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Options and Proposals for Taxation Reform

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OPTIONS AND PROSPECTS FOR TAXATION REFORM

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Comprehensive reform of Australia's taxation system increasingly seems necessary. As a long term structural change, taxation reform could secure and stabilise future government revenue, restore tax neutrality and facilitate greater productivity, reduce resources wasted on high tax compliance activities, and more equitably spread the burden of funding government activities. Income, expenditure and asset taxes are in disrepair, and Commonwealth, State and Local government taxes need to be reviewed and reformed. Influential community groups, including business and welfare organisations, and key politicians in Canberra and the various States have actively raised and advocated widespread and fundamental reform of Australia's system of taxation.

This lecture draws on economic analysis to provide a framework for guiding debate on taxation reform. First, it describes deficiencies with the current arrangements and argues that the present system has many problems. Second, it considers options for reform of the direct or income tax system, and of the indirect or expenditure tax system. A compelling prime fade case is established that a bold and comprehensive reform package could improve national welfare. Inevitably, a number of options with different pros and cons remain for further assessment and debate. Third, the lecture considers likely social and political opportunities and constraints bearing on achievable taxation reform, and it critiques some over-optimistic expectations of what reform might achieve.

Criticisms of Australian taxation and proposal reform options have been common. Especially important and still relevant are the government commissioned 1975 Asprey Report and the 1985 Draft White Paper. Numerous professional conferences and journal articles have pointed to directions for reform, with the conference volumes edited by John
Head (1983, 1986, 1989 and 1993) being good examples. More recent studies include Productivity Commission (1996) and Johnson et al. (1997). The 1996 Taxation Summit, jointly organised by the welfare group ACOSS and the business group ACCI, agreed on general criteria for a good tax system and a strong view developed that the existing income, expenditure, and perhaps asset, tax bases needed to be broader and more comprehensive than at present.

I. Current Taxation in Australia

Table 1 provides a picture of Australian taxation in terms of type of tax and the government authority. Aggregate tax revenue collected of $A149 billion is some 30% of GDP or just over $8000 per Australian per year. The Commonwealth collects 77% of all taxes, the States 20% and Locals 3%. Income taxes, which are collected exclusively by the Commonwealth account for 57% of all revenue, indirect taxes 38%, roughly collected in equal amounts by the Commonwealth and the States before the August 1997 High Court decision which declared State franchise fees illegal, and taxes on assets represent 5% of all taxes.

The income tax system is really a hybrid or mixture of different tax systems, especially in the taxation of capital income (Albon, Findlay and Jones, 1985, and Pender and Ross, 1993). Some items are accorded a nominal income tax treatment, for example interest received and paid, some a real income tax treatment, for example capital gains, some a consumption base system, for example owner occupied houses and business investment in human capital, and others a mixed system, for example, superannuation and accelerated depreciation. Taxation varies with the form of business organisation, and in particular as between companies, trusts and partnerships. Also, different forms of business finance, including new equity, retained earnings and debt, typically face different taxation.

Data in Australian Tax Office (1997) indicate that the income tax base has been eroded in recent years by increased claims, both in terms of numbers of tax payers and sums claimed, for exemptions, deductions and rebates. The reality of different tax systems and greater claims means that analyses should focus more on effective tax rates, which allow for tax base definitions as well as statutory tax rates, than on statutory tax rates alone.

The focus of the income tax system is on individuals and a progressive tax rate schedule. The imputation system for companies and its flat rate acts essentially as a withholding tax against shareholder income.

A large number of indirect or expenditure taxes are levied by the Commonwealth and the States. They are characterised by narrow tax bases, a heavy initial incidence on business inputs rather than final consumption, and high and variable tax rates. Some are ostensibly a crude form of user pay fee, for example excise and franchise fees on petroleum products and motor vehicle taxes to fund road construction and maintenance. Others are directed at externalities, such as taxes on tobacco, alcohol, petroleum and gambling. However, as special purpose taxes there is little evidence that the form of the tax, with mixtures of specific and ad valorem taxes, and the rates have been based on competent evaluations of the cost of services provided and marginal externality caused.

Other indirect taxes are general revenue raising taxes, including the Commonwealth wholesale sales tax and State payroll, financial taxes and stamp duties. The wholesale sales tax falls on goods, except food, clothing, newspapers and books, but not services, at rates of 12%, 22%, 26%, 32% and 45%. With payroll tax, the small firm exemption means that less than a half of the potential wage bill is taxed. Financial innovation and deregulation has led to an increasing share of financial transactions being tax exempt, and effective tax rates vary markedly from State to State.
Australia is one of the few OECD countries not to have some form of annual wealth tax, or gift and death duty taxes, although such taxes are not large revenue raisers. Land taxes are narrowly based, with most revenue collected on land in the city business districts. State municipal rates are a form of wealth tax which are used as a crude user pay system for local government services provided.

2. **Deficiencies of Current Taxation**

Underlying structural problems with Australian taxation arise from the mixed tax systems, and extensive deductions and exemptions. As a result, very different effective tax rates on closely related choice options alter decisions taken by businesses and individuals on what to produce and buy and how to undertake production. The changes in incentives and rewards imposed by the taxation system then give rise to deficiencies and criticisms of the current taxation system in terms of the public finance criteria of revenue, efficiency, equity and simplicity. 1

**Revenue Insecurity**

The ability of the current tax system to collect revenue as is being undermined in several ways. In general, taxpayers are responding to wide differences in effective tax rates by shifting their production, income and consumption choices from relatively highly taxed options to lower taxed options. The income tax system is being eroded by greater use of deductions and exemptions, by increased income splitting, by shifting into corporate business firms, and by shifting earning and investment into relatively lighter taxed options. Apparent unintended uses of concessions, for example of R & D allowances and infrastructure bonds, are closed periodically, but usually after considerable revenue loss. Indirect taxes, with their emphasis on goods which are a declining share of national expenditure, will, if not modified, collect less revenue as a share of GDP in the future. The use of comprehensive tax bases with minimum exemptions will facilitate protection of the future revenue flows.

