DISCUSSION PAPERS

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CONSUMPTION TAX CONFERENCE
24-25 February 1992

CONSUMPTION TAX:
A SOLUTION OR NEW PROBLEMS?
Terence Dwyer
and
ECONOMIC ARGUMENTS FOR A NEW
CONSUMPTION TAX
John Freebairn

DISCUSSION PAPER NO. 266
April 1992

G.P.O. Box 4, Canberra 2601, Australia
CONSUMPTION TAX:
A SOLUTION OR NEW PROBLEMS?

Terence Dwyer
Economic Consultant
Canberra

and

ECONOMIC ARGUMENTS FOR A
NEW CONSUMPTION TAX*

John Freebairn
Monash University

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CENTRE FOR ECONOMIC POLICY RESEARCH
CONSUMPTION TAX CONFERENCE
Monday/Tuesday, 24 and 25 February 1992
Convener: Dr. John Quiggin

PROGRAM OUTLINE

Opening Address: Mr Peter Reith
Deputy Leader of the Opposition and Shadow Treasurer

SESSION 1: Paper 1: Consumption Tax: A Solution or New Problems?
Terry Dwyer, Economic Consultant

Paper 2: Economic Arguments for a New Consumption Tax
John Freebairn, Monash University
Discussant (Papers 1 and 2): Fred Gruen, ANU

SESSION 2: Paper 3: Borrowing, Saving and Taxation
John Quiggin, ANU
Discussant: Robert Albon, ANU

PANEL DISCUSSION I:
What Can We Learn From The New Zealand Experience with the GST, Micro-economic Reform and Macroeconomic Policy?
Speakers: Alan Wood, The Australian
Alan Bollard,
NZ Institute of Economic Research

SESSION 3: Paper 4: Tax Reform and the Distribution of Income
Anne Harding,
Centre of Economic & Social Modelling
Dept of Health, Housing & Community Services

SESSION 4: Paper 5: National Savings Policy for Australia
Speaker: David Chessell, Access Economics

PANEL DISCUSSION II:
1. GST and the Size of Government
Geoff Brennan, Australian National University
2. GST and the Inflation Rate
Chris Murphy, Access Economics and ANU

SUMMARY SESSION
Opening Speaker: John Piggott
University of New South Wales
Open Discussion
# TABLE OF CONTENTS

## CONSUMPTION TAX: A SOLUTION OR NEW PROBLEMS? - Terence Dwyer

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>History of consumption tax</td>
<td>1</td>
</tr>
<tr>
<td>The case for a shift to consumption tax</td>
<td>2</td>
</tr>
<tr>
<td>The central problem - tax replacement or &quot;new taxes for old&quot;</td>
<td>2</td>
</tr>
<tr>
<td>Disincentive Effects of the Consumption Tax Package</td>
<td>3</td>
</tr>
<tr>
<td>The Broad Arithmetic</td>
<td>4</td>
</tr>
<tr>
<td>Bracket Creep</td>
<td>5</td>
</tr>
<tr>
<td>Incentive gains from the GST package</td>
<td>5</td>
</tr>
<tr>
<td>New disincentives created by the GST package</td>
<td>6</td>
</tr>
<tr>
<td>New Equivalent Marginal Tax Rate Disincentive Traps</td>
<td>6</td>
</tr>
<tr>
<td>The New Income Tax Disincentives</td>
<td>8</td>
</tr>
<tr>
<td>New Economic Distortions from the GST</td>
<td>9</td>
</tr>
<tr>
<td>Zero-rating Dilemmas</td>
<td>11</td>
</tr>
<tr>
<td>New Taxes on Business Inputs</td>
<td>11</td>
</tr>
<tr>
<td>Avoidance and Evasion</td>
<td>12</td>
</tr>
<tr>
<td>Administrative and Compliance Costs</td>
<td>13</td>
</tr>
<tr>
<td>Transitional Double Taxation</td>
<td>14</td>
</tr>
<tr>
<td>Some puzzles</td>
<td>14</td>
</tr>
<tr>
<td>Conclusions</td>
<td>19</td>
</tr>
<tr>
<td>Attachment 1</td>
<td>21</td>
</tr>
<tr>
<td>Endnotes</td>
<td>26</td>
</tr>
</tbody>
</table>

## ECONOMIC ARGUMENTS FOR A NEW CONSUMPTION TAX - John Freebairn

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australian Taxation</td>
<td>28</td>
</tr>
<tr>
<td>The GST Option</td>
<td>29</td>
</tr>
<tr>
<td>Rationalising Indirect Taxes</td>
<td>30</td>
</tr>
<tr>
<td>1. Wholesale sales tax (WST)</td>
<td>32</td>
</tr>
<tr>
<td>2. Other indirect taxes</td>
<td>33</td>
</tr>
<tr>
<td>Tax Mix Change</td>
<td>37</td>
</tr>
<tr>
<td>1. Comparison of tax bases</td>
<td>39</td>
</tr>
<tr>
<td>2. Reducing reliance on Australia's hybrid income tax system</td>
<td>40</td>
</tr>
<tr>
<td>Some Concluding Observations</td>
<td>45</td>
</tr>
<tr>
<td>Endnotes</td>
<td>46</td>
</tr>
<tr>
<td>Tables</td>
<td>48-51</td>
</tr>
<tr>
<td>References</td>
<td>52</td>
</tr>
<tr>
<td>List of Discussion Papers</td>
<td>55</td>
</tr>
</tbody>
</table>
CONSUMPTION TAX: A SOLUTION OR NEW PROBLEMS?

"But the age of chivalry is gone. That of sophists, economists, and calculators, has succeeded; and the glory of Europe is extinguished forever."

Edmund Burke
Reflections on the Revolution in France

History of consumption tax

One of the things which is surprising about the current debate over consumption tax is how little it appears to have benefited from the wisdom of history. It is as though the British excise of the 18th century or the French salt tax had never existed. Yet, as Edmund Burke’s quote reminds us, we should not let sophistical economic calculations based on a limited knowledge and models with limited variables overbear either our instincts or the knowledge we have paid for by experience.

Consumption taxes are not new. They arose in English fiscal history out of the collapse of the Crown revenues through the loss of its land-based feudal dues. Similarly, in the Australian colonies indirect consumption taxes in the form of customs duties and excises were resorted to by the Australian colonies as they exhausted their revenues from the alienation of Crown lands. There were men such as Sir John Quick and Sir Samuel Griffith, two of the founding fathers of this Federation, who recognised the long term folly of the disposal of a permanent source of public revenue and its replacement by taxation, but their voices were not heeded. Suffice to say that in this country we did by the late 19th century have a revenue system based heavily on indirect taxation.

It was in reaction to that heavy reliance on consumption taxation that the movement for land and income taxes took place. As in most tax debates that reaction was no doubt partly motivated by a wish to make the rich pay. However it had more to it. Those who argued for the abolition of taxes upon the consumption of the working people could quote the authority of Adam Smith. Adam Smith had remarked that, "taxes upon necessaries, by raising the wages of labour, necessarily tend to raise the price of all manufactures, and consequently to diminish the extent of their sale and consumption... any rise in the average price of necessaries, unless it is compensated by a proportionate rise in the wages of labour, must necessarily diminish more or less the ability of the poor to bring up numerous families, and consequently to supply the demand for useful labour... the middling and superior ranks of people, if they understood their own interests, ought always to oppose all taxes upon the necessaries of life as well as all direct taxes upon the wages of labour. The final payment of both the one and the other falls altogether upon themselves and always with a considerable overcharge... these and some other taxes of the same kind, by raising the price of labour, are said to have ruined the greater part of the manufactures of Holland... a French author of some note has proposed to reform the finances of his country, by substituting in the room of the greater part of other taxes, this most ruinous of all taxes. There is nothing so absurd says Cicero, which has not been asserted by some philosophers."
The case for a shift to consumption tax

The Objectives of the Consumption Tax Package

The economic motivations invoked in favour of a shift to consumption tax are understandable. We do need increased productivity to restore living standards through increased productivity. We do need to foster domestic savings and investment to generate increased future national income. And a country reliant on foreign capital should not have tax biases against exporters.

The professed objectives of the proposed consumption tax package are indeed laudable. They are:

- to improve work incentives;
- to improve savings incentives;
- to remove disincentives to exports;
- to remove taxes on business inputs to production;
- to reduce welfare dependency.

Few people would have difficulty with such objectives. In particular, I do not question the assertion that high equivalent marginal rates of taxation have serious distortionary effects upon economic activity. I do not question the desirability of removing economic disincentives. The question I will be raising in this paper is whether in fact the consumption tax package achieves those laudable aims.

Will the GST package actually reduce income tax distortions?
Does it successfully lower total equivalent marginal tax rates? Does the GST package promote national savings?

On the indirect tax front, will we reduce overall costs to business and economic distortions by replacing the present sales tax and payroll tax with a goods and services tax of the value added type? Will the tax cascading of the sales tax exist in other forms under GST?

The central problem - tax replacement or "new taxes for old"

The basic problem of all tax reform is that of tax replacement. Unless you are moving to a system of public revenue funded from natural resource endowments (as in the oil revenues of Saudi Arabia or the Crown lease rentals of Hong Kong), you have to bring in new taxes to replace the old. You have to analyze whether the new tax package is really any better and you should also bear in mind that change is costly. No one knows how much the implementation of the GST package will really cost both the public and private sectors in this country.

So it is salutary to remind ourselves that a VAT or GST is just a flat-rate income tax surcharge on residents only with an exemption for income not spent. Consumption is just a part of income, and a consumption tax is essentially just a way of having a second tax bite at the income cherry.
As Harry Gunnison Brown pointed out, a flat rate consumption tax, a sales tax, a value added tax, a goods and services tax - call it what you will - is nothing more than a flat rate income tax with no threshold and with no regard to the costs of human subsistence and reproduction. Indeed, as Geoff Bascand explains, a goods and services tax is analytically hardly different from a payroll tax. He notes that very few people would accept a tax reform which replaced income tax with a payroll tax on wage and salary income only and which exempted capital income yet this is very largely the effect of switching from income taxation towards a value added or goods and services tax.

Indeed it is one of the analytical curiosities of the consumption tax package that it involves replacing payroll tax with a value added tax. Given that they are analytically much the same one can only ask why bother?

Disincentive Effects of the Consumption Tax Package

In analyzing the disincentive effects of a tax/transfer system we should not allow ourselves to be seduced by the seen, as opposed to the unseen. We must look at the total marginal impact of all taxes and transfers affecting taxpayers, not just income tax. Some people try to say, foolishly, that only income tax disincentives matter because they are visible. If only that were so! But, as Kay and King observe, it is chimerical to think that the disincentive effects of taxes can be disguised by changing their names.

If a shift from income tax towards heavier consumption tax actually eliminated real economic disincentives we should be going all the way. We could abolish income tax entirely and replace with any tax - a GST, customs duties, a poll tax - and we would have got rid of all tax disincentives. No economist I know of is that silly. In looking at incentives it is generally accepted that we must add back the effects of other taxes and income tests to the standard income tax scale to get total equivalent marginal tax rates (EMTRs) which, consciously or unconsciously, ultimately affect people’s work and savings behaviour.

In looking at the GST package, the first and most obvious disincentive to add back is the 15% goods and services or value added tax itself. A 15% GST is roughly equivalent to a 200% increase in the existing wholesale sales tax or an income tax surcharge of at least 4.7%, probably considerably larger.

In looking at the new marginal rates of income tax it is thus necessary to add back the GST in the form of an income tax surcharge to get a true comparison with the present position. Given that the marginal rate cuts at the top are from 47% to 42% only, adding back, say, a 6% effect for the GST brings us to much the same position. For middle income earners adding 6% back to their more substantial cuts to marginal rates leaves us with greater cuts in marginal rates. This is, of course, a simplification and you can’t tax that part of income spent as tax. We also have to scale the 1995 tax scales down to 1992 dollars. As we shall see below, we then have to take into account new income tests etc.

An Overview of the Consumption Tax Package
From a revenue point of view tax reform is a bit like "squeezing the circle" - you have to get back where you started from. The arithmetic of the consumption tax package requires that all tax cuts be paid for, either by new taxes or tax increases elsewhere or by spending cuts.

