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The Changing Redistributional Role of Taxation in Australia Since Federation

by

Julie Patricia Smith

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of

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Declaration

The work presented in this thesis is original, and was undertaken by myself with the partial exception of Chapter 9. That chapter was co-authored with Mark D Dunstone, who contributed ideas and provided substantial comments on drafts, and drafted several paragraphs in the original paper.

Acknowledgments

Rather than initiating my career, this thesis has become more a chapter of it. That it has been completed owes something to the contribution of others, whom I would like to acknowledge.

I am particularly indebted to Professor Frank Castles for his commitment, his patient and incisive scrutiny of drafts, his interest in the subject, and his stern warnings against 'chasing hares'. The willingness of Professor Glenn Withers to become my supervisor maintained motivation at a critical stage, and his conscientious, timely and thoughtful review of drafts, especially Chapters 1, 2 and 14, has also been critical to the thesis completion: I am very grateful. I am deeply appreciative of the support and encouragement offered by the late Professor Max Neutze, and the late Professor Russell Mathews. Both provided comments on various chapters of this thesis and I feel immensely privileged to have benefited from their interest, their patience, their intellect, and their scholarship.

Professor Bob Gregory's role as timekeeper and taskmaster and his suggestions for its structure contributed to this thesis being completed, and I thank him.

Several individuals reviewed individual Chapters at different stages. For Chapter 3, I gratefully acknowledge the contribution of two anonymous referees for the *Australian Economic Review*, as well as Dr John Maindonald, Professor Peter Groenewegen, and (the late) Professor Russell Mathews. Early drafts of Chapter 5 benefitted from comments by Professor Colin Forster, Dr Michael Keating and Professor Marian Sawer, and Professors Peter Groenewegen, Glenn Withers, Max Neutze and John Nevile provided helpful suggestions for Chapter 6. Professor Peter Howell meticulously scrutinised the published version of Chapter 7, Jim Hancock's comments improved it, and Jacqui Rees' comments drastically shortened it to a length suitable for this thesis. For Chapter 8, the author is grateful for many useful suggestions and comments on various drafts from Professors Steve Dowrick, Max Neutze and John Quiggin, from Fred Argy and Ian McAuley, and from members of the Parliamentary Research Service. Chapter 10 was based on earlier research funded by the Australian Tax Research Foundation: two anonymous referees for the *Australian Economic Review*, and its joint editor Professor David Johnson, made helpful comments. I also appreciate the contribution of anonymous referees at the *Urban Policy and Research* journal regarding the published version of Chapter 9, and similarly at the *Economic and Labour Relations Review* regarding Chapter 11. The historical data series used in Chapter 11 was originally compiled in collaboration with Dr James Butler and funded by the Australian Tax Research Foundation; I am grateful to Ian McAuley for helpful discussion and comments on drafts and data sources. Chapters 12 and 13 arose from opportunities provided by the International Land Values Research Group, and the Australian Council of Social Services respectively.

Professors Julian Disney, Frank Stilwell, Hugh Stretton and the late Professor Peter Self taught me new ways of viewing public policy, and Professor Cliff Walsh introduced me to the importance of fiscal federalism.

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I appreciate the efforts of all these 'significant others', although of course remaining inadequacies are attributable to me.

Over several years that this thesis has intruded on our family life, I have benefited from the tolerance of my children, Cathy, Gareth and Roan. I acknowledge in particular the significance of the encouragement and practical, intellectual and moral support I received from Mark Dunstone, my life–partner and dearest friend.

To conclude these genuflections to the significant: I have been deeply inspired by and am thankful for the wisdom and humanity of an Australian historian and an Australian economist, both long dead. Historian W.K. Hancock wrote about the virtues of 'attachment, justice and span' for a historian, and as a active Canberra citizen was a model of his words: 'I am at war with bias, but equally am I at war with people who refuse to take sides when honest men stand up to be counted.'* Likewise, economist W. Scott told his professional colleagues in 1891 that 'we want knowledge of economic truth because knowledge is power; and all who care whether they are or their neighbours are richer or poorer, overworked or unemployed, are by that very fact interested in the study and progress of political economy.'* In a scientific manner, Scott argued against the 'economic truth' presented by colleagues that women were not educable for a career other than as mother and wife.