Revenue security is important to those dependent on government sources of income and services, particularly the poor. But also, it is important to taxpayer confidence. Growing tax avoidance leads to a loss of integrity and confidence in the system, and it breeds uncertainty about the next band aid to reduce revenue losses or even about the next area of new or increased taxation.

**Non-neutrality and Tax Distortions**

The highly variable effective tax rates on related choice options facing businesses and households distort their choices and result in a lower level of national productivity and welfare. Examples include: high effective tax rates on paid work versus leisure and home production; higher tax rates on saving and future consumption versus current consumption; different tax rates on different forms of remuneration such as wages, fringe benefits, superannuation; variable effective tax rates on different savings options such as bank deposits, own home, negatively geared property, shares; different effective tax rates on different business structures, including companies versus unincorporated business, on different forms of business finance, for example on debt versus equity; some business inputs are taxed but not others; and different indirect tax rates on different goods and services distort decisions on the mix of goods and services produced and consumed. The different effective tax rates on different choice options, unless justified by a market failure, result in efficiency losses referred to as deadweight costs or efficiency costs of taxation.

A few examples illustrate the magnitude of the non-neutrality of the current taxation system. While much focus is on high marginal income tax rates of 48.5% paid by those on higher income levels, in fact many on low and middle income levels face much higher effective tax rates. Effective tax rates which include the withdrawal of social security benefits such as unemployment benefits, family allowances and rent assistance, and of tax rebates such as for dependent spouses exceed 80% for many low and middle income earners (Polette, 1995, and Ingles, 1997). Such high tax rates, relative to zero on leisure,
represent disincentives to join the workforce, to search for jobs when unemployed, to take over-time, and to invest in the acquisition of skills.

The hybrid taxation system for different savings and investment choice options results in very different effective tax rates as illustrated in Table 2 using estimates compiled by Pender and Ross (1993). Effective tax rates are relatively low for negatively geared rental property (because of deductibility of nominal interest each year and deferred taxation of only the real capital gains when the property is sold) and for owner occupied housing (because imputed rent and capital gains are exempt). Conversely, effective tax rates are above statutory tax rates for deposits in banks and for debentures (because of the nominal income tax treatment of interest, including taxation of that part of interest to offset inflation) and overseas investment (because no imputation credits are attached to foreign tax paid). Within Australian domestic business investments, effective tax rates vary between business structures (because of asymmetries in operation of the imputation system and capital gains, as argued in Benge, 1997), between different investments in buildings, equipment, human capital and stocks, and between different ways of financing investment. Rational savers and investors are induced by the different effective tax rates on different choice options to favour lightly taxed options over more heavily taxed options. The distorted patterns of saving and investment lead to a loss of potential national productivity.

Australia’s indirect tax system is non-neutral and distorts the choice of business production methods and the mix of goods and services provided and consumed. In principle, select and relatively high indirect tax rates on specific activities add to efficiency if they counter externalities. To some extent, alcohol, tobacco, petroleum products and perhaps gambling generate externalities and warrant specific taxes. But, there is no supporting analysis that the current indirect taxes on these products are set at the marginal externality cost. Further, current tax rates vary with the form of alcohol (spirits being more highly taxed than beer and wine lower again), the form of fossil fuel (road use, LPG lower, and off-road use and electricity generation exempt) and on different forms of gambling (a win versus a trifecta, and poker machines in clubs versus pubs).

Over a half of current indirect taxes fall initially on selected business inputs (Chisholm, 1993, Scutella, 1997). Further, some inputs are taxed but not others. For example, road transport is taxed more heavily than air transport, and rail is almost exempt; payroll tax falls on medium and large businesses but not on small business (with payrolls of up to $500,000 a year). Stamp duties are only levied at the time of transfer and tend to lock in past decisions at the expense of socially beneficial exchange of ownership. The present narrow bases for the FID and BAD taxes result in different effective tax rates on different business financial transactions. Different effective tax rates on different business inputs distort the ways in which businesses organise production and in the mixes of inputs used to produce goods and services. Effectively, production takes place inside the production possibility frontier.

Effective taxes on goods and services purchased by households include those initially falling on consumer products plus those initially levied on business inputs and then passed on as higher output prices. Then, for example, while no indirect taxes currently are levied on most fresh foods, the price households pay at the supermarket include taxes levied on vehicles, financial services, labour and so forth used as business inputs by farmers, food producers and the supermarkets. Because of the narrow indirect tax bases and the multiple tax rates, effective tax rates at the retail level vary widely from product to product (Chisholm, 1993, and Scutella, 1997). For example, disaggregating the economy into 28 industries, Chisholm estimates the effective retail tax rate associated with the wholesale sales tax, payroll tax and a quarter of taxes on petroleum products to vary from 2.3% (for community services) to 32.9% (for transport equipment) with an average of 6.4%. These differences distort production and consumption choices away from the heavily taxed options to the low taxed goods and services.
Many would include vertical fiscal imbalance as a source of inefficiency in the Australian taxation system. The Commonwealth collects most of the revenue and passes some of it down to the State, who spend about twice what they collect, and to the Locals, who spend nearly three times the revenue they collect. In this context it is said that the States and the Locals are not responsible for raising what they spend and resources are wasted in inter-jurisdictional fighting and monitoring. An extreme contrary view is that Commonwealth tax revenue is used to fund inframarginal State and Local outlays, and at the margin the last dollars spent, for example on State education, are funded by State taxation, for example, payroll tax. Whether averages or margins drive decisions is an empirical issue which has not been evaluated in Australia.

