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Chapter 1

How Highly Taxed Are We?
Peter Burn

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In recent years Australia's level of taxation has fluctuated within a range between 29.8% and 32.1% of Gross Domestic Product (GDP). There is an underlying upwards trend (Table 1.1).

**Table 1.1: Total Taxation¹ as a Proportion of GDP
Australia 1995-6 to 2003-04**

1995-6	1996-7	1997-8	1998-9	1999-0	2000-1	2001-2	2002-3	2003-4
29.8%	30.4%	30.2%	30.9%	31.6%	32.1%	30.5%	31.4%	31.6%

Source: OECD, *2005 Revenue Statistics, 1965-2004*, 68.

Current levels of taxation can be contrasted with total revenue collections over the years since 1965-6. Figure 1.1 shows that since 1965, the share of total Australian taxation in GDP has grown on average by slightly more than a quarter of a percentage point of GDP per year. This growth of the share of taxation in GDP comes on top of the solid growth of GDP which increased by around 300% in real terms between 1965 and mid 2004.² In real terms, the amount of tax paid per person³ grew by over 200%.

Comparisons between OECD countries based on unweighted averages

Despite the increase in taxation over the years, it is often claimed that Australia is relatively lightly taxed. These claims almost invariably involve a comparison of Australian taxation levels with those of other members of the Organisation for Economic Co-operation and Development (OECD). In a recent article, for instance, the respected policy economist Michael Keating described Australia as 'being low-taxed relative to most other developed market economies'.⁴ In its analysis of taxation, the Australian Council of Trade Unions (ACTU) put forward the proposition that:

OECD data shows that Australia is a low tax country. The latest available figures (for 2000) show total tax revenue in Australia amounting to 31.5% of GDP. By comparison the OECD average is 37.2% of GDP; Canada has a total tax revenue equal to 38.7% of GDP, and Sweden has a total tax revenue equal to 52.2% of GDP.⁵

Similar claims have been made by the Australian Council of Social Service (ACOSS) which suggests that, 'By OECD standards, Australia is a low tax country.'⁶

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Chapter 2

How High Taxation Makes Us Poorer

Alex Robson

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If two or more individuals agree to exchange goods or services, then as long as the exchange is voluntary, both will be better off than if such exchange opportunities were not available. In an economy with free markets, the vast majority of exchanges are mutually beneficial—otherwise individuals would not conduct them. Individual pursuit of self interest—combined with institutions that facilitate voluntary exchange between individuals—tends to promote mutually beneficial outcomes, even though no single person consciously promotes this end. These mutually beneficial exchanges of goods and services lie at the heart of the creation of economic wealth and higher living standards.

In essence, taxes tend to discourage mutually beneficial exchanges by driving a wedge between the prices that suppliers wish to receive for their output, and the prices that consumers are willing to pay for these products. For example, income taxes drive a wedge between the wage that workers are willing to accept to supply labour, and the wage that employers are willing to pay them. Because of these wedges, some potential gains from mutually beneficial exchanges—which exist when demand prices exceed supply prices—are left unexploited. Agents instead are induced to conduct alternative exchanges which, while certainly involving mutually beneficial wealth creation, do not create *as much* wealth and are not *as* mutually beneficial. In summary, taxes, whilst raising revenue, also tend to divert economic resources from higher valued to lower valued economic uses. Economists generically refer to these unexploited gains from trade as the *deadweight loss* created by taxes.

Taxes therefore destroy economic wealth.¹ In 1819 the celebrated American jurist John Marshall noted that ‘the power to tax involves the power to destroy’. Unfortunately, Marshall’s wisdom regarding the nature of taxation continues to elude some economists.²

Another famous American jurist, Oliver Wendell Holmes, once remarked that ‘taxation is the price we pay for civilized society’. This view is as popular among those in charge of raising tax revenue as it is among those responsible for spending it.³ But the fact that a disbursement of funds may provide a benefit does *not* mean that the costs of raising those funds—the ‘price’, as Holmes put it—should be ignored or trivialised. What if the ‘price’ of a certain tax (in terms of its economic cost) exceeds the benefits that revenue allegedly provides? How are taxpayers supposed to know whether the gains from paying taxes are worth the costs?

Whether the benefits of government spending exceed the costs is a very different question from the questions of what exactly the costs are and...

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Chapter 3

Cut Taxes To Raise More Revenue¹

Sinclair Davidson

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Defenders of high taxation and high levels of government spending like to pretend that high income tax does little or nothing to reduce work incentives. In chapter 2, however, Alex Robson showed this is mistaken, for in addition to creating additional administrative, evasion, compliance and rent-seeking costs, any rise in income tax also generates deadweight losses, which can be substantial.

Robson's analysis rests on the observation that workers typically reduce their efforts if they have to pay more tax. However, some defenders of high taxation argue that the reverse might actually be the case—that higher income taxes might lead people to work harder in order to recoup the extra money they have lost. I therefore begin this chapter with a review of the evidence indicating how workers respond to changes in their net incomes. This evidence shows that particular kinds of workers respond very positively to changes in top marginal tax rates: they put in more effort if they see opportunities to earn more, and less effort if they see rewards for their labour declining. This conclusion may not shock most people, but it evidently surprises some economists.