I aspire to have done justice to both the historical and the scientific method demonstrated by these scholars. Whether or not I have succeeded, I accept Professor W.K Hancock's advice to Phd candidates which, paraphrased, is that 'while a scholar's inquiries are never finished, the thesis must be'.

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* Hancock 1976, p. .3.

* Scott 1895, p. 95.

Abstract

Despite the distinctiveness of Australia's tax transfer system and its 'wage earners' welfare state' approach to social protection, it is unclear what redistributional role taxation has played and why it evolved the way it did. Understanding how governments managed redistribution in a federal system can provide historical insights of value for current policymaking. This thesis investigates how the redistributional role of taxation has changed in Australia since Federation, how it was affected by economic change and fluctuations, and how it was influenced by Australia's institutions of social protection and federal finance.

Key findings are:

- The redistributional role of Australia's tax system over the past century was shaped by economic integration and structural change, and by economic shocks. War was the occasion not the cause of change.
- Australia's federal financial arrangements became increasing incongruent with economic and social integration during the interwar years. Income tax centralization and horizontal equalization were both responses to this problem.
- State Governments initiated mass income taxation to fund social security during the Depression: the Commonwealth followed precedent after 1942.
- Australia's economic structure encouraged a system of financing social protection through taxation, its urban industries and primary producers finding common cause with unions and welfare reformers who opposed contributory social insurance. Australia's income tax approach to funding social security was probably more progressive.
- The trend to mass income taxation since the Depression made income tax less progressive in structure. Its progressive effect is now mainly through the level of revenue it raises for redistributive public spending programs.
- Earmarking taxes for social security programs is now uncommon, but was a key political strategy supporting heavy income taxation. This may partly account for Australia's relatively low tax/expenditure ranking among OECD countries.
- Unbalanced federal finance arrangements created tendencies — predicted before Federation — for 'extravagent' Commonwealth expenditures and 'demoralised' States. Restraining States' public capital formation and encouraging 'reckless remission' of Commonwealth income taxation and public consumption spending, such arrangements inflated the economic cost of reducing inequality.
- Changing economic and demographic structures and vested industry interests also explain recent increases in Commonwealth tax subsidies such as for private health insurance, superannuation, infrastructure financing and capital gains.
- 'Fiscal benefit confusion' due to federal finance arrangements helps explain why Australia's post-war taxation and public spending levels are comparatively meager. Tax resistance is also explained by the wage earners' welfare state's residual social security system — wage earners' see their taxes as paying for 'benefits' to others without market incomes, rather than as earmarked contributions enhancing their own individual social security entitlement.
- The tax system is a valuable form of social capital, but suffers from 'free rider' problems. 'Fiscal termites' like tax avoidance and harmful tax competition erode it. Community distrust that taxes are justly levied and usefully expended risks creating a future society of impoverished 'rational fools'.

- Australian tax history suggests how nations might respond as globalisation and 'fiscal termites' threaten their role in social protection through causing a 'tax crisis of the nation-state'.

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Chapter 1
Introduction

Background

Australia has entered the 21st century with a 'New Tax System', the centrepiece of which is a goods and services tax (GST). This has profound implications for the redistributional role of taxation because of the diminished role it implies for progressive income taxation. Empirical studies since the 1960s show progressive income taxation is important to overall tax progressivity in Australia (Warren 1997).

Australia was renowned for its progressive taxes around the beginning of last century. Yet in recent decades, taxation seems to have become much less progressive. On standard measures of progressivity, it is now less progressive than in the early 1980s or perhaps even the 1950s. At any time over the past century, proposals to massively reduce tax progressivity would have received short shrift in Australia. Yet that is what has happened.

The declining trend in the redistributional role of taxation is more understandable if one looks at tax history in the context of the changing economy and Australia's institutions of federal finance. Another important backdrop to the taxation story is the distinctive and prominent redistributive role played by labour market institutions in Australia, which resulted in the characterisation of Australia as the wage earners' welfare state (Castles 1985). This study aims to further comprehension of how Australia arrived at the present point by looking at how the redistributional role of taxation has changed since Federation, how this has been affected by changes in the economy, and how it has been influenced by Australia's federal system of government financial arrangements and by institutions of 'the wage earners' welfare state.