Estimates of the efficiency or deadweight losses of taxation distortions to some decision choices by households have been reported for Australia, but none on the costs of distortions to business organisation and production decisions. The efficiency costs of distortions to work versus leisure decisions have been estimated at 5% of wage income by Findlay and Jones (1982) and 2% of GDP by Bascand and Trengove (1990), and the marginal efficiency costs of these distortions have been estimated at between 23 and 26% by Findlay and Jones and at 18% by Campbell and Bond (1997). Efficiency costs of tax concessions for investment in owner occupied housing have being estimated by Albon, Findlay and Piggott (1984) and the Industry Commission (1991) at between 0.25% and 0.45% of GDP. Indirect tax distortions to the mix of goods and services consumed are estimated to have deadweight costs equivalent to about 1% of expenditure (Chisholm, 1993, and Albon, 1996). Given the wide differences in effective tax rates facing many business choice options, together with likely high elasticities of substitution between the options, it is likely that the hybrid income tax system and selective business input taxing of indirect taxes generate large efficiency costs. This area seems a high priority research topic.

**Questionable Equity Effects**

Australian taxation is much less progressive than is often thought and it fails ideals of horizontal equity. Table 3 provides a picture of the distribution of the tax burden of income taxes and about a half of the indirect taxes for households with different levels of private income compiled by ABS data. A more detailed analysis for each type of tax is given in Warren (1989). These tax incidence studies are prepared on the assumptions that direct taxes are borne fully by factor owners and that indirect taxes are fully passed forward in higher prices to households. The veracity of these incidence assumptions in the Australian economy context deserves more research.

Personal income taxes are progressive, but they are not as progressive as suggested by simple comparisons of marginal or average income tax rates. As a generalisation, those on higher incomes have greater incentives and opportunities to avoid tax than those on lower incomes. For example, while the poor place most of their savings in highly taxed bank deposits, the well-off place more of their tax in lightly taxed negative gearing, superannuation and owner home options. Higher income people make more use of company and trust structures to reduce income tax paid than do low income wage earners.

Australian indirect taxes are regressive when expressed as a share of income and they are approximately proportional taxes as a share of expenditure. Indirect taxes fall relatively heavily on goods which dominate expenditure patterns of those on low incomes, and they are much less on services which are more important expenditure items for the rich.

Overall, the incidence of all Australian taxes has a U-shape. Those on very low incomes face higher average tax rates than those on middle incomes, and ultimately the progressive income tax raises the average tax rate on the very wealthy.
Both the income tax and the indirect tax systems are horizontally inequitable. Income splitting and the use of company structures to reduce income tax is easier and more widespread among non-PAYE taxpayers than for PAYE taxpayers. Again, households with the same aggregate savings but different portfolio compositions, for example bank accounts versus superannuation, pay very different tax burdens. The indirect tax system favours those who prefer spending on services, for example aerobics and holidays, relative to those who prefer goods, such as cars and electronic gadgets.

Complexities in the Australian taxation system appear as increased tax compliance costs and a diversion of scarce resources from other productive uses. The Income Tax Assessment Act now runs to some 7000 pages, it is not built on a comprehensive definition of income, and the many exemptions, deductions and rebates invite expenditures to avoid tax. Some 73% of individual taxpayers employ a tax agent to complete their forms, a number which has doubled over the last ten years (data from ATO, 1997). Company income tax and the FBT are expensive to comply with, in part because of frequent changes in regulations and rulings.

The various indirect taxes levied by the Commonwealth and the State are complicated because of the number of different taxes, differences between jurisdictions, narrow and often poorly defined tax bases, and multiple rates.

Tax compliance costs are costs to taxpayers associated with meeting statutory requirements for the payment of direct and indirect taxes. They may include: expenditure on professional fees of tax agents, accountants, investment advisers, lawyers and other advisers; and the additional time of internal staff spent on maintaining tax information, on completing forms and preparing data for advisers, and in dealing with tax authorities.

Table 4 compares estimates of compliance costs and of administration costs for Australia and some comparison countries. Administration costs at about 1% of tax revenue are comparable across countries. However, compliance costs in Australia are high relatively and absolutely. The studies for Australia have been criticised by the ATO. However, given that similar methods have been used, the implication of Table 4 that compliance costs in Australia are high relative to other countries seems robust, even if the absolute value is uncertain.

3. Reform Options

Many of the deficiencies of Australian taxation can be addressed only by fundamental reform aimed at broader and more comprehensive income and expenditure tax bases. Other issues include addition of an assets tax, changing the mix of the different tax bases, and the tax rate schedules to be applied.

Income tax

Income tax will continue to be the most important revenue collector in the coming years. It has a broad base, it allows for progressive taxation, and it is in place. Some will debate continuation of the individual as a taxable unit, versus the family, especially given use of the family in most means testing of social security benefits and pensions. However controversy about the pros and cons of the equity and efficiency implications of changing the tax unit (see, for example, the volume by Head and Krever, 1996) favours the status quo. Income taxes on business income, including the company tax, are likely to continue as an efficient form of withholding tax, including overseas investors.