Having established that taxation does reduce the incentive to work, I then consider another common claim advanced by defenders of high taxation—that government revenues would be hard hit if tax rates were cut, and that this would then necessitate reductions in vital public services. Against this, I suggest that revenues do not necessarily fall if tax rates are cut. I argue that Australia is on the wrong side of the so-called 'Laffer curve', which means we could find total revenues rising if taxes were cut. However, the short-term costs of remedying this situation may be too high for politicians to accept.

Do tax cuts encourage people to work more? Income effects versus substitution effects

The common sense, intuitive understanding is that high taxes make people work less. After all, we are told that if we want less of an activity, say pollution, we should tax it. Why then should tax on work be any different?

According to the Australian Election Survey of 2004, most Australians (64%) believe that, 'High income tax makes people less willing to work hard' (see Table 3.1). Even among those voters who would prefer to increase government spending on social services rather than reduce taxes, most (56%) still recognise that high taxation undermines work incentives.² But pro-tax commentators think these people are wrong.

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Chapter 4

**Who's Not Paying Their Fair Share Of
Income Tax?¹
Sinclair Davidson**

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There is a widespread belief in Australia that the ‘rich’ have benefited from income tax cuts since John Howard came to power, while the ‘battlers’ and middle-Australia have suffered under an increasingly heavy tax burden. The implication is that ordinary workers and their families are being ‘unfairly’ taxed while high-income earners do not pay their ‘fair’ share of tax. But when rhetoric is put to one side and taxation data are examined carefully, the evidence shows that it is the higher income earners who are paying the lion’s share of personal income tax, and that if anyone is being taxed unfairly, it is them.

Who pays personal income tax in Australia?

The 1986 Nobel laureate in economics, James Buchanan, posed the question, ‘Who finally pays for the public expenditures that are financed through the income tax?’² On the face of it this is a very simple question. Answers to this question tend to be ‘fudged’. Wayne Swan, for example, has written, ‘Australians on low and middle incomes are shouldering more of the tax burden than those at the top.’³ Similarly, Stephen Harrison, chief executive of The Institute of Chartered Accountants of Australia, has stated: ‘Australia has one of the highest levels of reliance on personal income taxes in the OECD with a disproportionate tax burden falling on the middle-income earner.’⁴ And at the 2004 federal election, the Greens stated: ‘At present, Pay As You Go (PAYG) taxpayers on low to middle incomes pay more tax in proportion to their income than people on high incomes.’⁵

These views are commonly held, but are not supported by any evidence. While Harrison is right that we rely more on personal income tax revenues than other countries do (see Peter Burn’s discussion in chapter 1), it is not true that workers on low and middle incomes are paying proportionately more than those on higher incomes. Quite the reverse is the case.

To evaluate Wayne Swan’s claim I investigated the Australian Tax Office *Taxation Statistics*.⁶ Table 4.1 classifies individual tax returns into 20 quantiles ranked from the lowest to the highest income groups.⁷ It then shows the percentage share of net tax⁸ paid by each of these groups (i.e. the tax they pay is expressed relative to the total net tax paid by all individuals). Tax shares are reported for each year from 1996–7 to 2002–3. It is clear from Table 4.1 that the share of tax paid increases monotonically, and dramatically, as income increases. There is also a trend, albeit slight, for tax shares to fall across time except for the highest quantile.

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Chapter 5

The Moral Case For A Flat Tax
Lauchlan Chipman

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If we consider the waste of energy and effort which progressive taxation in so many ways leads to, it should not be impossible to convince reasonable people of its undesirability. Yet experience in this field shows how rapidly habit blunts the sense of justice and even elevates into a principle what in fact has no better basis than envy.

F. A. Hayek, *The Constitution of Liberty* (London: Routledge and Kegan Paul, 1960), 322.

Arguments about the desirability of different tax policies invariably involve assertions about their effects on human behaviour. Some claims are empirical (for example, the claim that lower taxes will encourage people to work harder). Other claims are more philosophical (for example, the idea that it is desirable that taxes should be reduced in order to encourage people to work rather than rely on state welfare).

The empirical claims are often very difficult to evaluate because they rest on assumptions about human psychology, about which we just do not know enough. This vacuum in our knowledge is often filled by intuitively grounded conjecture which equally frequently turns out to be wrong. We are on more secure ground when we analyse past changes—we observe that the introduction of such and such an incentive in the past resulted in a particular set of changes in people's behaviour—but because most debate about taxation policy is focused on the future, there are limits to how far past experience can guide our future actions. In sum, the limitations of the current state of the sciences of human behaviour mean that judgements about the probable effects of this or that change in taxation policy must be made under conditions of considerable uncertainty.