Despite its distinctiveness, Australia still lacks a comprehensive historical analysis of taxation policy (Groenewegen 1995). Existing histories focus on specific aspects of its income tax history or on short periods of time (for example, Van den Driesen and Fayle 1987; Groenewegen 1988; Groenewegen 1981; Head 1983a, 1991, 1992), with nothing comparable with Shehab's (1953) analysis of the history of progressive income taxation in the United Kingdom, or Witte's (1985) study of the evolution of the federal income tax in the United States. Garland's 1934 study of land taxation in Australia is updated by Mathews (1992) but, despite three informative studies on the demise of death taxes (Hill 1975; Johns and Sheehan 1977; Pedrick 1981), there is no broad history of Australian taxes on inherited wealth and economic rents. Likewise, the twentieth century course of customs and excise taxation is viewed from the perspective of tariff policy rather than for its use as an indirect tax instrument (for example, see Glezer 1982; Moffat 1970; Rattigan 1986).

Although Australia's apparently heavy reliance on income taxation is explained substantially by its choice of general taxation rather than earmarked social insurance contributions to fund its social security system, no study has explored the tax system's place in and its implications for the wage earners' welfare state or, relatedly, for its classification within 'the fourth world of radical welfare capitalism' (Castles and Mitchell 1992, p. 20). Taxation is '[an] instrument influencing welfare outcomes [which is] extraordinarily neglected in comparative social research' (Castles and Mitchell 1992, p. 12).

Company tax is similarly neglected, despite Australia's relatively heavy reliance on this source of revenue compared to other Organisation for Economic Cooperation and Development (OECD) countries (Economic Planning Advisory Commission 1993).

The expanded role of government in Australia since World War II appeared as a victory for those seeking social protection from such catastrophes as the 1890s financial collapse and the 1929–32 Depression. The Uniform Tax Plan adopted by Australia in 1942 supposedly

reflected the end of State government parochialism in income tax burden-setting and foreshadowed a new era of post-war reconstruction and social security, underwritten by the establishment of the 'National Welfare Fund'. However, a more sombre glow is cast over the post-war fiscal landscape by the possibility that the working man, far from getting a fiscal bargain from these changes, was paying for his own child endowment and dole. In *Government and Capitalism in Australia* (1982), Butlin *et al.* study the changing role of government in Australia within the context of a shift in political power from pastoral, financial and trading interests to labour, manufacturing and farm sector interests during the early decades of the twentieth century. Tracing a shift from a system focussed on poverty alleviation to one focused on 'welfare for all', from 1945, they speculate on how the redistributive role of the tax system changed and ask whether the public provision of welfare services after 1945 was actually redistributive:

> The question remains whether persons otherwise exposed to the risk of impoverished old age, unemployment, invalidity or maternity secured support through public funding processes from categories of individuals who were exposed to similar risk or from others who were cushioned by personal affluence, from these risks (Butlin *et al.* 1982, p. 338).

Since the 1960s, fundamental changes have been occurring in the Australian economy. While Australia has long been a highly urbanised and service based economy (Butlin 1964; Dowie 1970), the relatively closed pre-World War II economy based on 'protection all round' for its manufacturing and farm sector — all 'riding on the sheep's back' — has been changing to an economy increasingly integrated into the international economy through multinational corporations and enterprises involved in mineral and pastoral exports (Butlin *et al.* 1982), or more recently tourist, financial and other commercial activities centred around major cities, notably Sydney (Stilwell 1997; Courchene 1993). These economic developments suggest significant changes in the nature of the pressures brought to bear by private interests on public policy, as manufacturing, farm and labour interests diminish in political power and the concerns of new industries gain political ascendancy. This in turn implies further reorientation of the public sector's role in the late twentieth century, with consequences for redistribution policies, including taxation.