The hybrid nature of the current income tax system with its different tax treatment of different forms of saving and investment and of different business structures underlies existing difficulties with the taxation of capital income. In terms of a consistent tax system there are three broad options. These are: a comprehensive income tax base with
preference for a real income rather than a nominal income base; a comprehensive direct expenditure tax base; or, removing and/or quarantining some of the more offensive areas of the current hybrid tax system.

The choice between an income base or an expenditure base is not clear. Under both options labour income would be taxed roughly as now. Fringe benefit taxation could be simplified and the remaining concessions removed. Key differences between the tax bases lie in the tax treatment of capital income, or of savings and investment decisions (see Bascand, 1989, or Kay and King, 1990, and references therein). With an income tax base, all income is taxed whether it is spent on consumption or saved. By contrast, under an expenditure tax, saving is tax exempt and only taxed in the future when the savings, and the return, are spent. The expenditure tax removes distortions to saving versus consumption choices, and it provides a more neutral tax treatment of different savings and investment choice options. However, because the tax base of an expenditure tax is less than that of an income tax, by savings, for aggregate revenue neutrality a higher tax rate is required. This higher tax rate falls on labour income and aggravates distortions to work versus leisure decisions. The relative magnitude of efficiency distortions in the capital and labour markets is an empirical issue; and there is much uncertainty in the literature about key elasticities of work, saving and investment option choice which determine the outcome. From an equity perspective, supporters of the income base argue that earnings is the appropriate measure of capacity to pay, while proponents of an expenditure base argue that consumption is the appropriate capacity to pay measure.

Transition adjustment problems and costs for Australia moving to a comprehensive income base or a comprehensive expenditure base seem similar. Under the present hybrid mix the current system is probably closer to an expenditure base than to an income base given the importance of investment in human capital and in owner occupied homes in total investment.

Rather than replace the current hybrid income tax system with either a comprehensive income base or a comprehensive expenditure base, a number of ways of broadening the present hybrid income tax have been proposed to safeguard the revenue and/or to fund lower tax rates, to improve equity and to improve neutrality and efficiency. Suggested changes include: removing most personal income tax deductions, including work related expenses; treating all forms of labour income as wages, including lump sums and fringe benefits; tighter control of income splitting through partnerships, trusts and companies; returning to economic depreciation; closer alignment of the top personal tax rate and the corporate tax rate; extension of the capital gains tax to include the family home, pre-1985 asset purchases, and deeming transfer at death, and removing the interest free loan component of deferred capital gains tax; quarantining negative gearing to the current income earned on assets, as in the US; and reform of the taxation of superannuation. Conservatively, some of these changes could fund at least a 10% reduction in average income tax rates.

Given the direct tax base, discussion shifts to the tax rate schedule to apply. Transparency and revenue neutrality requires automatic indexation of the thresholds of the schedule and of all deductions and rebates.

The degree of progressivity of the direct tax base schedule is very much driven by political and social views on vertical equity. Only a pure flat tax rate offers significant gains in simplicity. Given the tyranny of the present distributional outcomes, it seems unlikely that tax reform which increases the burden for low income earners or significantly reduces it for the top decile will gain political support. Thus a progressive rate scale seems inevitable.

Greater neutrality and equity would be achieved if all business structures, including partnerships, trusts and companies, were taxed the same way. Whether this involves a company type imputation system for all business units, or a better integrated and partnership type system for companies as well, deserves more evaluation. As argued by
Head (1997), moving measured business taxable income closer to real income by removing special exemptions and deductions would facilitate better integration of the taxation of business to their equity owners. Alignment of the business withholding tax rate with the top personal rate, and providing refunds for excess tax paid, would add to neutrality and equity of the company imputation tax system.

**Indirect Tax**

Rationalisation of the array of Commonwealth and State indirect taxes is best considered in the two contexts of general purpose revenue raising taxes and the special purpose indirect taxes. The principal motivation of the wholesale sales tax, payroll taxes, stamp duties and financial taxes is for revenue raising. At least a part to all the excise and franchise fees taxes, motor vehicle taxes, and perhaps taxes on gambling, is a crude form of user pay charge or an externality tax. Both sets of motivations raise different reform options.

For general revenue raising purposes a broad based consumption tax at a single rate has considerable advantages as a replacement for the existing taxes. It would have revenue buoyancy, it would remove taxation of business inputs, it would provide a more neutral pattern of taxation of different goods and services, and it would restore horizontal neutrality. Importantly also, given that the existing indirect taxes to be replaced are roughly proportional to expenditure (Table 3 last row) a single rate tax on all consumption expenditure would have a similar vertical equity incidence. The comprehensive base with no exemptions and a single rate would contribute to transparency and simplicity. There are several options for broad expenditure taxes to replace the existing general revenue raising indirect taxes.

Taxation of most household consumption expenditure on goods and services is best achieved by a single stage retail sales tax (RST), for example as used in the states of the US, or a multistage tax known as a value added tax (VAT) in Europe or as a goods and services tax (GST) in New Zealand and Canada or dubbed as a PAYS (pay as you spend) at the 1996 National Tax Reform Summit. There is growing support for a multistage system (Chossen, 1989). It is more effective in sorting household purchases (to be taxed) from business purchases (not to be taxed), in working examples it has a more comprehensive and larger tax base, and the added paper trail, while adding to compliance costs, reduces tax evasion and avoidance. Currently, 21 of all 24 OECD countries have a VAT or a GST system. The New Zealand model is widely considered an ideal prototype for Australia to copy.