**The Broad Arithmetic**

The main features of the Coalition’s consumption tax package in 1990/91 dollar terms are:

- a $27 billion goods and services or value added tax;
- a $12.5 billion income tax cut;
- a $9.4 billion abolition of the wholesale sales tax;
- a $6.6 billion abolition of the fuel excise;
- a $5.8 billion abolition of payroll tax;
- a $2.4 billion social security compensation package for a consumption tax;
- $3 billion from bracket creep until 1995 which will contribute towards the future tax cuts;
- a major increase in tax revenues from company tax and new taxes on superannuation of some $1.4 billion;
- gross spending cuts of $9.7 billion achieved over the next three years to that recurrent level annually;
- $6 billion in new spending (including GST compensation)

The surprising thing about the package is that spending cuts are only contributing $4 billion towards tax reductions. *The rest of the tax cuts are being paid for by new or increased taxes.*

Thus it can be seen that the main thrust of the consumption tax package is to redistribute the means of financing Government spending rather than reducing it. Benefits of abolition or cuts in some taxes tend to be largely offset by increases in others or by the new consumption tax. This is not really surprising as it tends to be rather hard to square a circle.

It is somewhat surprising that the capital gains tax is not only to remain but us so strongly defended in the documentation to the GST package. The capital gains tax has major distorting effects in locking up assets in less rather than more productive hands, it can create tax cascading affects where assets are owned through several intermediate entities and its denial of losses as deductions against ordinary income creates further distortions.

It is also worth noting the wastage of the gross spending cuts caused by the need to compensate for the GST. The gross spending cuts of $10 billion could almost have financed abolition of both sales tax and capital gains tax - we could have got rid of almost both the wholesale sales tax and the capital gains tax and not have needed a 15% GST at all! Even with the new spending initiatives, some $6.5 billion could have been directed towards reducing the sales tax without needing to spend a cent on compensating for its replacement, the GST.

One suspects that in terms of international competitiveness and work and savings incentive that would have been a much better result. No compensation through the social security
system would have been required. No new income tests would have been necessary and there
would have been no new administrative burdens on the private sector as unpaid tax collectors.

Bracket Creep

The other interesting thing about the tax cuts offered is how much they are being financed
by the very same bracket creep which has operated since the 1960s and which the Fightback
documents so rightly deplore. The tax cuts do not start to take effect until late 1994 so $3
billion in increased taxes from bracket creep between 1992 and 1993 is a major funding
component of the tax cuts.

This also means that the cuts to marginal income tax rates in the formal tables presented in
Tables 2.5 and 2.6 of the main Fightback document tend to somewhat overstate the true
extent of the tax rate cuts.

Similarly cut off points (eg. the $30,000 and $40,000 cut off points for family allowance
increases) should be scaled down to their 1992 equivalents. Without such an adjustment they
appear more generous than they are. In practice, of course, few families will be able to
benefit from increased family allowances since most families will have combined family
incomes in excess of $40,000 by 1994. Average adult male total weekly earnings are already
running at around $637.70 per week or $33,250 per annum.

Given that most adult males with dependants tend to have higher earnings (they have to!) and
given that most families rely in any case on two incomes it can be seen that very few families
will benefit from increases in family allowance.

Incentive gains from the GST package

The main beneficial effects of the package from a tax point of view come from the following
sources:

- cuts in marginal income tax rates (although it should be noted that the top marginal
  income tax rate is only reduced from 47 to 42 per cent). Middle income earners
  will receive greater cuts in marginal rates and will come down towards a marginal
  income tax rate of 30 per cent.

- The abolition of the fuel excise is a major benefit for industry and consumers and
  will eliminate a substantial area where distortions are created by tax upon tax.

- The abolition of the wholesale sales tax, although touted as a major benefit to
  exporters, is intended mainly to benefit consumers. If the benefit of the abolition
  of wholesales sales tax does not flow on to consumers there would be little to
  offset the full impact of the 15% consumption tax.

- The abolition of customs duties by 2000 will be a major benefit to consumers.
  Unfortunately they will have to pay the 15% GST from 1994 on top of the tariff
  in the meantime.
As indicated elsewhere in this paper, one can question whether the abolition of payroll tax and its replacement by GST is an improvement.

New disincentives created by the GST package

What is most interesting about the consumption tax package is the extent to which new disincentive effects are being created in the tax/transfer system by a multitude of new income tested or means tested benefits.

Any claims that work incentives are improved must be questioned. The reductions in marginal income tax rates are offset to some extent by the impact of the GST itself in reducing disposable after tax income. In addition new disincentive traps are created in the rate scale through new income tests on family allowance increases, the spouse rebate, the Medicare levy surcharge, home savings grants, wealth compensation etc. You do not necessarily improve overall incentive by shifting disincentives out of the income tax system and re-incarnating them throughout a system of income-tested transfer payments.

New Equivalent Marginal Tax Rate Disincentive Traps

These new levies and income tests add new equivalent marginal tax rate (EMTR) disincentive traps to discourage earning extra income at various points in the income scale. To look at the total incentive picture one has to add back these disincentive effects on top of the lower marginal income tax rates together with the tax rate effect of the GST itself.

The result is to create a pattern of kinks in the effective marginal rate scale which will depend on family circumstances, age and other factors. These effects are, for example, increased with the number of dependent children. The problem has been growing ever since Family Income (now Family Allowance) Supplement was introduced in 1982. It has been exacerbated by income testing of Family Allowance and removal of the sibling concession from AUSTUDY. One might have thought that a package which aimed to reduce welfare dependency would have been designed to not to increase the disincentive effects faced by breadwinners. However, that is its effect.

Turning now to the new EMTR disincentive effects created by the GST package, there are the following:

1. income tested family allowance increases:-
   - there is a $30,000 cut-off for 100% increase
   - a $40,000 cut-off for the 50% increase

2. lowered family allowance cut-offs:-
   - the family allowance sudden death cut-off comes closer to more taxpayers at $55,000 for 1 child plus $3,000 for each additional child.
3. the additional dependent spouse rebate combined income test:
   as well as the 25% income test on the spouses's own income this is
now also tested on combined income, so a primary breadwinner faces
an additional EMTR of 25% from $50,000 if there are no children and
from $75,000 if there are children.

4. the income tested first home owners scheme
   there is a $40,000 cut-off for eligibility for GST compensation for first
home buyers.

5. the Medicare levy surcharge
   an extra $400 or $800 becomes payable over the income ranges of
$35,000-$40,000 for singles and $45,000-$50,000 for families.

6. income tested health insurance tax credits
   for those not relying solely on Medicare, new EMTRs are created by
the income tested health insurance tax credits. These affect marginal
incentives at incomes of $12,000 or $14,500 for over 65s, and
$12,000, $20,000 and $30,000 for singles and families.

7. the pharmaceutical benefits concession card
   eligibility for this benefit disappears when income exceeds $40,000 for
single over 65s or $50,000 for married over 65s

8. the tax free savings scheme
   there is a $50,000 cut-off for full exemption as opposed to a 30% 
rebate.

9. wealth compensation for retirees
   there is a shade-out over the income range of $20,000-$30,000 for
wealth compensation.

10. The GST credit for employed non-social security beneficiaries or pensioners creates
a 16.2% EMTR between pre and post GST tax-free thresholds.
   these ranges are $5,400-$7,000 for singles and $10,800-$14,000 for
marrieds with a dependent spouse. They are $11,880-$15,400 for
marrieds with a dependent spouse and children and $10,475-$13,579
for a sole parent.

11. The GST credit for pensioners/beneficiaries also has shade-out features.
it ends at $17,554 for a single pensioner; $14,723 for a married pensioner; $9,729 for a single beneficiary and $5,505 for a married beneficiary.

12. The GST credit for low income earner non-employed non-pensioners under 60 this has a $20,000 cut-off.

Modelling these new EMTR effects on a spreadsheet is extremely complex. Not all effects will operate on the same people and there are assets test to consider as well. But some general observations may be made:

the more dependants you have the more disincentive effects you will face;
the new EMTRs will cut in at lower real incomes than it may seem at first sight because they are quoted in 1995 dollars and are often based on combined family incomes.

The disincentive effects may be significant because it is not a case of putting high EMTRs at the bottom of the income range (where they will only discourage a few poor people) or at the top of the income range (where there are a few very well-off people). A lot of people are going to run into these EMTR disincentive traps.

Because the consumption tax package proceeds on the fundamentally mistaken assumption that all expenditure on children and other forms of investment in human capital are unproductive consumption it necessarily bears more heavily on family breadwinners. At the same time benefits are being increased for lower income families and there is thus a dual incentive for families to become more rather than less dependent on welfare.

The New Income Tax Disincentives

Surprisingly, the GST package also contains significant income tax increases, which will have the normal disincentive effects.

While it may be conceded that the package does little for work incentives some may argue that the real benefit of the shift to consumption tax is in increasing national savings. While this argument has some merit in theory, I might point out that encouraging savings could be done more cleanly by simply directing the benefits of expenditure cuts towards financing deductions in the income tax for savings. It was simply not necessary to have a GST to achieve the result.

Leaving the theoretical point aside, the consumption tax package we actually have in front of us is remarkable for the forthright assault it makes on two very important areas of national savings - superannuation and corporate profits.
The most striking is the increased income taxation of superannuation savings. The tax rate on fund income is increased to 25% (which unlike the previous ill-advised tax of 15% is not offset by anything like imputation credits). Secondly, there is effective abolition of deductibility for employer and employee contributions for higher income earners and the self-employed. The only tax benefit for superannuation contributions is a 25% rebate on first $6,000 - the most you can save in tax from saving through superannuation contributions is $1,500. These changes are surprising because they go in the opposite direction to a consumption tax which, in the personal expenditure tax form, would exempt all savings.

The effective abolition of superannuation contribution deductions and the increase in the tax on superannuation from 15% to 25% will make the vast majority of income earners question the wisdom of being in superannuation schemes at all. Only a fool would put money into a superannuation scheme where it is taxed not much less than the marginal rate he is already paying and yet cannot be touched till he is aged sixty. When combined with the abolition of the lump sum tax, the immediate incentive appears to be for people to get out of superannuation as fast as possible. Although the package claims that the rebate of $1,500 available on the first $6,000 of contribution is attractive, one suspects that in practice it will prove attractive to very few. Middle and high income earners need generally larger rates of contribution to maintain a worthwhile retirement income, while lower income earners will not be attracted to the idea of saving themselves out of the old age pension. Why should they be?

The increase in company tax rate on income and capital gains to 42% is also surprising.

The increase in the corporate tax rate from 39% to 42% is not insignificant and will raise a considerable amount of revenue, nearly $1 billion. This presumably will affect corporate saving. Given the rhetoric of increased international competitiveness, one might have thought Australia would be seeking to bring its corporate tax rate downwards to compete with places such as Singapore, especially given the aspirations in the package to make Sydney an Asia-Pacific financial centre. Quite frankly, any competent tax adviser will have to tell you that a corporate tax rate of 42% plus a capital gains tax plus a foreign tax credit system plus controlled foreign companies tax rules makes even a Communist-controlled Hong Kong look more attractive.

New Economic Distortions from the GST

The effect of a GST on human capital inputs to production has been largely overlooked in the literature, notwithstanding Adam Smith's warnings. Like Edmund Burke, Adam Smith was not disposed to mathematical economic models. However he pointed to a great limitation in the modern economic models which are generally used to support a case for a consumption tax. He made the very simple and obvious point that an increase in the cost of living caused by a consumption tax will necessarily make it more difficult to bring up families. The long term labour supply of a country may therefore respond adversely to the introduction of a consumption tax. For an economic system to continue, workers have to eat, to be sheltered from the elements and raise up their successors.
An argument constantly made for a value added tax is that it is necessary to exempt inputs to business from taxation, to avoid economic distortions. I agree with that proposition. But it is only part of a broader proposition - that all inputs to production should be exempt from tax and that only surpluses should be taxed. The broader statement of the principle requires that inputs to the production of labour should also be exempt from tax. Capital and labour are both active factors of production, they both have a real cost of production and if it desirable to exempt the costs of acquiring the one it is equally desirable to exempt the costs of producing the other. If it is argued that we should exempt from tax the costs of purchases made by a business why should we not also exempt from tax the cost of the food and fares necessary for a working man to keep his body and soul together and arrive at his place of work? It is simply nonsense to pretend that the only inputs to production are what business buys and that salaries or wages are a net surplus.