There is also a wide literature on aspects of Commonwealth–State finance, with detailed historical analysis of the institutions of fiscal federalism (Mathews and Jay 1972; Prest and Mathews 1980). However, there is little from the specific perspective of how these institutions or the political economy of federalism have influenced the evolution of progressive taxation or the redistributional role of taxation in Australia. Groenewegen's review of the political economy of Australian federalism 'raises more questions than it answers about the political, social and economic forces which shaped this important aspect of the role of the state in the Australian economy': his 'preliminary investigation' concluded that 'this aspect of Australian history requires considerably more investigation before a conclusion can be confidently expressed' (1983b, p. 170). Levi (1988a) acknowledges the federal dimension of Australian taxation, but her broad 'rational choice' interpretation of Commonwealth income tax history as an example of 'predatory rule' by a party-driven, opportunistic tax 'Leviathan' constrained by stereotypical 'tax-shy' State governments leaves little room for insights on how uniform income taxation evolved from broader economic and social forces. Nor does it address questions on how these forces interacted with the specific constraints set by the Constitution's allocation of fiscal powers, or on what the economic costs were of federal institutions creating the fiscal subservience of the States.

While taxation studies such as those by Levi (1988b) and by Maddock (1982) assume or assert the importance of political party and ideology in explaining Australian taxation policies, the well-known distinctiveness of its labour market institutions is ignored. Yet a key to understanding the characteristics of the 'fourth world of radical welfare capitalism' — 'low expenditures, high equalising' welfare regimes — is an understanding of the channels of influence of a strong labour movement on welfare systems in a country where labour power was rarely translated into cabinet incumbency (Castles and Mitchell 1992, p. 17). Groenewegen

(1983b), scrutinising the financial aspects of Australian federalism, has shown that Labor party and conservative party attitudes to federalism in Australia have been largely a matter of class interest rather than reflecting a principled position on States' rights. Indeed, it has been argued that Australia's distinctive system of social protection is 'a manifestation of the effects of class politics unalloyed by the influence of party' (Castles and Mitchell 1992, p. 17).

Despite the large literature on tax policy in Australia (see Smith 1993b for a bibliography), and the distinctive role taxation plays in our system of social protection, what role taxation has played in Australia's system of social protection is unclear. Nor do we know why Australia's distinctive tax-transfer system evolved as it did. Unsurprisingly, Butlin *et al.* (1982) concluded that 'an historical study ... on the role of taxation (as a distributive mechanism) ... could be most rewarding' (p. 95).

Research methodology

This thesis aims to further our understanding of what drives changes in taxation policy by exploring how and why the distributional role of taxation has changed in Australia over the last century.

The thesis places its exploration of the taxation problem in the broad socio-economic and political landscape drawn by Butlin *et al.* (1982) and Castles (1985), linking changes in the tax system with the emergence of labour, manufacturing and farm interests as key partners in economic development with the Commonwealth government until the 1960s (Butlin *et al.* 1982), and with the residualist welfare policies of the wage earners' welfare state (Castles 1985, 1990; Castles and Mitchell 1992). It also draws on theories of taxation and redistribution in federal systems to illuminate significant aspects of Australia's federal fiscal development, and draw links to present day problems presented for tax policy by economic integration and globalisation against the background of debates on a 'tax crisis' of the state (Goldscheid 1958 [1925]; Schumpeter 1959 [1918]; O'Connor 1973; Musgrave 1980; Tanzi 1998b).

This thesis is not, however, the 'full economic history of this complex subject' sought after by Groenewegen (1995, p. 114). As it is a thesis bringing together several related research endeavours, it takes its tone and direction from that.

Because the problems of tax policy are multidimensional, it is investigated from economic and political perspectives and using a combination of statistical analysis and historical narrative and interpretation. The aim is to explore key aspects of Australia's tax policy history within an empirical framework, not to apply economic or political theory to the evolution of tax policy. As Butlin's work has emphasised, 'much western historical experience (and its related theory) has only limited value to Australia because of the prominence of governments throughout virtually the whole of Australian history' (Butlin *et al.* 1982, p. 4). In any case, theory has had only very limited success in explaining the evolution of taxation policy in OECD countries (Messere 1993). Theory is used in this thesis for its exploratory value (Hancock 1982), to guide the collection of evidence, draw connections that might otherwise be missed, and give coherence to narrative and analysis. Theory is also used to keep in touch with the 'big picture' issues. To a historian, opening a window on the past is worthwhile in itself. But this thesis is also concerned with the public policy issues of today. This analysis of the changing redistributive role of taxation over the twentieth–century seeks to provide insights from Australian history which are relevant to contemporary discussions on adapting national finances to globalisation and international factor mobility during the present era of rapid technological, economic and social change (Tanzi 1998b, 1999, 2000a, 2000b).

