix. We must not neglect the hard technical and institutional graft which ensures that this coherence is reflected in the many detailed decisions made on the ground. Grand constructs give one a good feeling of security and completeness. Human being like to feel they have a handle on the world. But the warm glow is no substitute for hard work on technical tax issues on the ground.

Finally then, we need to ensure that we put into place the conceptual structures and the resources to make the tax system work properly. Increasingly effective public institutions must be developed to underpin effective performance of the free market. Without an effective framework of principles, the institutions to constantly reinforce such principles and to flexibly adapt them to the realities of the battlefield, the market has a tendency to drift into a situation where the paper shufflers and marginal operators are allowed to dictate the dynamics of the "market place". The ability to obtain insider information, to sterilize competition or to gain an unfair edge through a tax scheme are factors which can give a critical competitive edge to the smart operator. Without constant vigilance and constant redefinition of issues the smart operator seeks and exploits the line of least resistance, and then the competitive pressures of the market ensure that others will follow. Like water finding hollows in the even playing field, "the market" will find its own level in the deepest hole of easy money and channel productive resources in the wrong directions. The producers of real goods and services who cannot or will not play these games will be put at a critical relative disadvantage and will be destroyed.

Paradoxically, only by active and intelligent intervention strategies to combat these nihilist dynamics can a free market operate in the way it was intended to operate and produce the desired economic outcomes. Adam Smith might have said, has he had the benefit of a decade of hindsight Australian style, that we need a guiding hand informed by a deep self conscious understanding of the rules of the economic game and a steady eye.

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