To take a real-world example which drives home the point, where is the economic logic in the New Zealand GST which zero rates bullion purchases by a miser who floats over his gold in his cellar while the mother feeding her children pays GST on the milk which builds the bones of future workers? Which is the input to production?

As the French philosopher Bertrand De Jouvenal observed, "the family performs in society no less important a function than the firm. The firm produces the goods, the family produces the people. It is puzzling that the needs of the former should be so well understood by the law-makers and the needs of the latter so disregarded. It seems that law-makers can picture only the firm as an institution with a purpose and therefore respectable. The income recipient, on the other hand, his day's work done, is seen as going round the booths of a fair, blushing his rights to consumer-satisfaction. It is not realised that he is an entrepreneur in his own right. He marries, sets up a house, raises children, and, it is to be assumed, struggles to bring himself and his family to the greatest possible degree of accomplishment. His achievement is to be recognised as useful to society in that he fits himself and his descendants for their roles as producers; in this respect, it is an indirect contribution to national income . . . It is quite incomprehensible that a breeder of dogs for the race-track should be allowed his cost, depreciation etc, while the father of a family is not. It is as if the law-makers sympathised more with the purpose of the former, which is to sell dogs for the track, than with the purpose of the latter, which gives men to society - incidentally for soldiering and taxpaying."

The fallacy that all labour income is surplus income, capable of being taxed, is present in our existing income tax system. But, at least in theory, our income tax system through the exemption of a subsistence threshold and through some residual recognition of dependent rebates recognises that not all labour income is surplus income capable of being taxed. The great error of an indirect consumption tax of the value added kind is that it totally overlooks this fundamental economic truth.

I have no difficulty with an attempt to achieve the benefits of a consumption tax through a direct consumption tax which may easily be established by exempting savings from the income tax without taxing family subsistence incomes. But an indirect consumption tax (which is what we are talking about) on the lines of value added tax is, I suggest, unsound.
The fundamental problem of an *indirect* consumption tax is that it does totally ignore this necessary investment in human capital if an economic system is to continue. Europe, the Old World, from whom the advocates of value added taxation draw their inspiration is facing a demographic collapse not seen since the days of the later Roman Empire. I do not pretend to know the full extent of the part played by value added taxation in rendering it more difficult for the native populations of Europe to maintain their vigour but I know that it has certainly not made it easier for people in Europe to afford numerous families. And, as many of you will know, the long term demographic decline of Europe has as a consequence the long term bankruptcy of their unfunded welfare states.

**Zero-rating Dilemmas**

No GST in the world taxes all goods and services alike. Apart from considerations of optimal tax theory which teaches that it is inefficient to do so, the fact is that many goods and services cannot be taxed or to do so involves intolerable economic distortions. Thus the GST package proposes to zero-rate (that is, not tax) governments, health, education and welfare services.

This raises the question of zero-rating food. Most countries accept the argument that food is an input to production and either zero-rate it or give a concessional tax rate. I have set out in an attachment the treatment of food under most VATs in developed countries. Hardly any countries tax food at anything like 15% - 15% is not a "world class" tax rate - it is almost out of this world!

If food is not zero-rated there are going to be interesting anomalies in regard to welfare bodies. For example, if the St Vincent de Paul or the Smith Family give a welfare cheque to a poor person to buy food, that food would be taxed at 15%. But if the welfare body buys the food itself and gives it to the recipient, it will be zero-rated.

Distinguishing the "commercial" activities of governments (eg garbage collection?) from their zero-rated governmental activities is not going to be easy. One might also point out that States, Territories, semi-government and municipal authorities may challenge the Constitutional validity of any Federal attempt to tax any of their operations.

Another area of GST distortion is going to be distinguishing private and business uses of goods or services (eg consumer durables). Just as with the Fringe Benefits Tax, enormous effort is going to be expended on questions such as whether this petrol was used for business purposes or not. Filling the car log book will become a real art form once people realize that you save GST as well as FBT - one does wonder whether we will become "a nation of fiddlers" as was once unkindly remarked of a post-Imperial Britain.

**New Taxes on Business Inputs**

While one can applaud the removal of the petrol excise, it is disappointing that major new taxes are being proposed on business inputs.
Because housing is being input taxed, so is commercial building. Although one might think it easier to track bricks into business or personal use than to track petrol, no refunds will be given to business users for GST on shops, offices, warehouses and factories. This is a major change from the relatively light taxation of building under the current sales tax. It will eventually feed into increased business rental costs. For small businesses the impact of the consumption tax on commercial rents may be quite significant. Even businesses in existing premises may suffer rent increases from a GST because many commercial leases rents are contractually increased in line with the consumer price index (CPI). Thus if the overall GST package produces a CPI effective 5%, 6%, 7% or higher many small business lease rentals will automatically increase with no provision for compensation.

Another area where businesses will bear new taxes on inputs is the financial services area which is also input-taxed. The input taxing of financial institutions without abolition of financial institutions duty or the debits tax or stamp duties does not appear to contribute to neutrality in indirect taxation and will probably result in higher interest margins being charged on to customers.

To take a pertinent example of financial services distortions, ACT stamp duty on disability income insurance is already 10%. With GST it will be a 25% tax on insuring yourself to save the government an invalid pension should you suffer illness or accident. This seems to be a departure from neutrality of the same type admitted by the GST package in conceding the case for zero-rating charities.

Avoidance and Evasion

A common argument for a consumption tax is that it will finance tax cuts for the honest taxpayer by subjecting a black economy to tax. This proposition is almost certainly nonsense. Prostitutes and drug dealers are no more likely to register for GST than they are to file income tax returns. If it thought that at least their expenditure will be subjected to tax when they purchase goods from the legitimate economy, it must be remembered that tax on sales by the legitimate economy is already included in the revenue calculations and will be offset by income tax cuts to the suppliers of those goods. It may be noted that the Canadian experience did not show any great benefit in terms of increased tax compliance. As for the assertion sometimes made that the New Zealand experience showed that there were many more firms registering for GST than was expected by the Treasury that experience was ambiguous. In the first place one does not know precisely how the estimates were arrived at. Treasury revenue estimates, as for the capital gains tax and for the controlled foreign companies tax, may be half-deliberate underestimates, both to avoid Budget shortfalls and to avoid stirring up resistance.

Secondly there is a very good tax planning reason why some businesses would wish to register for GST rather than not. You will be aware that the Commissioner of Taxation often seeks to deny business losses in situations where he feels that the business is merely a hobby. It may well be the case that some hobby businesses, in order to bolster their claims for deductibility of losses for income
tax purposes, deliberately set out to register for GST. If that is the case the introduction of GST may facilitate some loss claims for income tax purposes.

In the household services area, the GST provides a fillip to the black economy by creating a dual incentive for evasion. At present, the supplier has more reason to raise the subject of a decent discount for cash. Under a GST both the supplier and the customer have an incentive to broach the delicate subject of cash in the hand. It may be of some interest to note that a former Commissioner of the Inland Revenue, Sir William Pile, I believe, had to confess to a UK Parliamentary committee that he had to pay cash to get work done around his home.

As for the argument that a GST cannot be avoided, without going into the details here, I note that transfer pricing problems will exist between exempt and taxable suppliers within the same corporate group. Thus banks in Holland apparently organised separate computing services which as separate subsidiaries were able to reclaim their input tax while on-selling to the bank (which could not reclaim the VAT) at a below market price. Other areas of avoidance will no doubt include shifting from independent contractor status to employee status as and when required. This is because wages earned by an employee do not have to have VAT charged on them whereas fees by an independent contractor do. Therefore a small business providing consulting services for example, could arrange to reclaim all its input tax while providing most of its "services" through temporary employment.

There are other games which no doubt will be played, ranging from outright fraud in false claims for VAT refunds to more sophisticated manoeuvres in regard to the international market for services. Suffice to say that tax consultants will not be out of jobs. Perhaps we are the only winners from the package.

Administrative and Compliance Costs

Because GST, like all value added taxes is collected incrementally at each stage in production and distribution, it necessarily generates a churning of paper to get net VAT tax revenue. $1 of final GST revenue could represent gross collections of $15 and refunds of $14. All of this has to be keypunched, totalled, verified and paid back and forth through the banking system. As with Medicare refunds, it's all a lot of paperwork and it is a net cost to the community. For small business - perhaps up to 2,000,000 businesses it's not a thrilling prospect. I note that one New Zealand accountant has warned small business people to forget Sundays on the beach with their families. For larger businesses, the cost in computer upgrades and banking charges as well as staff training cannot be overlooked.

Business, especially small businesses and farmers, appear to lose in that there is no real compensation for the administrative costs they will bear in collecting GST. Although there is a suggestion that they may gain from temporary use of tax funds before remitting them to the Treasury one may doubt whether this advantage will compensate them for the increased costs borne by them as tax collectors.

One also wonders whether small business will be able to pass on the cost of GST, particularly in the service industries. It will be recalled that when the Tax Office tried to impose sales
tax on computer software the burden of that tax was in some cases borne by the software designers rather than their customers. The sales tax was resented by many software developers as simply being a 20% income tax surcharge on top of their provisional tax. If there had been scope to pass on the tax they would already have bargained for higher remuneration.

Companies in industries, subject to input taxation such as banking, financial services, residential and commercial construction, will often have businesses producing both taxable and exempt supplies. The administrative costs of organising their affairs to claim GST refunds on taxable supplies should not be underestimated. Complex anti-avoidance provisions will be necessary to stop suppliers of exempt goods and services from reclaiming GST on inputs to those suppliers by reallocating it to an ostensibly taxable use. Many larger businesses will find they are partially exempt suppliers and will have to do complex pro rata calculations to ensure they reclaim as much of the GST on their inputs as they can without provoking a charge of GST fraud upon audit. Those businesses which have had the pleasure of prolonged Tax Office income tax audits may not find any more joy in a GST audit.

The new exemptions proposed within the capital gains tax will make it even more complex to administer. I suppose that as a tax adviser with an active interest in capital gains tax I should not complain. However, from an economic point of view, I would have been happier had the tax been abolished altogether.

Transitional Double Taxation

An interesting transitional effect relates to sales tax already paid on goods which have gone into service in businesses. Although a refund of sales tax will be allowed on goods held as stock there is no provision in the package to refund sales tax paid on goods which have already gone into productive use. For example, the sales tax paid on air conditioning duct work in an office or swimming pool equipment in an amusement park will not be refunded. The asset was taxed and now the flow of services from the asset is taxed again.

Similarly, there is a large transitional impact on those approaching retirement. Having saved through high income tax years, unless wealth compensation is adequate and permanent, they face double taxation in the form of a new tax when they come to spend their savings. When the population is ageing what was an equal revenue shift from income to consumption tax at one time results in longer term revenue gain to the Treasury at the taxpayers’ expense in future periods.

Some puzzles

Payroll tax

The abolition of the payroll tax is curious. Although it is portrayed as a tax upon employment, it is not made clear in the documents as to why it is any more a tax on employment than PAYE income tax. Curiously, the consumption tax package appears to assume that the benefit of the abolition of the payroll tax will go partly to consumers and
partly to employers in the form of reduced prices and increased profits respectively. This is highly dubious.

From an historical point of view payroll tax was always conceived of as a tax upon wages to redistribute wages from employees without dependants to employees with dependants, being the instrument by which child endowment was funded in 1941. Although the link with child endowment has long since been abolished, union leaders are not necessarily unmindful of it and they will certainly appreciate that if payroll tax was previously a cost of employing labour, profitable employers will remain just as profitable if the payroll tax cheque is sent to the workers in the future rather than to State Treasurers.

Indeed it is hard to see the reason for abolishing payroll tax when it is being replaced by a value added tax with much the same incidence properties. Payroll tax and value added tax are largely interchangeable from an analytic view. If as I have suggested the abolition of payroll tax will be quickly be redirected to the benefit of labour the CPI figure of 4.7% immediately shifts toward 5.6%. This is because the coalition’s calculations of the CPI effect assume that payroll tax will benefit consumers to the extent of a 0.9% drop in the CPI. This seems highly dubious.

Another point which may be worth noticing about payroll tax abolition is that if payroll tax abolition results in wage claims by employees of larger employers there will likely be spillover effects upon small business, which however is not generally subject to payroll tax at the moment. Thus small business will gain nothing through abolition of the payroll tax yet face competitive pressure in the long run to match increased worker remuneration caused by readjustments within the labour costs of large employers. Small business people thus appear to be potential losers from the abolition of payroll tax.