Ideally, an investigation of the redistributional role of taxation would be based on a statistical analysis of fiscal incidence (Musgrave and Musgrave 1989). This would provide a check on the possible subjectivity in identifying and classifying periods of significant tax change and would generate comprehensive and consistent information on when and how the distributional role of taxation changed. However, it was not until the mid 1960s in Australia that the necessary data on the distribution of incomes, social security benefits and public

expenditures became available. Lack of agreement over the economic incidence of company taxation, together with absence of data linking company shareholders with taxpayers, makes futile any attempt to include corporate taxation in such an analysis. The starting point for this thesis is, therefore, a study applying established techniques for measuring tax progressivity to historical data on the income distribution of Commonwealth personal income taxes (Chapter 3).

Also, a study of the origins and evolution of Australia's federal finance system illustrates the institutional context of the evolution of the tax system and its consequences since Federation in 1901 (Chapter 7). Against the background of the fiscal landscape sketched in these two chapters, other chapters examine selected 'cases' of Australian taxation.

The objective of using 'cases' is to illuminate the problems, motivations and circumstances as perceived by the key actors through looking in detail at how significant features of Australia's tax system evolved. As 'examples' risk being haphazardly selected or unsystematically studied, the issues raised by Chapters 3 and 7 are used to select themes and examples that follow each tax policy problem in twentieth-century Australia. While this case-study method has its limitations, it can have advantages over other approaches to policy analysis if used under certain conditions and in particular ways (Hall *et al.* 1975). One advantage is in building real world complexity into attempts to generalize; another is its value in exploring the meanings participants in policymaking attach to their decisions and actions. The images of real life generated by such a historical narrative also helps minimise the risk of 'the contemporaneity of theory' creating 'barriers ... between us and the people of other times' (Hancock 1982, p. 13).

More detail on how these case studies of Australian tax history fit together in this thesis, and how particular examples help explain development of Australia's tax-transfer system, is provided in Chapter 2. Some conclusions and implications are drawn in its Concluding Remarks.

Chapter 2
The Historical Tax Policy Landscape — Thesis Overview

Introduction

This chapter discusses the themes and significance of each of the case studies included in this thesis, and shows how they connect. The thesis is in three parts. This chapter explains the structure and material in Part I, then does the same for Parts II and III.

- Part I of the thesis relates mainly to the historical evolution of taxation in Australia, and to the relationship between economic change, political and labour market institutions and the evolution of the tax-transfer system. These chapters (3–6) bear particularly on questions of how Australia paid for its welfare state in the earlier decades of the twentieth century and how this was constrained by key institutions, and on how Australia's industry structure, labour markets and social needs shaped the tax policy responses to economic shocks and problems of tax policy.
- Part II, covering Chapters 7–10, links these issues to the institutions of Australian federal finance, examining how the constitutional allocation of fiscal powers interacted with economic and social change and States' economic diversity to shape important distributive elements of the tax system (uniform taxation and horizontal equalization). These chapters also identify the need to appraise the economic costs of Australia's institutional choices.
- Part III of the thesis (Chapters 11–13) relates to present problems of tax policy and is more forward-looking and speculative. Reviewing the tax policy challenges of the 1990s, this part of the thesis connects the trends and issues in Australian taxation policy since the 1970s with the political economy of taxation explored in Part I and the institutional constraints identified in Part II.