Proposals to extend the wholesale sales tax and to apply a single tax rate, together with the introduction of a new tax on services, raises several problems and deficiencies relative to a GST. To remove the business input taxing component of the present tax would reduce the base by 60%, and most services associated with the household purchase of wholesale sales tax goods would fall outside the tax. Defining taxable household services, and to exempt services purchased as business inputs, clearly will be complex. Transition costs associated with introducing a GST seem unlikely to be higher than those of a revamped goods tax plus a new services tax. Yet, a GST once settled in, would be superior in terms of long term efficiency, equity and simplicity gains.

The present payroll tax base could be doubled in size by removing the small business and other exemptions. Further, simplification and lower compliance costs could be achieved by measuring the payroll tax base using the Commonwealth PAYE and FBT and SGL tax base, or by using the States workers' compensation measure.

There is an interesting choice between a GST, a payroll tax, or a combination. In principle and in the long run, a comprehensive GST at a single rate and a comprehensive payroll tax at a single rate collecting the same revenue have identical economic effects (Freebairn, 1993, and Ryan, 1995). In practice it is difficult with the GST to fully tax financial services and gambling, whereas with payroll tax it is difficult to measure and to tax the labour component of income of the self employed. These practical difficulties, and those
concerned with leaving States with only their broad based tax, given High Court decisions restricting State taxation of expenditure on goods, may justify retention of a broad based payroll tax.

If a GST is to be introduced, a case might be made for a broad based tax on financial services. This would involve removing the present FID and BAD taxes and stamp duties on financial transactions with a low rate broad based financial tax. An expanded debits tax on all accounts with all financial institutions has been suggested.

Table 5 provides indicative estimates of the required tax rate of a GST to replace the revenue now collected by existing general revenue raising indirect taxes. Two tax bases are considered; a broad NZ type base and a base with the necessities of food, health and education tax exempt. A revenue neutral indirect tax rationalisation package would require a GST rate of about 11% on the broad base and nearly 16% if the narrower base is adopted. The Table illustrates a major trade off between exemptions from the tax base and the required tax rate.

Over and above the general revenue raising taxes on expenditure, specific purpose taxes for user fees and for externalities would contribute to economic efficiency and generate revenue. Typically the appropriate tax would be a specific tax per unit quantity. In this context the excise taxes are more appropriate than ad valorem taxes, such as the now illegal franchise fees. Candidates for externality taxes are fossil fuels, not just on petroleum products for road use as now but also for off road use, electricity generation and other industrial uses; alcohol products with a common externality tax per litre of alcohol rather than varying by beverage type; tobacco; and maybe gambling. In each case the externality tax rate would be set to reflect the marginal externality cost.

In the case of funding road construction and maintenance, policing and associated government outlays, a simpler system can be used to replace the Commonwealth wholesale sales tax and petroleum products excise and the State business franchise, stamp duties on motor vehicle transfers and vehicle registration fees. A two part tariff consisting of an annual access fee, such as a registration fee to finance overhead annual capital and maintenance costs, and a quantity usage fee, such as per tonne per axle per kilometre or less satisfactorily per litre of fuel, is one option to explore.

**Tax Mix Change**

The Labour Government in 1985 with its preferred Option C, the Coalition Parties in 1993 with Fightback! and it seems also the Prime Minister in his 1997 reform strategy proposed to change the tax mix towards consumption away from income. Revenue from a new broad based consumption tax would be used partly to replace existing indirect taxes as analysed above and also some would be used to fund reductions in income taxation. That is, GST tax rates would be greater. perhaps five percentage points or more, than those shown in Table 5.

For a constant aggregate taxation revenue collection, changing the tax mix from income to consumption has a number of readily identified redistribution effects. The tax mix change reduces the burden of tax on saving and capital income, and it replaces a progressive income tax with a single rate consumption tax. The latter vertical equity redistributive effects can be offset largely by making the remaining income tax more progressive than before, by increasing social security pensions and benefits, and by special targeted rebates for self supporting retirees. However, despite the best intentions, inevitably some will be worse off (see, for example, Draft White Paper, 1985, and Warren, 1990), and a portion of the consumption tax revenue will be required to fund a compensation package. In general, a tax mix change favours those who save over those who are running down past savings or borrowing against future income. Over a lifetime these savings pluses and minuses roughly balance for most individuals. For the majority of taxpayers with negligible net savings, gains in lower income tax associated with a tax mix change approximately are offset by increases in taxation of income when it is spent. Certainly careful tax design can minimise the number of losers and the extent of their losses, but there will be exceptions...
and attempts to protect almost everyone requires special provisions which bring increased complexity.

The net efficiency effects of a tax mix change are ambiguous. The effective tax rate on savings and investment falls while that on labour rises. Lower income tax rates reduce distortions to intertemporal consumption choices and they reduce distortions to the choice of the mix of different saving and investment options. But higher effective tax rates on labour income aggravates distortions to work versus leisure decisions and to paid work versus home work. Imperfect knowledge of the key elasticities, especially for Australia, makes it difficult to resolve the trade-offs. Detailed simulations and sensitivity assessments of a tax mix change for the US by Randolph and Rogers (1995) find the net efficiency gains are small and possibly negative.

Claims that a tax mix change will reap a fiscal dividend and improve equity by taxing income that is evaded or avoided income tax are not substantiated (Kesselman, 1993). Income evading taxation, including the black economy and dubious claims for expenses, also will come from expenditure that will evade a consumption tax. Reducing such evasion requires better administration. Once a general equilibrium view of the economy is taken, and remembering that tax reform, including a tax mix change, is a long term structural change, market prices affecting relative pre tax incomes and product prices respond to essentially restore after tax real spending capacities of those who evade and avoid taxes relative to others in the economy.