Superannuation and national savings

It is curious that a package which has been justified by the need to improve our national savings performance in order to reduce our reliance of foreign debt has mounted such a far reaching attack on superannuation, which is such a significant source of long term national savings. One suspects that many Australian will decide to invest in offshore superannuation arrangements and either legally avoid or illegally evade any Australian tax on the earnings of their savings invested overseas. If you invest in a mutual fund or superannuation fund in a place such as Jersey you pay no tax on superannuation earnings. Why should you bother investing in an Australian superannuation fund at all?

Alternatively, many employees may simply prefer to plough their savings into paying off their homes faster and reducing their non tax deductible mortgage interest commitments. Even under the present arrangements with the 15% tax on contributions and 15% tax on superannuation fund earnings many employees on lower marginal rates would be better advised not to join a superannuation scheme but pay the normal tax on their earnings and plough back the after-tax amount into getting rid of their non-deductible mortgage interest.

From an equity point of view, interesting anomalies are going to be raised by the new treatment of superannuation proposed in the consumption tax package. The taxation arrangements proposed are incapable of operation in regard to unfunded defined benefit
schemes such as those applicable to State and Federal public servants, the military and Federal and State judges, as well as Federal and State parliamentarians. The only way to simulate the effect of the taxes for an unfunded superannuation scheme are for the benefits payable under these unfunded public sector arrangements to be cut unilaterally.

One suspects that any unilateral attempt by a Federal Government to cut public sector remuneration where it is currently being earned under quasi-contractual long term employment arrangements will produce a fairly violent industrial backlash. People tend not to like unilateral retrospective renegotiation of contracts especially where they have planned their age retirement on that basis. For example, public servants, soldiers, sailors and others planning to retire at 55 and who have been working for many years towards that end may question why they should unilaterally be forced to wait till age 60. Again one can expect that the judges will politely draw the attention of the Commonwealth government to provisions restricting any reduction in their remuneration during their terms of office. It is doubtful whether the Commonwealth government can unilaterally reduce the superannuation entitlements of serving High Court justices for example.

Another anomaly which will no doubt appear is the discrepancy between the superannuation arrangements available to employees of Australian versus foreign countries. Multinationals based outside Australia and contributing to superannuation funds outside Australia will not be affected by the 25% tax on superannuation fund contributions and will therefore be able to offer the Australian employees better remuneration packages than the Australian based multinationals. Perhaps Australian based multinationals will start setting up foreign superannuation funds investing offshore in order to compete for skilled Australian employees.

With lowered marginal rates, reduced tax advantages to superannuation and no lump sum tax one suspects there will be a massive cashing out of superannuation entitlements and a move to wind up funds. Certainly the many remaining thousands of small family business superannuation funds would appear to be prime candidates for liquidation.

The superannuation industry thus appears to be a big loser. The tax changes to superannuation - the abolition of tax deductibility and the increased tax on fund earnings up to 25% mean that for many people superannuation will simply become unattractive. If there is a drying up of fund flows to the superannuation industry as a result of the GST package one wonders whether there could be a liquidity problem analogous to that recently experienced by the property trust industry.

The abolition of superannuation tax concessions will severely hit the self employed such as doctors and lawyers, who for years have complained that they were inequitably treated compared to federal public servants, politicians and judges.

In regard to savings, although in theory, the shift towards heavier taxation of consumption could improve savings, the empirical evidence for the extent of such a shift was ambiguous. However, in the concrete GST package before us the effect on savings is far more problematical in any case. One suspects that the attack on superannuation will have a very adverse long term effect on national savings.
One can only speculate as to the effect on the Stock Exchange. If you adhere to the "weight of the money" theory of share prices, you would expect a withdrawal of people from funded superannuation schemes to pull something of a carpet from under blue chip share prices into which so much superannuation money has gone.

**Tax-free savings scheme**

An interesting question is whether the tax-free savings incentive scheme will only encourage the rearrangement of affairs in the base year in order to claim tax benefits for saving which is merely making up for previous dis-saving or shifting of assets.

**Demand shifts**

Transitional demand effects will also be complex. Even those industries which appear to gain from the abolition of the sales tax may suffer if patterns of consumer demand are disrupted in the transitional period. For example, consumers rightly or wrongly, may expect certain goods to go up and bring forward purchases. This could result in a surge of demand followed by a slump which has appeared to happen in New Zealand.

**CPI impact**

The GST package assumes that abolition of sales tax and petrol excise will be passed on fully to the consumer. Given the oligopolistic nature of much of the Australian economy one wonders if this will occur. If businesses are not sure about how much their suppliers will pass on to savings to them and how much workers will demand from abolition of the payroll tax, they may feel prudence demands a "price for the worst" policy. This could in turn engender cost pressures elsewhere.

Unless there is vigorous enforcement of competition policy, one wonders how much of business cost reductions will flow through to consumers. In theory they should. If they don’t, we may have to have an expanded Trade Practices Commission and Prices Surveillance Authority bureaucracies.

**Impact on Rural Exporters**

Another group that prima facie one would expect to be losers would be farmers, particularly the smaller family farmers. Because of income tax losses, tax averaging, income equalisation deposits and the deductions available to primary producers most farm families do not face very high income tax burdens. The income tax cuts may not be worth much to many farmers - many of them are probably wishing they did have incomes to pay tax on.

While as producers farmers will gain from the abolition of the petrol excise this will be offset for them as consumers to a considerable extent by the extension of indirect taxation to services such as freight which are at present exempt from the wholesales sales tax. Thus it is likely that the increased cost of personal consumption for farmers will outweigh the income tax cuts while the benefit of the abolition of the petrol excise may not flow through fully to reduce costs of living in country areas because it will be counteracted by the extension of
indirect tax to freight and retailing margins. For example a carton of milk might cost 85
cents in a suburban shop and cost $1.22 in a country area. It is unclear that this differential
will shrink or even increase under the GST package. In addition, both prices will be subject
to GST and the higher the price the greater the impact of the GST on one's cost of living.

The abolition of payroll tax will not in any case benefit many farmers since so few have to
pay it.

Another question is whether farmers will lose ground in our domestic markets if food is taxed
while food imports from places such as the EC are being sold at subsidized prices. One also
wonders how much of a benefit sales tax abolition is for farmers, given that both exports and
food sold domestically are exempt from the existing sales tax.

Two million new jobs

One has to wonder whether a tax on consumption is consistent with the increased demand
necessary to generate new jobs. In that regard it is worth recalling Harry Gunnison Brown's
observation of the USA in the 1930s "Depression has ... promoted the spread of sales taxes.
Yet ... the spread of such taxes has also fostered depression, has put more workers out of
jobs ..." Would more jobs be generated by the natural growth of the economy in any
case?

Approaches to the problem of increasing aged welfare dependency

One of the surprising things in the package is its apparent sensitivity to the over sixties versus
its apparent insensitivity to those in the workforce or below age 60. While efforts are made
to compensate the over sixties for the wealth effect of the introduction of the GST, no attempt
is made to compensate those under sixty. For example, if you are a widow aged 55 who has
been living off the interest on some life insurance policy proceeds invested in a bank, you
will not be eligible for wealth compensation. Most families, the vast majority, will receive
only a 6% increase in family allowance as compensation.

Yet while the dole is being tightened up again in the middle of a recession, there is no
proposal to in any way tighten eligibility for the age pension. A home, no matter how
valuable, remains an asset test exempt asset; no changes are proposed to either the free area
or the taper rates in order to target the aged pension more towards those in most need.

Given the emphasis placed on the long-term budgetary problems generated by the ageing of
the population one might have thought that policy responses would have been:

- First, to tighten eligibility for the age pension, to avoid budgetary wastage;
- Second, to ensure that superannuation benefits were encouraged by less rather than
  more taxation and were as a quid pro quo only payable as life annuities which
  could be income tested dollar for dollar; and
- Thirdly that some tax relief might be directed towards those who are doing their
  bit to prevent the ageing of the population by raising children. We seem to be
anxious to give tax relief to investors in physical capital, but, unlike the
Singaporeans or the Japanese, we seem unwilling to consider tax relief for those
investing in the next generation of taxpayers. The Treasury, it seems, like Adam
Smith's landlords, loves to reap where it never sowed - the costs of raising children
are a private expense but their earnings will nonetheless be garnished by the fisc
when they reach adulthood.

In each of these areas the policy of the consumption tax package appears to be the opposite
of what one might have thought.

Conclusions

Efficiency gains

In regard to the assertions for the economic efficiency benefits of the GST package it may
be noted that very little of the literature is cited in support of such assertions. As I have
indicated, the GST package is a complex document with many proposals for change, some
of them quite attractive in their own right. The problem is working out the overall efficiency
price tag. From an efficiency point of view, are we really getting an overall reduction in tax
distortions or is it a case of "new taxes for old"? The answer is not clear cut, but one has
to have doubts.

The re-distributive issue: a zero or even negative sum game?

A Canadian Minister for Finance, who had served many years in that post, is reported to
have once remarked in a debate in the House of Commons that in his experience of taxation
and, he added, it was considerable, there was only one tax that was truly popular and that
was the tax on the other fellow. While economists tend to be interested in the incentive or
disincentive effects of taxes most people are more interested in how they stand to lose or gain
out of a change in the tax system.

The first point to make is that we cannot all be winners. One has to be suspicious of any tax
reform package which asserts that there are no losers. One cannot really subscribe to cargo
cult arguments which seem to think that somehow a wicked black economy will suddenly
become virtuous and pay for tax cuts for 90% of us.

Obviously, prima facie, the initial losers will be those with higher ratios than average than
consumption expenditure to income (eg. families). It is interesting that in the Fightback
package in the analysis of the household expenditure statistics some 6.5% of the sample was
excluded in working out the distributional impact of the package.11 Some of those excluded
had ratios of expenditure to income ranging up to two and a half times their income. One
suspects that such people were self employed eg. farmers suffering from adverse economic
circumstances. The practical question then is that if you have a high ratio of expenditure to
income how are you going to be compensated?

It seems that families will be under compensated quite substantially. The general increase
in family allowances will only be 6%. Yet family allowances are only a small proportion of
the additional expenditure on dependents incurred by people with children compared to people
without children. The increases in family allowance are only available to those with family incomes below 1994 levels of $30,000 and $40,000 say $25,000 or $35,000 in today’s terms. Thus the vast bulk of families will get no compensation for children except a small 6% increase in their family allowance notwithstanding that their consumption ratios to income tend to be higher than those without children.

In this paper I have raised many questions about the GST package. I have not dealt with in any great detail, the general theoretical arguments for or against the consumption tax. I refer you to the paper Consumption Tax - Is It Necessary? which was commissioned by the Australian Catholic Social Welfare Commission.1 I believe questions raised in that paper still stand. Instead today I have tried to concentrate on the concrete GST package with which we have been presented. At this stage perhaps it is safest to say the case is by no means proven and consumers might consider the old adage caveat emptor - buyer beware!

I would like to emphasise that in making these comments I am of course speaking only for myself and I should also like to emphasise that I am not adverse to many of the professed objectives of the package. I believe that incentives do matter, that this country’s tax burden is too high, that there are incentives in the present system towards welfare dependency, that we do face a long term structural budgetary problem with an ageing population and that something ought to be done about these things.

One suspects that the public interest and support for the idea of radical reform reflects a similar view. However, there is always the danger that a drowning man will clutch at any straw. It behoves us to examine all the implications of this major reform package very carefully indeed. Finally, it is perhaps proper to add that I am not without sympathy for the problem which the coalition has presented itself. As Edmund Burke remarked...to tax and to please, no more than to love and be wise is not given to man.

Terence Dwyer
Pearce ACT 2607
20 February 1992
ATTACHMENT 1

THE TAXATION OF FOOD UNDER VALUE ADDED TAXES

The following sets out the tax treatment of food under most VAT systems in the developed countries. The countries surveyed are those in Europe, New Zealand, Canada and Japan. The table is subject to revision.