As for the philosophical questions, they can only be answered in relation to whatever is postulated as a preferred set of desirable outcomes, and this is an essentially contestable judgement. Arguments about what is desirable and what is not cannot be resolved by appeal to evidence. Instead, these arguments rest on ethical judgements regarding value-laden terms like equity, equality, justice, fairness, and moral obligation. Questions about what socio-economic objectives taxation policies ought to achieve are dependent ultimately on our vision for society.

For example, there is a widely-held belief that material equality is a desirable social goal. As will become clear in the course of this chapter, this is a philosophically contentious position, but, *ceteris paribus*, those who believe in the pursuit of greater equality tend to favour taxation policies that can be expected to lead to a 'more equal' distribution of wealth. In...

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Chapter 6

Tax Complexity And The Rule Of Law¹
Geoffrey de Q. Walker

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The importance for national prosperity of sound institutions of government, and especially of the rule of law, is well understood today. *The Australian Law Journal* notes that ‘Institutional economics has established a high correlation between economic growth and the rule of law’.² Research indicates that most of the international variation in income per capita—perhaps as much as 85%—can be explained by the institutions and policies countries adopt.³

Equally well appreciated is the quasi-constitutional nature of tax law. It is the primary link between a nation’s citizens and their government, a window into the nation’s views about justice and civic society.⁴ The Nobel laureate James Buchanan points out that part of its quasi-constitutional character comes from the fact that it remains in force, with minor variations, over a sequence of budgetary periods,⁵ as well as electoral cycles. But it goes beyond that. Revenue law and policy played a central role in the evolution of Western constitutional democracy, not least because it triggered the three great constitutional revolutions—the English, the American and the French. Australia’s only popular uprising, the 1854 Eureka rebellion, is generally regarded as a tax revolt. The United States experience with the income tax levied to finance the war of independence—which Jefferson attacked on the ground that it required the government to wage a war against the people to collect it—led the constitutional framers to deny Congress the power to impose an income tax, a power it did not receive until the 16th Amendment was passed in 1913.⁶

Economist Joseph Schumpeter once said that a people’s spirit is written in its fiscal history, ‘stripped of all phrases’. In like vein, the historian Charles Adams views the whole history of organised society as a series of events in which government increases its tax burden beyond what taxpayers are willing to stand. That then leads to taxpayer revolt, violence and drastic changes in the structure of society.⁷ On that view, the state of a nation’s tax system is a good pointer to its social and political future.

The Australian tax system displays a range of symptoms suggesting a virtual collapse of the rule of law. Those symptoms include the flourishing cash economy which, at an estimated 15% of GDP, is one of the developed world’s largest and equivalent to New Zealand’s entire economy.⁸ An underground economy of that magnitude requires the involvement not only of many businesses, but also of millions of consumers, who apparently believe that the greater spending power they can achieve through cash discounts is worth more than the duty to comply with a law they obviously consider unworthy of respect.

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Chapter 8

The Taxation Of Shared Family Incomes ¹
Terry Dwyer

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Economic theory assumes that in the absence of distortions, people will make choices which maximise their utility, that is their economic welfare. When a tax or transfer system is introduced it may well influence those economic choices. Sometimes this is deliberate, as in 'sin' taxes on gambling, smoking and drinking. However, tax theorists generally argue that a tax system should be as neutral as possible if economic welfare is to be maximised.

The meaning of economic neutrality is that a choice made after the introduction of a tax or transfer system should not be different from what it would have been before. Thus, if in the absence of a tax, a person would have preferred to work 40 hours a week, the tax is neutral if the person wishes to work the same number of hours after its introduction. The tax does not modify desired behaviour.

The principle of tax neutrality should apply to the way we tax (and pay benefits to) families (although because people have different preferences, design of a neutral tax system is not easy). Some women may prefer not to have children and pursue full-time careers; others may prefer to pursue a career raising children; and others again may, over their lifetimes, wish to pursue both. Some households may prefer to get by with two wage earners but no onerous overtime or promotion; others may prefer more specialisation, with one partner earning market income and the other partner caring for children at home. A neutral tax-transfer system should not interfere with the preferences of these households. The choices households wish to make after the imposition of the tax and transfer system should be the same as before. There should be no bias in favour of the choice of a one-earner household or the choice of a two-earner household. There should be no bias for or against raising children.

A second important principle of taxation (discussed by Lauchlan Chipman in chapter 5) is that people in similar circumstances should be liable to the same amount of tax (so-called 'horizontal equity'). Again, this principle is not easily translated into practical policies. What does treating equals equally mean? How, for example, does one achieve horizontal equity between one-income and two-income families earning the same total income? Because our tax system currently refuses to recognise income sharing within families, a single breadwinner family can pay more tax and be worse off than a two breadwinner family with the same (or even a much larger) total income, because the two income family obtains the advantage of two sets of thresholds and lower tax rates. This clearly violates the principle of horizontal equity.

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Chapter 9

**Rebuilding Australia's Tax And Welfare
Systems¹**

John Humphreys