The case for a tax mix change, both in terms of the public finance criteria of revenue, equity, efficiency and simplicity, and of political acceptability is unclear. Potential efficiency gains are uncertain and probably small at best, the reality of a fiscal dividend is negligible, it is difficult to compensate potential losers and even rough justice requires complexity, and the scope for political opportunism may be extensive.

4. Opportunities and Constraints

There is a growing consensus of the need for significant changes to all taxes raised in Australia, and some of the parameters limiting acceptable options are becoming evident. Deficiencies with the current system largely rule out the option of no change, both for Commonwealth and State taxes. Politicians, including the Prime Minister and Premiers, and many community groups, including those from welfare and business, are pushing for changes, but with different specific objectives and proposals. This section discusses likely restrictions on achievable reform options in terms of revenue and equity criteria, and it comments on claims that tax reform will facilitate employment growth.

Debate on taxation reform would be facilitated if discussion focussed on an aggregate revenue neutral package. Here revenue neutral means a similar share of GDP over the coming years and ensures revenue buoyancy. The focus of the debate then is on the structure of taxation, and in particular the form of taxation and base definitions and measurement. Those wanting more revenue would argue for higher tax rate schedules, and those for smaller government lower tax rates.

A subset of the revenue issue will be the division of taxation between the different levels of government. The indirect tax rationalisation proposals involving a broad based consumption tax will further aggravate the dominance of the Commonwealth in tax collection. It has the sole right to levy a GST which would replace some of the State taxes; and the High Court decision of August 1997 effectively ruled against State franchise fees. Giving the States a greater share of aggregate taxation revenue requires a major review of current Commonwealth/State financial arrangements. Options include: giving the States a guaranteed share of one or both of the income tax revenue or broad based consumption tax revenue; the Commonwealth reducing its personal income tax rate schedule and making room for State personal income tax on the common tax base. The second option provides opportunities for competition between the States, whereas the first nearly precludes such competition.
Equity, both real and perceived, will dominate debate on, and public acceptability of, different reform options. There is a wide consensus that those on lower incomes, including the quarter of Australians dependent on Social Security for most of their income and low wage earners, should not be worse off. Also, although less explicit, it is unlikely that reforms showing significant gains for the upper deciles will be acceptable. At first sight such constraints would seem stifling to much reform. However, there are at least three sources of confidence.

First, if tax reform is to be worthwhile it is a positive sum game. Productivity and efficiency gains are the rewards or pay-off for a more neutral and less distorting tax system. While the magnitude of potential gains is not known, it seems likely that over several years they could be several percent of GDP. Reductions in tax compliance costs would release extra resources for the production of goods and services that increase household well being.

Second, tax reform involving broader and more comprehensive tax bases will increase revenue collected from those now avoiding tax with the revenue gain used to fund reductions in tax burdens for those now not avoiding tax, particularly PAYE taxpayers. Certainly there will be losers, and no doubt they will be vocal. However, PAYE taxpayers are a larger group, and a sense of fairness and horizontal equity surely carries some weight.

Third, conventional static snapshot assessments of the distributional effects of tax reform options present a worst case outcome. Tax reform means changes in relative prices, incomes and other incentives. Households and businesses respond to changes in incentives and move to a higher welfare or profit set of decisions. Decision responses in some cases will take several years to affect and to lead to observable welfare gains.

Wishes and claims that tax reform can be used as an instrument for increasing employment and reducing unemployment have dubious merit. In an aggregate revenue neutral context, to reduce one form of tax, say on labour, requires increases in other taxes, for example capital or on expenditure. Then, for example, the suggestion that reductions in payroll tax or of PAYE tax would lead to lower employer labour costs and increased employment is only one part of the story. If a higher expenditure tax is used to fund the payroll or PAYE tax reduction, employees would seek a compensating pre-tax wage rise, and recall that tax reform is about longer term structural changes and where asymmetrical money illusion effects would be minimal. Alternatively, if the revenue shortfall is to be funded by higher taxation of capital, certainly there would be favourable labour for capital substitution effects, but also there would be unfavourable scale effects as the overall level of saving and investment is reduced.

5. Conclusions

Comprehensive reform of income and expenditure taxes, and perhaps also asset taxes, and of Commonwealth and State taxes, is overdue. In part reform will be pushed by major deficiencies of the present system and in part it will be pulled by the potential benefits of a more secure and buoyant revenue flow, by greater equity, by greater efficiency and national productivity, and by lower tax compliance costs.

The general direction of reform must be to broader and more comprehensive tax bases, both of income and expenditure. Changing the tax mix between income and expenditure seems problematic, with uncertain efficiency effects and potentially important redistribution effects. Reform of the present hybrid income tax base could be radical involving adoption of either a comprehensive income base, and preferably a real income base, or a comprehensive expenditure base. More likely, income tax reform will be directed to reducing special exemptions and deductions and to using a similar tax system for different forms of business structure. The revenue gains from base broadening would
Fund reductions in income tax rates, with continuation of a progressive personal income tax rate schedule.

Reform of current indirect taxes in an aggregate revenue neutral context could proceed along two paths. First, broad based taxes at a single rate would be used for general revenue raising. Here a multistage VAT or GST is desirable, but consideration also has to be given to broadening payroll and financial taxes if they are to remain. A New Zealand type GST with a rate of about 10% would fund replacement of the wholesale sales tax, payroll tax, most stamp duties and financial taxes. Second, additional special indirect taxes for externality purposes and for user pay purposes need to be respecified in terms of tax type and tax rate. Indirect tax changes will aggravate the present vertical fiscal imbalance and require significant overhaul of Commonwealth/State financial relations.