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>STANDARD RATE</th>
<th>RATE ON FOOD</th>
</tr>
</thead>
<tbody>
<tr>
<td>AUSTRIA</td>
<td>20%</td>
<td>10%</td>
</tr>
<tr>
<td>(IBFD 95-96, 59)</td>
<td></td>
<td>(take away not reduced)</td>
</tr>
<tr>
<td>BELGIUM</td>
<td>19%</td>
<td>6%</td>
</tr>
<tr>
<td>(IBFD 69, 112)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CANADA</td>
<td>7%</td>
<td>0%</td>
</tr>
<tr>
<td>(GST Summary 7, 12)</td>
<td></td>
<td>(basic groceries)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>7%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(snack foods, restaurant meals)</td>
</tr>
<tr>
<td>DENMARK</td>
<td>22%</td>
<td>22%</td>
</tr>
<tr>
<td>(IBFD 43, 47)</td>
<td></td>
<td>(but some tax reimbursements to dairies</td>
</tr>
<tr>
<td></td>
<td></td>
<td>to lower consumer price of dairy products)</td>
</tr>
<tr>
<td>FRANCE</td>
<td>18.6%</td>
<td>5.5%</td>
</tr>
<tr>
<td>(IBFD 52, 54)</td>
<td></td>
<td>(7% for meals in canteens)</td>
</tr>
<tr>
<td>GERMANY</td>
<td>14%</td>
<td>7%</td>
</tr>
<tr>
<td>(IBFD 76, 112)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GREECE</td>
<td>16%</td>
<td>6%</td>
</tr>
<tr>
<td>(IBFD (i), 22)</td>
<td></td>
<td>(reduced rate for essential goods)</td>
</tr>
<tr>
<td>Country</td>
<td>Rate</td>
<td>Notes</td>
</tr>
<tr>
<td>---------------</td>
<td>------</td>
<td>--------------------------------------------</td>
</tr>
<tr>
<td>HUNGARY</td>
<td>25%</td>
<td>(IBFD 43-44, 78)</td>
</tr>
<tr>
<td>IRELAND</td>
<td>25%</td>
<td>(IBFD 45, 61-62, 104, 108)</td>
</tr>
<tr>
<td>ITALY</td>
<td>18%</td>
<td>(IBFD 55, 89)</td>
</tr>
<tr>
<td>JAPAN</td>
<td>3%</td>
<td>(IBFD TNS 21/2/90 APTIRC Bulletin April 1990 at 27)</td>
</tr>
<tr>
<td>LUXEMBOURG</td>
<td>12%</td>
<td>(IBFD 48-49, 79-80, 85)</td>
</tr>
<tr>
<td>NEW ZEALAND</td>
<td>12.5%</td>
<td>(GST Guide 9 GST Act s 8(1))</td>
</tr>
<tr>
<td>NETHERLANDS</td>
<td>18.5%</td>
<td>(IBFD 53-54, 83)</td>
</tr>
<tr>
<td>NORWAY</td>
<td>20%</td>
<td>(IBFD 61-62)</td>
</tr>
<tr>
<td>PORTUGAL</td>
<td>17%</td>
<td>(IBFD 36, 48-48a, 89)</td>
</tr>
<tr>
<td>SPAIN</td>
<td>12%</td>
<td>(IBFD 71, 131)</td>
</tr>
<tr>
<td>SWEDEN</td>
<td>23.46%</td>
<td>(IBFD 42-44)</td>
</tr>
</tbody>
</table>

Note: The rate for Sweden is an effective rate, which includes the VAT rate and any applicable surcharges or reductions.
<table>
<thead>
<tr>
<th>Country</th>
<th>VAT Rate</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>SWITZERLAND</td>
<td>No VAT</td>
<td>(rejected at successive referenda since 1977)</td>
</tr>
<tr>
<td>TURKEY</td>
<td>10%</td>
<td>3% (for basic foodstuffs, milk, bread etc; zero-rating abolished 1 January 1988)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>10% (for dried fruits and herbs, 1% prior to retail stage)</td>
</tr>
<tr>
<td>UNITED KINGDOM</td>
<td>17.5% (15% prior to 1991 phasing out of poll tax)</td>
<td>0% (except for catering and some confectionery and snack foods)</td>
</tr>
</tbody>
</table>

(Sources: International Bureau of Fiscal Documentation (IBFD) *Value Added Taxes in Europe*, looseleaf, November, 1989)

IBFD Tax News Service (TNS)

Asian Pacific Tax and Investment Research Centre (APTIRC) Bulletin


Canada, Department of Finance *Goods and Services Tax: A Summary*, Ottawa, September, 1991


Summary

Very few countries tax food at the standard VAT rate. The great majority either zero-rate (ie completely exempt) food or at least give it a substantially concessional rate of tax. It may also be noted that among countries which do not give concessions in their VAT to food there may also be subsidies or tax concessions to food producers (eg Denmark and perhaps New Zealand).
EQUIVALENT MARGINAL TAX RATES - 1995
MARRED TAXPAYER WITH SIX CHILDREN

PRIVATE INCOME AS PER CENT OF AWE

-50% - 0% 33% 60% 99% 132% 165% 198% 232%

EMTR (PER CENT)

Income Tax
Medicare Levy
Family Allowance
FAS
GST
EQUIVALENT MARGINAL TAX RATES – 1995
MARRIED TAXPAYER WITH THREE CHILDREN

PRIVATE INCOME AS PER CENT OF AWE

-50%  0%  33%  66%  99%  132%  165%  188%  232%

EMTR (PER CENT)

0%  50%  100%  150%  200%

Income Tax  Medicare Levy  Family Allowance  FAS  GST
ENDNOTES


5. See Fightback, main document, § 4.2, p 38. "The taxation of capital gain is an essential element of any taxation system which continues to rely on income as a taxation base." Why? Australia survived from 1915 to 1985 without one and does it matter if capital gains are not taxable if capital outlays are equally non-deductible?

6. Fightback, main document, § 2.2, pp 11-12

7. Mr Ken Dance, President of the Association of Superannuation Funds of Australia, has also flagged some of these and other problems. See Super with GST, *The Australian Accountant* February, 1992, pp 28-32


9. See Fightback, main document, Table 8.1, p 134


11. Fightback, main document, Table 10.1, p 155
12. Terence Dwyer Consumption Tax: Is it necessary? published at $13 (inc. postage) by Australian Catholic Social Welfare Commission, 22 Theodore Street, Curtin ACT 2605
Taxation reform is about longer term structural change affecting incentives and rewards. This paper considers the implications of introducing a broad based consumption tax to replace revenue now collected by some existing indirect taxes and a part of the revenue now collected by personal income taxation. The specific example of a multistage goods and services tax (GST) levied at a single rate on a broad base of final private consumption expenditure is analysed. Effects of changes in the composition of Australian taxation associated with the introduction of a GST are assessed in terms of the conventional public finance criteria of revenue collected, efficiency, equity and simplicity. Most focus is given to longer term effects with some comments on transitional adjustment effects.

Pressures and proposals for the introduction of a broad based consumption tax in Australia over recent years have come from several sources. The Atprey Committee (1975) proposed a value added tax and the Draft White Paper (1985) a retail sales tax in its Option C, however, neither of these proposals was adopted. The topic has been important in academic debate, see for example the conference volume by Head (1986), and some, including Mathews (1984) and Groenewegen (1984), have been strong advocates of introducing a broad based consumption tax. In recent years a number of business organisations have advocated the introduction of a New Zealand type GST and they have commissioned the analysis of specific proposals (see Victorian Employer's Federation, 1990, Freebairn and Chisholm, 1991, for Business Council, and Warren, 1990, for National Farmers Federation). As part of their Fightback proposals the Coalition Parties in November 1991 proposed the introduction of a 15% GST, replacement of the existing wholesale sales tax, petroleum product excise and payroll tax (to absorb about 80% of the revenue collected by the GST), and significant reductions in personal income taxation funded roughly half and half by the GST and net reductions in government expenditure.
Economic arguments for and against the introduction of a GST will be considered in three contexts: replacement of some existing indirect taxes, especially the WST; the relative merits of consumption base taxes and income base taxes in a general context; reduction of a part of the present hybrid income tax burden. Before this assessment, the paper provides a brief overview of current taxation in Australia and of proposals for an Australian GST.

**Australian Taxation**

A summary of the current pattern of taxation in Australia is shown in Table 1. About 80% of all revenue is collected by the Commonwealth and the rest by the State/Local sector. Income taxes collected by the Commonwealth account for 58% of all taxes, and income taxes on individuals for 45% of revenue (although much of the enterprise tax revenue is in the form of a withholding tax on dividends to be received by individuals). About 33% of all revenue comes in the form of a variety of indirect taxes levied by the Commonwealth and State governments.

The last half of the 1980s saw significant changes, generally for the better, to the Commonwealth income taxation system. As summarised by Head (1991), while the system for labour income is close to a comprehensive base, the taxation of capital income can be best described as a hybrid or mongrel system. As shown in more detail by Albon, Findlay and Jones (1983), Harper (1989), Frechbairn (1991) and others, different saving and investment options are subject to different tax bases, to measurement errors and to different tax rates. The tax base ranges from a consumption base (for owner occupied homes and a large part of household and business investment in human capital), to a real income tax base (for capital gains) to a nominal income tax base (for most business investment and financial savings). Inflation, even at rates as low as 5% per annum, significantly alters measured taxable income, and various forms of accelerated depreciation result in mismeasurement of income for taxation assessment. Tax rates vary between corporate and non-corporate firms, between domestic and overseas investments, and superannuation fund investment receives a relatively low fixed tax rate. As a result, the effective tax rate on different saving and investment options vary, and in some cases by tens of percentage points.

Australia’s system of indirect taxation is notable for the absence of a broad based consumption tax. A variety of Commonwealth and State indirect taxes are imposed. Each
of these taxes is characterised by narrow taxes bases, different tax rates, and a high incidence on business inputs. For example, the WST is levied on a narrow range of goods, of which motor vehicles represent 36% and household and office equipment and furniture another 24%, three rates of tax are levied, and over two-thirds of the initial incidences is on business inputs (see Draft White Paper, 1985, and Chisholm, Freebairn and Porter, 1990). Even the payroll tax falls on little over a half of employees, non-wage forms of remuneration are exempt, and marginal tax rates are variable (see Collins Report, 1988). Even where there is some market failure justification for different taxation levels on different goods and services (for example health and other externalities in the case of tobacco and alcohol, and for road construction and maintenance in the case of motor vehicles and petroleum products), there has been no formal assessment of the required tax rate and several studies find marked deficiencies with the present excise, franchise fees and motor vehicle taxes (see IAC, 1985, and Edwards, 1989). These types of arguments underlie criticisms of the Draft White Paper (1985), Head (1991), Coalition Parties (1991) and others of serious inefficiencies, inequities and complexity of the present system of indirect taxes.

Overall, serious deficiencies of the present taxation system, especially as they concern distortions to economic choices and a resulting inefficient mix of production and consumption, indicate that further taxation reform should be part of the wider agenda of microeconomic reform directed at raising national productivity. The introduction of a GST is just one of many potential reform options for reducing the distorting effects of the current system.¹

The GST Option

In reality there are a number of potential practical variants of the broad based consumption tax. I will focus on the multistage VAT or GST system characterised by a broad base of final consumption expenditure and a single tax rate.² But even here there are variants in terms of the precise tax base, the rate chosen, taxes to be replaced, and other policy changes.

The ideal tax base for a GST is private final consumption expenditure. In practice it is not feasible to tax imputed rent on owner occupied dwellings for the same reason this item is not included in the income tax base, equity suggests that other residential rent also should
be omitted, and so far it has not proved practicable to tax the value added component of most financial services because of fungibility of interest differentials and service charges; but these services can be input taxed, or technically treated as tax exempt items. This base is the New Zealand model. Other suggested items for exclusion, either as tax exempt or zero rated, are health and education services on the grounds that the present price gap between highly subsidised government supply and private provision would be increased even further, and sales by welfare, charitable and religious institutions. These items are zero rated in the Coalition Parties Fightback proposals. In another variant, Chisholm, Freebairn and Porter (1990) do not increase the overall indirect tax burden on the already heavily taxed tobacco, alcohol and petroleum products.

Some have argued for exclusion of the necessities of food and clothing for vertical redistribution reasons, and such exclusions are found in many of the European countries and Canada. While this proposition has some merit, it is a very blunt and inefficient redistributive mechanism relative to the policy instruments of increasing social security payments and adjusting the income tax schedule to be even more progressive (see, Stiglitz, 1988). Also, the more comprehensive base simplifies the GST and offers greater potential efficiency gains. For these reasons this paper includes food and clothing in the GST base.

A guide to the tax rates required to replace different existing indirect taxes with a GST is provided by the Coalition Parties Fightback proposals. For the chosen base a rate of 5.2% replaces the present wholesale sales tax, 3.7% to replace the Commonwealth petroleum products excise and 3.2% to replace the State payroll taxes. These indirect tax replacements require an aggregate rate of 12%, or 80% of the revenue to be collected by the proposed 15% GST. A more comprehensive base, à la New Zealand, would involve slightly lower rates; and similarly, narrower bases would require higher tax rates.

It turns out that using a GST to replace many of the existing indirect taxes in a revenue neutral way has negligible net redistributive effects, inflationary effects, and other effects requiring complementary policy changes.

Proposals to use a GST to change the tax mix away from income to consumption taxes which also minimize vertical redistribution and are approximately revenue neutral are constrained in several ways, especially in the initial period context of a static zero-sum game. The associated one-off price increase requires compensating payments for social
security recipients, and the consequent use of some of the revenue collected. Because a GST by definition collects revenue proportional to consumption and hence is regressive in terms of income, whereas the present personal income tax system is a progressive tax, an approximately vertical distribution neutral tax mix change requires that the new lower revenue collecting income tax be even more progressive. In practice this means an increase in the tax-free threshold and smaller cuts in marginal income tax rates at the upper thresholds than at the lower and middle thresholds.

To illustrate, with a broad base, a consumption tax rate of 6% to 8% generates enough GST revenue to fund about a 20% (or $10 billion) reduction in personal income taxation and maintenance of the real purchasing power of social security pensions and benefits. If the same income tax base is retained, changes in the income tax schedule of the order of increases in the tax-free threshold from $5400 to $7000 or $8000, and reductions in marginal tax rates at low and middle income levels of 5 to 6 percentage points and at high income levels of no more than 3 percentage points can be funded. Naturally the particular numbers are sensitive to the choice of the tax base and the extent of the tax mix change.

A minimum of 12 months, and more likely 18 months, from the time of policy announcement to implementation of a GST will be required to register businesses, to enable the ATO to respond, and to educate the nation about the new tax. Tax reform of this type is a form of longer term structural reform. It does not offer a quick fix and nor should it be considered as a key component of short term macroeconomic policy manipulation. This longer term focus provides a strong case for restricting the assessment to an approximately revenue neutral package of changes in the composition of Australian taxes.

Rationalising Indirect Taxes

This section considers the efficiency, distributional and simplicity effects of replacing some of the existing indirect taxes with an equal revenue yielding GST. Initial consideration is given to the GST for WST replacement.
1. Wholesale sales tax (WST)

The WST, introduced as a temporary revenue raising measure in 1930, has been criticised by Groenewegen (1983), Draft White Paper (1985), Chisholm, Freebairn and Porter (1990) and many others. A GST of between 5% and 6%, depending on the specific base chosen, will collect the $9.2 billion estimated to be collected by the WST in 1991-92.

Table 2 provides a comparison of the WST and GST options. Sections 1 and 2 describe the statutory impact of the taxes in terms of tax base and rates. The WST is levied on some goods only at the wholesale level, with clothing, food and all services being notable omissions. Only about 40% of these goods are actually purchased by consumers, the majority are used as business inputs. By contrast, the GST is applied to a broad base, but because of practical reasons not a fully comprehensive base, of consumer outlays on goods and services. The tax exempt treatment of housing and financial services results in some business input taxing, but less than 10% of the base. With the WST there are three statutory rates of 10%, 20% and 30%, compared to a single rate for the GST.

Of more interest than the statutory tax rates is the economic tax rates once markets have adjusted. In this paper I follow the conventional assumption that in the long run product taxes are fully passed forward to buyers. Implicitly this outcome requires perfectly elastic supply curves. Experience with New Zealand and Canada suggest that this long run price pass-forward outcome occurred also in the short run as a result of competitive forces and political jaw-boning.4 Because of the extensive business input taxing component of the WST, including of motor transport and of office equipment and furniture, almost every business input, final consumer item and export bears some WST, but at literally millions of different rates. By contrast, the GST results in negligible tax burdens on business inputs and exports, and close to a constant rate on domestic consumption purchases.

Table 3 provides a comparison of the effective tax rate on eleven broad categories of final consumption for the WST and a revenue neutral GST. The column for WST indicates the dominance of the burden on furnishings and appliances, transport equipment and to a lesser extent housing (which is a heavy user of transport and appliances), and also it indicates how the heavy reliance on input taxing flows through to food, clothing and other items. A finer level of disaggregation would indicate a more marked pattern of variable tax rates. By contrast, the GST generates a much more level playing field, with housing and
financial services (in miscellaneous) being relatively lightly taxed. The standard deviation of tax rates at this high level of product aggregation for the GST is a half of that for the WST.

In terms of tax neutrality and economic efficiency, a GST for WST swap offers gains at two levels. First, it removes tax distortions to the choice of methods of production. Whereas the GST has negligible effects on relative business input costs, the WST has significant distortions on relative input costs for reasons which have no market failure or other rational basis. For example, the WST falls heavily on road transport but not on air and rail transport. This adversely affects the choice of the form of transport and also location decisions. Distorting input taxes provide a set of incentives resulting in the economy operating within its production possibility set.

Second, the more level tax playing field of the GST on prices of final goods and services, both for domestic consumption and for export, results in less distortions to the mix of goods and services produced and consumed than occurs with the WST. There is no evidence that the WST pattern is supported by market failure arguments - and remember that the excise taxes and franchise fees on tobacco, alcohol and petroleum products remain - or that the relatively heavily WST items are more highly correlated with non-taxed leisure and home produced items. By removing many of the distortions to production and consumption decisions a GST for WST swap would enable Australia to achieve a higher level of well being.

Unfortunately there are no compelling available estimates of the magnitude of the efficiency gains of replacing the WST with a revenue neutral GST for Australia. Piggott (1983) simulates the use of a uniform consumption tax, such as a GST, to replace all Australian taxes using a computable general equilibrium model. Only a portion of the estimated efficiency gain equivalent to 3.9% of GDP can be attributed to the replacement of the WST. Dixon and Meagher (1990) and Meagher (1991) have used the ORANI model to estimate the effects of a GST for WST swap on macroeconomic variables and on industry outputs. While of much interest, these studies have limitations in assessing the efficiency gains; welfare gains are not measured, and changes in measured GDP are a poor indicator of such gains; and the short run setting in which changes in returns to investment and the associated aggregate investment response dominate the results is at variance with a long run full employment scenario. Even so, the changes in industry outputs, with 29 out
112 changing by more than 2% and for 5 by more than 5% indicates significant resource reallocations would follow.

In general terms, the efficiency gain of a less distorting tax system is the product of differences in effective tax rates on choice options, and typically the tax rate differential squared, and the quantitative response of activity levels to changes in tax incentives. We know that the tax rate differentials are of the order of 10% to 30% in the case of business inputs and much smaller, probably less than 5% in the majority of cases, for final goods and services, and that industry outputs will alter with replacement of the WST with a GST. Together, these numbers suggest considerable efficiency gains, with the larger gains coming from reduction of distortions to the choice of business inputs.

Assessment of the redistributitional effects of a GST for WST swap can be made in two steps. For the 81% of the WST which ultimately is passed on to domestic consumers the assessment is straightforward. For the 10% passed on to exporters and their customers the assessment requires consideration of further second round adjustments. In the longer run, a GST for WST swap by reducing business input taxing will increase the profitability of export and import substitution production. Other things equal, perhaps a strong assumption, the increase in net exports will initiate a currency appreciation and fall in the real price of domestic goods and services. In the case of the 9% of the WST estimated to be passed on to government, but which will not happen with the GST, again second round reactions (with lower taxation, increased outlays or a smaller deficit) will benefit domestic consumers. To simplify the assessment the next few paragraphs restrict the redistributitional assessment to that part of the WST now passed on to consumers and a revenue neutral GST.

In terms of a broad measure of vertical equity using income deciles, a GST for WST swap is approximately distributionally neutral. Table 4 shows estimates of the relative burdens in terms of income and expenditure. Both are regressive in terms of income and proportional in terms of expenditure. The latter result is almost true as a consequence of a broad based consumption tax for the GST, and in the case of the WST the result is simply a coincidence. In the swap, what low income earners lose in higher prices for the ‘necessities’ of food and clothing, they gain in lower prices for the ‘necessities’ of housing and transport, and the GST levies higher tax burdens on services which are relatively more important components of expenditure of the higher income.
From the perspective of horizontal equity, the GST is superior to the WST. Households with the same aggregate expenditure, but with different mixes of goods and services purchased, pay the same indirect tax burden with a GST. By contrast, with the WST the aggregate tax burden is altered by the composition of expenditure.

A number of opposing considerations have a bearing on the relative simplicity properties and on the relative costs to taxpayer and tax collector of the WST and GST options. The WST already is in place and involves less taxpayers - about 70,000 relative to estimates of 700,000 to one million. However, other businesses as buyers of goods are involved in assessing their status with reference to the WST. The vast majority of new businesses to become involved in the GST already are registered income taxpayers, or they should be, and income tax records provide the information necessary to compute GST returns.

The WST is a more complex and litigation-ridden tax system with many key uncertainties (see, for example, Williams and Guthleben, 1990, for a damning indictment). By contrast, the simplicity of the GST with its broad base and a single rate is a clear advantage.

These is only sparse data of questionable relevance on the comparative costs of the two indirect taxes. The ATO reports administrative costs for the WST of 0.46% of revenue collected. This is below the 1% reported by Sandford, Godwin and Hardwick (1989) for the UK's VAT, but that system involves multiple rates and a narrower base than the proposed GST. Administration costs of the New Zealand GST, which is closer to the Australian proposal, are below 1%. Sandford, Godwin and Hardwick estimate net compliance costs for the UK VAT at about 1% of revenue collected. Available cost estimate numbers are small, and differences between the WST and GST will be smaller again. Such small cost differences suggest that differences in administration and compliance costs are not an important area of distinction.

Overall, the GST for WST swap promises gains in economic efficiency, some gain in horizontal equity, and very small changes if any in vertical equity and in costs of administration and compliance.
2. *Other indirect taxes*

Of the other indirect taxes in Table 1, there have been proposals to use a GST to replace payroll tax (Coalition Parties and Australian Chamber of Manufacturers), part or all of the petroleum products excise (Coalition Parties and National Farmers Federation) and import tariffs (National Farmers Federation). Of the other indirect taxes, the excise tax on crude oil and LPG is really a resource rent tax, excise on alcohol and tobacco is a de facto tax on the externalities of these products, albeit a contentious and debateable one, and special taxes on gambling often receive a similar externality argument, and so far it has not proved practicable to use a GST to replace existing indirect taxes on financial services, although these taxes have been criticised.

In the context of a long run full employment equilibrium, the economic effects of a broad based payroll tax and a broad based consumption tax are identical (Samuelson, 1961, Bascand, 1989). In effect, payroll tax does not tax capital income in the same way that a consumption tax does not tax income earned on savings and investment. The fact that existing Australian payroll taxes have narrow bases - with little more than a half of employees taxable due to small firm and other exemptions, and with non-wage and salary components of labour remuneration exempt - and the multiple marginal rates, there is a potential efficiency case for either reforming them or replacing them with a more neutral GST.

Another set of arguments in a GST for payroll tax swap might be mounted in the context of the short run starting from a disequilibrium level of high unemployment. If too high real labour costs are part of the cause of unemployment, then, dollar for dollar, a reduction in payroll tax initially will stimulate employment more than would a reduction in consumption taxation which falls on the capital input as well as the labour input. Given the lag of 18 months in introducing a GST, inherent failures in economic forecasting this far ahead, the longer term nature of tax reform, and the rather indirect way of addressing a labour market disequilibrium problem, the proposal to substitute a GST for payroll tax to stimulate employment becomes a dubious proposition.

Consider next using a GST to replace some or all of the revenue collected by the current excise tax on petroleum products. While initially levied as a means of funding road construction and maintenance, subsequent increases in the excise rate mean that the

37
petroleum products excise is largely a form of general revenue raising. The excise, plus state franchise fees on petroleum products and motor vehicle taxes, collect much more revenue than annual government expenditure on roads - perhaps in excess of $3 billion a year. In addition, as noted by the IAC (1986), fuel usage is poorly correlated with road usage. Again, fuel use is not highly correlated with congestion. While concerns about green house gas emissions may indicate economic reasons for taxing fossil fuels, to tax petroleum products for this purpose but not coal and gas fired electricity risks failure of the second best. Then, while the precise fraction is debateable, perhaps more than a half of the present petroleum products excise cannot be justified on the grounds of market failure.