Footnotes

*The lecture extensively relies on material in Freebairn (1997) and Johnson, et al. (1997).

1. In addition to the structural problems, administration of the tax system also is the subject of criticism, particularly under the criteria of simplicity. For reasons of space, this area will not be considered further.


3. A real income tax base would allow for inflation in the measurement of capital gains, of depreciation, of interest income and deductions, of stocks, and of losses carried forward.

4. According to the Treasury (1997) large concessions continue for motor vehicles and some concessions are given to child care.

5. The argument for a single rate tax for efficiency has been subject to debate. If everything is taxed, relative prices are not changed and deadweight costs are zero. In reality not all items will be taxed, including leisure. Then, in principle, as argued in the optimal tax literature, a set of Ramsey taxes is more efficient (see, for example, Stern, 1984, or Creedy, 1993). There are, however, serious practical problems in the applications of an optimal tax system; the lack of sufficiently accurate elasticity estimates; the resulting incentives for wasteful rent seeking; additional complexity; and the equity effects of higher tax rates on necessities.

6. The problem arises in measuring the value added which is a combination of fees for intermediation and the spread of the borrowing and lending rates. Most countries treat those industries as tax exempt (that is no tax is collected on sales and no credit is
given for tax paid on input purchases), with the result of an effective tax rate less than the statutory GST rate.

7. Here it is proposed that the Commonwealth continue with a common corporate tax rate and international income tax treatments.

References


Asprey Committee (1975), Taxation Review Committee: Final Report, AGPS, Canberra.


Table 1: Taxes Collected by Category of Tax and by Level of Government, 1995-96

($billion)

<table>
<thead>
<tr>
<th>Category of Tax</th>
<th>Commonwealth</th>
<th>State and Local</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Income Taxes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individuals</td>
<td>60.6</td>
<td></td>
<td>60.6</td>
</tr>
<tr>
<td>Enterprises</td>
<td>22.1</td>
<td></td>
<td>22.1</td>
</tr>
<tr>
<td>Non-residents</td>
<td>1.5</td>
<td></td>
<td>1.5</td>
</tr>
<tr>
<td>Total</td>
<td>84.2</td>
<td></td>
<td>84.2</td>
</tr>
<tr>
<td>2. Indirect or expenditure taxes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wholesale sales tax</td>
<td>13.0</td>
<td></td>
<td>13.0</td>
</tr>
<tr>
<td>Payroll</td>
<td>7.1</td>
<td>7.1</td>
<td>7.1</td>
</tr>
<tr>
<td>Exercise and franchise fees</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Petroleum products</td>
<td>10.3</td>
<td>1.5</td>
<td>11.8</td>
</tr>
<tr>
<td>Tobacco</td>
<td>1.6</td>
<td>2.6</td>
<td>4.2</td>
</tr>
<tr>
<td>Alcohol and liquor</td>
<td>1.1</td>
<td>0.7</td>
<td>1.8</td>
</tr>
<tr>
<td>Motor vehicle taxes</td>
<td>3.5</td>
<td></td>
<td>3.5</td>
</tr>
<tr>
<td>Gambling taxes</td>
<td>3.3</td>
<td></td>
<td>3.3</td>
</tr>
<tr>
<td>Financial and capital</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stamp duties</td>
<td>4.2</td>
<td></td>
<td>4.2</td>
</tr>
<tr>
<td>Financial Institutions</td>
<td>1.9</td>
<td></td>
<td>1.9</td>
</tr>
<tr>
<td>Taxes on insurance</td>
<td>1.7</td>
<td></td>
<td>1.7</td>
</tr>
<tr>
<td>Taxes on international trade</td>
<td>3.1</td>
<td></td>
<td>3.1</td>
</tr>
<tr>
<td>Other</td>
<td>0.4</td>
<td>1.1</td>
<td>1.5</td>
</tr>
<tr>
<td>Total</td>
<td>29.5</td>
<td>27.6</td>
<td>57.1</td>
</tr>
<tr>
<td>3. Wealth taxes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land taxes</td>
<td>1.5</td>
<td></td>
<td>1.5</td>
</tr>
<tr>
<td>Municipal rates</td>
<td>5.1</td>
<td></td>
<td>5.1</td>
</tr>
<tr>
<td>Resource rent tax</td>
<td>0.9</td>
<td></td>
<td>0.9</td>
</tr>
<tr>
<td>Total</td>
<td>0.9</td>
<td>6.7</td>
<td>7.6</td>
</tr>
<tr>
<td>4. Total taxes</td>
<td>114.6</td>
<td>34.3</td>
<td>148.9</td>
</tr>
</tbody>
</table>

Sources: Compiled from ABS, Taxation Revenue, Australia, 1995-96, Cat. no. 5506.0; and, Willis and Beazley, Budget Statements 1995-96, Budget Paper Number 1, AGPS, Canberra.
### Table 2: Effective Tax Rate on Major Asset Classes for Individual Savers with Different Statutory Tax Rates, 1992

<table>
<thead>
<tr>
<th>Asset category</th>
<th>Statutory personal tax rate:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>39 per cent</td>
</tr>
<tr>
<td>Interest bearing deposit</td>
<td>62.4</td>
</tr>
<tr>
<td>Owner occupied home</td>
<td>11.4</td>
</tr>
<tr>
<td>Negatively geared rental property</td>
<td>-0.8</td>
</tr>
<tr>
<td>Unincorporated enterprise</td>
<td>23.0</td>
</tr>
<tr>
<td>Local company</td>
<td>36.6</td>
</tr>
<tr>
<td>Investment abroad</td>
<td>62.9</td>
</tr>
</tbody>
</table>

Note: (a) Effective tax rate is measured as tax paid divided by the real income return, expressed as a percentage. In all cases inflation of 3 per cent is assumed.

Source: Pender & Ross (1993, Table 4).

### Table 3: Estimated Vertical Equity Effects of Selected Australian Taxes, 1993-94

<table>
<thead>
<tr>
<th>Households by gross income quintile</th>
<th>Lowest 20 per cent</th>
<th>Second</th>
<th>Third</th>
<th>Fourth</th>
<th>Highest 20 per cent</th>
<th>All households</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income (dollars per week)</td>
<td>151.7</td>
<td>353.9</td>
<td>592.3</td>
<td>909.1</td>
<td>1608.8</td>
<td>732.2</td>
</tr>
<tr>
<td>Taxes paid (dollars per week)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Personal income tax (dollars per week)</td>
<td>2.1</td>
<td>18.0</td>
<td>80.3</td>
<td>171.2</td>
<td>412.9</td>
<td>137.0</td>
</tr>
<tr>
<td>Selected indirect taxes (dollars per week)</td>
<td>28.9</td>
<td>43.2</td>
<td>59.0</td>
<td>73.8</td>
<td>96.6</td>
<td>60.3</td>
</tr>
<tr>
<td>Taxes paid as share of gross income (per cent)</td>
<td>1.4</td>
<td>5.1</td>
<td>13.6</td>
<td>18.8</td>
<td>25.7</td>
<td>18.9</td>
</tr>
<tr>
<td>Personal income tax (per cent)</td>
<td>1.4</td>
<td>5.1</td>
<td>13.6</td>
<td>18.8</td>
<td>25.7</td>
<td>18.9</td>
</tr>
<tr>
<td>Selected indirect taxes (per cent)</td>
<td>19.1</td>
<td>12.2</td>
<td>10.0</td>
<td>8.1</td>
<td>6.0</td>
<td>8.3</td>
</tr>
<tr>
<td>Selected indirect taxes (per cent)</td>
<td>9.5</td>
<td>10.1</td>
<td>10.3</td>
<td>10.3</td>
<td>9.8</td>
<td>10.0</td>
</tr>
</tbody>
</table>

Notes: (a) Private income plus direct social security payments received.
(b) Assumed to be fully borne by households.
(c) Covers only 47 per cent of all indirect taxes. Assumed to be fully passed forward.

Table 4: International Comparison Between Administration and Compliance Costs as a Percentage of Tax Revenue

<table>
<thead>
<tr>
<th>Country</th>
<th>Compliance costs as a percentage of tax revenue</th>
<th>Administration costs as a percentage of tax revenue</th>
<th>Total costs as a percentage of tax revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia* (1990-91)</td>
<td>12.1</td>
<td>1.1</td>
<td>13.2</td>
</tr>
<tr>
<td>United Kingdom* (1986-87)</td>
<td>2.5</td>
<td>1.2</td>
<td>3.7</td>
</tr>
<tr>
<td>Canada* (1986)</td>
<td>5.9</td>
<td>unknown</td>
<td>unknown</td>
</tr>
<tr>
<td>USA* (1990)</td>
<td>3.2</td>
<td>unknown</td>
<td>unknown</td>
</tr>
<tr>
<td>Sweden* (1992)</td>
<td>1.3</td>
<td>0.7</td>
<td>2.0</td>
</tr>
<tr>
<td>Netherlands* (1990)</td>
<td>4.1</td>
<td>1.1</td>
<td>5.2</td>
</tr>
</tbody>
</table>

Notes and Sources: (a) Pope (1995), includes personal income tax, employers PAYE tax, employers PPS, company tax and wholesale sales tax.
(b) Godwin (in Sandford, 1995 Table 4.2), includes income tax, capital gains tax, value added tax, corporation tax, petroleum revenue tax, excise duties, stamp duties, gambling taxes and local government rate.
(c) Vaillancourt (in Sandford, 1995 p. 208), includes personal income tax and payroll taxes.
(d) Blumenthal and Slemrod (in Sandford, 1995 p. 167) includes Federal and state income taxes
(e) Malmer (in Sandford, 1995, Table 11.27) includes income tax, payroll tax, value added tax and excise duty.
(f) Allers (1994, table 7.1), includes value added taxes, excise duties, transfer taxes, taxes on motor vehicles, personal income tax, wealth tax, succession duty, property tax and import duties.

Table 5: Indicative GST tax rate required to replace current general revenue raising expenditure taxes, 1994/95

<table>
<thead>
<tr>
<th>Taxes replaced</th>
<th>PAYS tax rate required with:</th>
<th>Broad Base</th>
<th>“Necessities” exempt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wholesale sales tax</td>
<td></td>
<td>5.0</td>
<td>7.1</td>
</tr>
<tr>
<td>Payroll</td>
<td></td>
<td>2.8</td>
<td>3.9</td>
</tr>
<tr>
<td>Stamp duties</td>
<td></td>
<td>1.7</td>
<td>2.3</td>
</tr>
<tr>
<td>Financial institutions</td>
<td></td>
<td>0.8</td>
<td>1.0</td>
</tr>
<tr>
<td>All of above</td>
<td></td>
<td>10.9</td>
<td>15.6</td>
</tr>
</tbody>
</table>

Note: A Broad base is private final consumption less 70 percent of expenditure on dwelling rent and 50 percent of expenditure on financial services, and less tax revenue of taxes being replaced.
(b) “Necessities” exempt is broad base with food, health and education zero rate.
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