That part of petroleum products excise collected as a general form of revenue raising incurs efficiency costs, and these costs could be reduced by substituting a broad based consumption tax. About 55% of the excise falls on intermediate business inputs and distorts the choice of production methods towards less petroleum product intensive techniques than is socially desirable. In addition, the mix of products produced and consumed is distorted away from those which directly and indirectly are relatively intensive users of petroleum products. A GST for petroleum products excise swap would generate national welfare gains in the same ways as argued earlier for the GST for WST swap. Analysis of such a swap by the IAC (1986, Chapter 6 and especially Table 9.3) indicate resource reallocations between industries and hence efficiency gains.

Estimates of the vertical distributional implications of various taxes for households classified by income decile by Warren (1991) indicate similar patterns for the WST, payroll tax and petroleum products excise. Then, extrapolating these results with those of Chisholm, Freebairn and Porter (1990) for similarity of the incidence of the GST and WST suggest that revenue neutral GST for payroll tax and GST for petroleum products excise swaps will have negligible redistributive effects at the broad vertical equity context.

Since a GST already would be in place for the GST for WST swap, extending the rationalisation of indirect taxes would reduce costs now incurred with the payroll and petroleum products excise tax and negligible extra costs would come with a higher GST rate.

Overall, using a GST to fund replacement of the present payroll tax system and reduction of the general revenue raising portion of petroleum products excise will lead to efficiency
gains, some saving of administration and compliance costs, and minor changes to distribution of the tax burden.

Tax Mix Change

This section considers efficiency, distributional and transitional macroeconomic effects of using some of the funds collected by a GST to reduce personal income taxation in a way which approximately is revenue neutral and which minimises vertical redistribution from the status quo. Much of the assessment can be derived from the economic and national income accounts income and expenditure identity

\[ Y = C + S = C + I \]

where \( Y \) is income, \( C \) is consumption, \( S \) is saving and \( I \) is investment. A tax mix change envisages lower taxation of \( Y \), and hence of \( C + S \) and of \( C + I \), and heavier taxation of \( C \). In effect, the proposal envisages a net increase in taxation of consumption, \( C \), and a net decrease in the taxation of saving and investment, \( S \) and \( I \), or of capital income. Of course, when savings and the income earned is spent in the future that part of income becomes subject to a deferred form of taxation.

The introduction of a GST as part of a tax mix change proposal results in only a reduction of the tax rate on saving and investment and not its elimination. For example, in Chisholm, Freebairn and Porter (1990), the marginal tax rate on saving and investment is reduced by 3 percentage points for high income earners and by 5 percentage points for middle income earners; and in the Coalition Parties (1991) proposal the reductions are 5 and 8 percentage points, respectively, for high income and middle income taxpayers.

It is convenient to consider the economic arguments pro and con a tax mix change in two contexts: first, at the more abstract level of the relative merits of a comprehensive consumption base versus a comprehensive income base, and then in the context of Australia's present hybrid income tax system.

1. Comparison of tax bases

There is an extensive and in general inconclusive literature on the relative efficiency and horizontal equity implications of a comprehensive income base versus a comprehensive
consumption base. These arguments provide a perspective on the direction of effects of changing the tax mix towards greater emphasis on a consumption base.

The principal conceptual appeal of the consumption base is the avoidance of double taxation of saving which occurs with an income base. Using a simple life cycle optimisation model with two periods, certainty, perfect capital markets and no labour supply response, the consumption base unambiguously dominates the income base in terms of minimising distortions to intertemporal consumption and saving decisions and in achieving horizontal equity for households with different consumption preference patterns. The magnitude of the gains and of the savings response are subjects of a wide range of controversial estimates.

However, the strong result of the superiority of the consumption base derived for the simple theoretical model are not robust in the face of more complex and potentially more realistic extensions of the model. For example, introducing labour-leisure choices and complementarities of leisure with consumption, imperfect capital markets, bequests, multiple time periods with some complementarities in intertemporal consumption, and so forth can result in superiority of the income tax base over the consumption tax base. Again, transitional adjustment problems and costs can favour maintenance of the status quo. Ultimately, estimates of key substitution elasticities and other parameters are required to resolve the various conflicting effects. Unfortunately, consensus estimates of the key parameters are not yet available and may not be available for the foreseeable future.

It, therefore, is difficult to conclude with confidence one way or the other on the general merits of changing the tax mix towards greater reliance on consumption taxation. However, because Australia's income tax system is not a pure income base, but rather a hybrid base system, these conceptual arguments tell only a part of the story.

2. Reducing reliance on Australia's hybrid income tax system

Assessment of the effects of introducing a GST as part of a tax mix change on the level and composition of saving and investment must be cognizant of the present hybrid tax treatment of different options. The lower marginal income tax rate will have no effect on much saving and investment in housing which already receives a consumption tax treatment and similarly in the case of much investment in human capital, and on other business investment outlays.
such as R & D and repairs which are immediately expensed as occurs with a consumption tax. None of the proposals to date have suggested lowering the 15% tax rate on income earned by superannuation fund investments. Household saving in financial instruments and most business investments in plant, equipment, buildings and inventories, all of which are subject to a nominal income tax base, will face lower income tax burdens under a tax mix change.

The net effect of proposed packages involving a tax mix change on the aggregate level of private saving is likely to be small; the assumption of a revenue neutral package means no change in net public saving. First, the income tax rate reduction is relatively small. Second, because of the hybrid income tax system, the reduction will apply to less than a third of household saving given the dominance of saving via owner occupied homes and superannuation. For those households whose saving behaviour follows the life cycle model and who are not liquidity restrained, the lower tax rate on the income earned on part of their savings portfolio will lead to additional savings because the substitution effect dominates any income effect (which must be negligible because of approximate revenue and distributional neutrality of the package). Also, such households will gain additional utility from a reduction in distortions to intertemporal choices. Third, many households who find themselves liquidity constrained or on corner point solutions, and those whose saving is dominated by habit, rather than intertemporal optimisation motives will not respond to changes in the tax system.

On the other hand, a tax mix change is likely to have important effects on the composition of saving and investment and its productivity. The pattern of very different effective tax rates on different saving and investment options will be reduced significantly (see, for example, Freebairn, 1991). Further, there seems no strong market failure or other logical argument for the present distorting pattern of effective tax rates. Because the efficiency costs of distorting taxes are proportional to the square of differences in tax rates on different investment options, even small reductions from the present highly distorted pattern yield large benefits. Crude indicative estimates by Freebairn (1991) suggest efficiency gains equivalent to several percentage points of capital income.

Claimed benefits for a tax mix change on lower distortions to work versus leisure and non-market production activities almost certainly are illusory. What a worker gains in lower income tax approximately is lost in extra consumption tax because of the distributional
neutral constraint. That is, an hour of work will command about the same basket of market goods and services before and after a tax mix change. Reliance on a money illusion argument that workers understand and see income taxes (most taken out as PAYE by their employers) but not GST taxes (which also are taken out by sellers) as argued by Morgan (1990) seems unrealistic, especially in a long run context.

The potential effect of a tax mix change in combating tax avoidance and evasion, and of yielding a fiscal dividend, of the magnitude claimed in the Draft White Paper (1985) and the Coalition Parties (1991) seems exaggerated, especially with reference to the black economy. The incentives and procedures used to avoid and evade income tax are similar to those for the GST since the ATO, common taxpayers and common records are involved. For example, just as most drug dealing and backyard repairs escape income tax, so will they escape the GST. Certainly when black economy income is spent on the white economy the expenditure will attract a low GST not now paid, and in this sense black economy members will make a greater contribution to public revenue, and hence there will be some gain in general equity. However, from the perspective of aggregate revenue collected, the extra GST revenue will closely correspond to a fall in income tax revenue paid by white economy suppliers of goods and services to the black economy buyers. Tax evasion and avoidance should be attacked not by changes in the tax mix but by improved design and administration of the different taxes.

A tax mix change will generate a one-off increase in general indexes of consumer prices. This one-off increase may or may not generate subsequent inflation. Opponents of a tax mix change, such as Dwyer (1991), are concerned with the inflation risk, and this line of reasoning was an important one in the government’s decision in 1985 not to proceed with Option C.

The optimistic no-inflation outcome is associated with the following behaviour. Forces of competition, political jaw-boning, and media and public outrage ensure that businesses do not increase initial prices by more than the net increase in indirect taxes. Because of the tax rebate provisions for GST paid on business inputs, the effective cost of business purchases of materials, services, equipment, etc. would not rise. If workers are given a distributionally neutral package such that increased costs of buying goods and services with the GST are offset by increased disposable income financed by lower income tax rates, then the tax mix change provides no reason for an extra increase in pre-tax wage rates. Then,
with no net increase in business costs or wages, the initial consumer price increase can be contained to be a one-off in increase with no effect on the underlying inflation rate. This is roughly the story which happened in New Zealand in 1986 as analysed by Stephens (1989).

Clearly achievement of a no inflation increase outcome is a difficult task. It places constraints on the tax mix design, it requires an extensive education program, it places a premium on competitive markets and in the effectiveness of politically imposed restraints on non-competitive markets, and it requires responsible behaviour by business and labour. Failure, and the associated wage/price/inflation spiral, would bring significant social costs.

Specification of a distributionally neutral package of changes in consumption taxes, income taxes, special rebates and social security rates is important if potential efficiency gains are to become sustained benefits. Because a tax mix change causes a change in the time profile of taxes paid and collected, with those on savings being deferred, the base for compensation (disposable income, consumption, wealth) and the period of assessment (current year, future years) require careful delineation.

Compensation for the net increase in indirect taxes was assessed with reference to disposable income in the Draft White Pater (1985), to consumption expenditure in Victorian Employers' Federation (1990), Chisholm, Freebairn and Porter (1990) and Freebairn and Chisholm (1991), and to disposable income and financial wealth for the elderly in Coalition Parties (1991). Because disposable income exceeds consumption by savings, the income option requires a short term budgetary deficit, but this is recaptured in the future such that the present value fiscal outcome remains in balance (Benge and Albon, 1991). By contrast, the consumption base for compensation is consistent with short-period as well as longer run fiscal neutrality. The Draft White Paper financed the extra compensation with income base broadening measures and a fiscal dividend, and the Coalition Parties used expenditure reductions and some fiscal dividend from taxation of the black economy.

Inevitably compensation can be approximate only, and then across broad categories, with a tax mix change.11 Taxpayers and families with relatively high consumption to income ratios will be losers and those with relatively high saving ratios will be winners. To the extent that units can be categorised by income level and demographic type with systematic
differences in savings ratios, rough justice can be done. This philosophy has been behind the strategy of giving relatively larger compensation for those at lower income levels, for families, and for those in retirement. Even so, in any one year there will be wide dispersion of saving ratios and of over-and-under-compensation for individual households within each category average. Because saving ratios tend to be less variable when averaged over a number of years as good and bad years balance and as people move through career and life cycles, any tax mix redistribution will be much less when viewed over several years than when evaluated over the more traditional first year snapshot picture. Finally, there is only poor data for Australia on savings ratios at the individual or household level. Thus, inevitably a tax mix change will involve some redistribution, although this can be minimised for broad categories of households, and limitations with available data caution interpretation of estimates reported.

One of the concerns of a tax mix discussed around the time of the 1985 National Tax Summit was the likelihood of a short term sharp drop in economic activity during the transition period. Formal rationalisation of this type of outcome by Argy and Hooke (1986) and Neville (1986) argued for a sharp increase in savings and a reduction in aggregate demand. As discussed above, the net savings response nowadays is considered to be small. In addition, these models did not allow for positive responses of investment and net exports to an increase in domestic saving. Early reaction to the Fightback proposal by the Coalition Parties, of which a tax mix change is just one component, indicate that the package will have a positive influence on animal spirits which drive aggregate demand.

As an overall assessment, using revenue from a GST to fund reductions in Australia’s present hybrid income tax system seem likely to offer most benefits in terms of a more productive mix of saving and investment. Contributions to the aggregate level of savings, to greater work effort, and to combating tax evasion and avoidance are doubtful and in any event they are likely to be small at best. Some redistribution, especially in the short run, seems inevitable, although it can be minimised. While the risks of a tax mix change initiating a burst of inflation cannot be completely discounted, in logic inflation can be avoided as has happened with other countries.
Some Concluding Observations

The introduction of a broad based consumption tax to replace some of Australia's existing distorting indirect taxes offers considerable national productivity gains with few and small downside risks. The case is clear cut with reference to the WST. In the case of existing payroll taxes, a GST swap is a comparable option to broadening the base of the existing tax to cover all employees, the labour income component of the self employed and all forms of labour remuneration. National efficiency gains would be achieved by using a GST to replace the general revenue raising component of excise taxes and franchise fees on petroleum products and motor vehicle taxes. There is legitimate argument about the extent of general revenue raising and about the appropriate user pay system for road construction and maintenance, pollution and congestion. While existing taxes on financial services have serious economic deficiencies, the GST is not at present a practicable substitute option.

The case to further increase the GST rate to fund reductions in income taxation as part of a tax mix change package is more debateable. Given the hybrid treatment of different saving and investment options, lower income tax rates will lead to a more productive mix of saving and investment. Such efficiency gains, and potentially larger gains, could be achieved by comprehensive reform of the income tax system. Something that Head (1991) and others question as a feasible option, or by a direct expenditure tax, which, despite its conceptual appeal and strong professional support, has not been implemented in full form in any country to date. The relative merits of these three options is more a case of political will and feasibility than of economic assessment. A tax mix change offers little in the way of efficiency gains in work versus leisure decisions and in intertemporal consumption choice decisions, to the aggregate level of savings and work effort and to countering tax evasion and avoidance.

Potential downside risks of a tax mix change include a stimulus to inflation and undesired redistribution of the tax burden. Careful design of the package and community education can drive these risks very close to zero.
ENDNOTES

1. A number of other reform options that should be considered include: a comprehensive nominal income system, a comprehensive real income system; a direct expenditure system, as well as reforms to various income tax and indirect tax components.

2. There is a growing consensus from both logic and practical experience of the superiority of the multistage system over the single stage retail sales tax; see, for example, Crouzen (1987 and 1989).

3. Chisholm, Freebairn and Porter (1990) estimated a 6.8% GST rate to replace the EST. This reflects their larger estimate of WST revenue of $11.6 billion versus $9.4 billion, and they excluded the excise products from their tax base.

4. These constraints are of course arbitrary and they are open to different interpretations. Retention of the present distribution pattern assumes that the current distribution pattern is acceptable and represents the tyranny of the status quo. In measuring overall price effects different numbers appear to be generated for such measures as the CPI and the implicit consumption deflator (see Draft White Paper, 1985, and Freebairn and Chisholm, 1991, for more discussions). The base for compensation is open to debate; disposable income (consumption plus saving) or consumption, and to compensate wealth or not. Different answers will be given if the perspective is just the initial period effect, or if a number of years or even a lifetime perspective is taken. Where a longer period view is taken likely behavioural responses and the prospect of a positive sum game enter the calculations.

5. This particular example is drawn from more detailed assessments by Chisholm, Freebairn and Porter, 1990, and Freebairn and Chisholm, 1991. The Fightback proposal involves a net revenue shortfall, funded by savings in public expenditure, and a smaller contribution of GST revenue.

6. See, for example, Stephens (1989).

7. From the optimal tax literature there is an in principle argument that so long as leisure and home produced goods are not taxed, economic efficiency can be enhanced by placing relatively high taxes on market products complementary to these non-taxed items. The information requirements of an optimal tax system are onerous and beyond current availability. In the spirit of Ng’s (1977) theory of the third best, seeking a level playing field for market items has a high probability of giving the most efficient outcome.

8. For a comprehensive review see the survey by Sandmo (1985) and references therein, and Rose (1990). Other discussions can be found in Head (1991) and Benge and Albon (1991).


10. I have in mind the Harberger (1964) model which is applied in Freebairn (1991).

12. These propositions are well documented with US data, see, for example, Davies, St Hilaire and Whalley (1984). Only anecdotal supporting evidence is available for Australia.

13. Savings ratios can be drawn from the ABS Household Expenditure Survey. Because errors in measurement of both income and expenditure compound is the savings ratio, ABS warns against use of the data for this purpose. The Draft White Paper (1985) attempts to adjust and reconcile the HES data and aggregate National Income Accounts data, and EPAC (1988) also has undertaken some manipulations. These secondary data sources are likely to be more useful than the raw data.
### Table 1
Level and Composition of Taxes Collected by Australian Governments, 1989-90

<table>
<thead>
<tr>
<th>Tax Category</th>
<th>Commonwealth</th>
<th>State/Local</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income taxes:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individuals</td>
<td>50019</td>
<td></td>
<td>50019</td>
</tr>
<tr>
<td>Enterprises</td>
<td>14512</td>
<td></td>
<td>14512</td>
</tr>
<tr>
<td>Non-residents</td>
<td>915</td>
<td></td>
<td>915</td>
</tr>
<tr>
<td></td>
<td><strong>65446</strong></td>
<td><strong>55654</strong></td>
<td><strong>65654</strong></td>
</tr>
<tr>
<td><strong>Indirect taxes:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxes on goods and services</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• wholesale sales tax</td>
<td><strong>10132</strong></td>
<td></td>
<td><strong>10132</strong></td>
</tr>
<tr>
<td>• excise</td>
<td><strong>1232</strong></td>
<td></td>
<td><strong>1232</strong></td>
</tr>
<tr>
<td>• crude oil and LPG</td>
<td><strong>5623</strong></td>
<td></td>
<td><strong>5623</strong></td>
</tr>
<tr>
<td>• petroleum products</td>
<td><strong>2239</strong></td>
<td></td>
<td><strong>2239</strong></td>
</tr>
<tr>
<td>• other</td>
<td><strong>2395</strong></td>
<td></td>
<td><strong>2395</strong></td>
</tr>
<tr>
<td>• franchise fees</td>
<td><strong>21</strong></td>
<td><strong>2390</strong></td>
<td><strong>2411</strong></td>
</tr>
<tr>
<td>• motor vehicles</td>
<td><strong>387</strong></td>
<td><strong>4234</strong></td>
<td><strong>4621</strong></td>
</tr>
<tr>
<td>• financial taxes</td>
<td><strong>1755</strong></td>
<td></td>
<td><strong>1755</strong></td>
</tr>
<tr>
<td>• gambling</td>
<td><strong>929</strong></td>
<td></td>
<td><strong>929</strong></td>
</tr>
<tr>
<td>• insurance</td>
<td><strong>3977</strong></td>
<td><strong>5200</strong></td>
<td><strong>5200</strong></td>
</tr>
<tr>
<td>• taxes on imports and exports</td>
<td><strong>3977</strong></td>
<td><strong>5200</strong></td>
<td><strong>5200</strong></td>
</tr>
<tr>
<td>Payroll tax</td>
<td><strong>21477</strong></td>
<td><strong>13120</strong></td>
<td><strong>34597</strong></td>
</tr>
<tr>
<td>Property Taxes:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Taxes</td>
<td><strong>89823</strong></td>
<td><strong>22609</strong></td>
<td><strong>112432</strong></td>
</tr>
</tbody>
</table>

### Table 2
Comparison of WST and GST

<table>
<thead>
<tr>
<th></th>
<th>WST</th>
<th>GST</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. TAX BASE</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Narrow:</td>
<td>some wholesale goods</td>
<td>Broad:</td>
</tr>
<tr>
<td></td>
<td>60% on business inputs</td>
<td>final consumption</td>
</tr>
<tr>
<td></td>
<td></td>
<td>of goods and services</td>
</tr>
<tr>
<td><strong>2. STATUTORY TAX RATES</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Multiple:</td>
<td>10%, 20%, 30%</td>
<td>Single:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>between 5% and 6%</td>
</tr>
<tr>
<td><strong>3. ECONOMIC TAX RATES</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Business inputs:</td>
<td>many</td>
<td>Business inputs:</td>
</tr>
<tr>
<td>Consumer goods:</td>
<td>millions</td>
<td>Consumer goods:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>most at statutory rate</td>
</tr>
<tr>
<td>Exports:</td>
<td>many</td>
<td>Exports:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>mostly zero</td>
</tr>
<tr>
<td><strong>4. TAX NEUTRALITY</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Distortions:</td>
<td>methods of production</td>
<td>Many fewer distortions</td>
</tr>
<tr>
<td></td>
<td>mix of goods and services</td>
<td></td>
</tr>
<tr>
<td></td>
<td>produced and consumed</td>
<td></td>
</tr>
<tr>
<td><strong>5. TAX EQUITY</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vertical:</td>
<td>proportional to</td>
<td>Vertical:</td>
</tr>
<tr>
<td></td>
<td>consumption</td>
<td>proportional to</td>
</tr>
<tr>
<td>Horizontal:</td>
<td>inequitable</td>
<td>consumption</td>
</tr>
<tr>
<td></td>
<td></td>
<td>equitable</td>
</tr>
<tr>
<td><strong>6. SIMPLICITY</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Complex</td>
<td></td>
<td>Simple</td>
</tr>
<tr>
<td>Litigation</td>
<td></td>
<td>More taxpayers</td>
</tr>
</tbody>
</table>
Table 3
Comparison of Effective Tax Rates Levied on Final Consumption
by Revenue Equal WST and GST for Eleven Broad Categories of Expenditure, 1990-91

<table>
<thead>
<tr>
<th>Household Expenditure Survey Commodity Category</th>
<th>Effective Tax Rate on Final Consumption Purchases (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>WST</td>
</tr>
<tr>
<td>Housing</td>
<td>6.1</td>
</tr>
<tr>
<td>Fuel</td>
<td>3.9</td>
</tr>
<tr>
<td>Food</td>
<td>2.7</td>
</tr>
<tr>
<td>Clothing</td>
<td>1.6</td>
</tr>
<tr>
<td>Furnishings and appliances</td>
<td>8.7</td>
</tr>
<tr>
<td>Household services</td>
<td>4.7</td>
</tr>
<tr>
<td>Medical</td>
<td>1.2</td>
</tr>
<tr>
<td>Transport</td>
<td>7.6</td>
</tr>
<tr>
<td>Recreation</td>
<td>4.9</td>
</tr>
<tr>
<td>Personal care</td>
<td>4.9</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>4.3</td>
</tr>
<tr>
<td>All categories</td>
<td>5.0</td>
</tr>
<tr>
<td>Standard deviation</td>
<td>2.2</td>
</tr>
</tbody>
</table>

Source: from Chisholm, Freebairn and Porter (1990, Table 5). Computed using data from 1983-84 Household Expenditure Survey and 1982-83 Input-Output Tables assuming both WST and GST are fully passed forward. The WST refers only to that component (about 90%) passed on to domestic consumers, and the GST rate is chosen to be revenue neutral.
Table 4
Comparative Incidence of the WST and GST on Families Classified by Private Income Decile, 1990-91

<table>
<thead>
<tr>
<th>Income Decile</th>
<th>Indirect Tax/Gross Income</th>
<th>Indirect Tax/Expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>WST %</td>
<td>GST %</td>
</tr>
<tr>
<td>1 (lowest)</td>
<td>7.8</td>
<td>7.6</td>
</tr>
<tr>
<td>2</td>
<td>6.3</td>
<td>6.5</td>
</tr>
<tr>
<td>3</td>
<td>6.7</td>
<td>6.4</td>
</tr>
<tr>
<td>4</td>
<td>5.2</td>
<td>5.0</td>
</tr>
<tr>
<td>5</td>
<td>4.5</td>
<td>4.3</td>
</tr>
<tr>
<td>6</td>
<td>4.0</td>
<td>4.0</td>
</tr>
<tr>
<td>7</td>
<td>3.7</td>
<td>3.7</td>
</tr>
<tr>
<td>8</td>
<td>3.5</td>
<td>3.5</td>
</tr>
<tr>
<td>9</td>
<td>3.1</td>
<td>3.2</td>
</tr>
<tr>
<td>10 (highest)</td>
<td>2.4</td>
<td>2.5</td>
</tr>
</tbody>
</table>

*Source:* From Chisholm, Freebairn and Porter (1990, Table 6).
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