The themes, contributions and connections of Part I

The thesis begins in Part I with a study measuring changes in the progressivity of the Commonwealth personal income tax between 1917 and 1997 (Chapter 3).[1] Estimating three different global measures of tax progression common in the literature, Chapter 3 identifies the main episodes of change in the degree and character of progressivity. The contribution of this study is in applying established tools of tax analysis to data extracted from historical records in order to systematically assess trends in tax progressivity over time. It identifies relative stability in Commonwealth income tax progressivity until World War II, when progressivity increased sharply, then a shift to a less progressive 'mass tax' from the 1950s. Lack of Commonwealth action against rising tax avoidance and inflation and, more recently, tax cuts are found to be the major element in the reduced progressivity between 1917 and the late 1990s. This chapter also points to a change in the character of the income tax — from a 'class' to a 'mass' tax — that was initiated by State governments before 1939, an issue explored in Chapters 4 and 5.

Why change occurs is less easily identified from the statistical analysis such as that in Chapter 3 than *what* occurs. Chapters 4–6 address the issues identified in earlier chapters about why Australia's tax system evolved as it did by examining the economic and political history of States' income taxes, State and Commonwealth payroll taxes, and the 1930 Commonwealth sales tax respectively. They develop themes of the wage earner paying for social security through mass income taxation and sales taxation rather than through social insurance and of

[1] Chapter 3 was published in 2001 as 'Progressivity of the Commonwealth personal income tax, 1917–1997', *Australian Economic Review*, vol. 34, pp. 263–78.

Australia's changing economy, industry structure, and fiscal politics shaping tax and social spending policies within constraints set by its distinctive political and labour market institutions.

The findings of tax histories of other countries suggest the possible explanations of tax policy in Australia, and guide the explorations in Chapters 4, 5 and 6. Empirical research shows, for example, that tax systems respond to long-run changes in economic structure and taxable capacity (Hinrichs 1966; Musgrave 1986b [1969]), as well as democratisation of political institutions (Justman and Gradstein 1999; Shehab 1953), and fiscal sociology and politics (Musgrave 1980; O'Connor 1973). International comparisons also suggest social protection and taxation systems were shaped historically by economic vulnerability, with changes arising particularly in response to economic shocks such as financial instability or depression which increased income inequality to an unacceptable extent (Castles 1988; Katzenstein 1985).

Although the historical relationship between increased income inequality and more progressive taxation is largely unexplored, studies of income inequality find a declining contribution to redistribution from progressive taxation in the second part of the twentieth century (Atkinson 1983). Tax progressivity may be permitted to diminish because progressive rates of tax raise more revenue and the urgent revenue need has been addressed (Witte 1985), or because reduced inequality has reduced the public appeal of progressive taxation (Slemrod 1994). It may also diminish because rising incomes or other factors bring a politically influential group such as the middle class or the 'median voter' to resist progressive taxation in their own self-interest (Musgrave 1980, 1986a [1959]), or because of increased concerns about disincentive effects as tax rates rise (Musgrave 1994).

The evidence from some countries suggests that tax systems change most during crisis (Peacock and Wiseman 1967), with taxation levels drastically 'ratcheting' up during war. Witte (1985) has also attributed the strongly progressive structure of United States income taxes to the revenue imperatives of war. Such findings have led to speculation that national crises overcome political and institutional barriers to increased taxation, creating a visible revenue pool which is then absorbed for non-defence purposes after the conflict (according to Borcherding 1977, by fiscal or bureaucratic interest groups). On the other hand, Musgrave and Musgrave (1989) argue there were no such clear conclusions to be drawn from American war history: the pattern of growth in civilian expenditure might well represent the normal rise of expenditures interrupted by war periods. This is in keeping with the warning by Rose and Karran (1987) that 'crisis' models of decision-making are inappropriate for taxation because

> There is never an 'all-or-nothing' decision about taxation, as in choices between war and peace. Decisions about taxation concern changes at the margin. ... Changes in the structure of taxation are most likely to occur by the compounding of seemingly small rates of change (p. 12).

The observation that tax systems are quite stable over long periods of time led Rose and Karran (1987) to characterise tax policy in the United Kingdom in the post-war era as 'keeping out of trouble ... by not making decisions about taxes', that is, 'taxation by political inertia' (pp. 5–6). Similarly, Head (1983a, p. 1) explains the long periods of apparent stability in taxation systems by the 'quasi-constitutional nature' of taxation, best left largely undisturbed lest major reform opens up 'a veritable Pandora's box of controversy' by disturbing hard won and delicately balanced compromises on the distribution of income and wealth. An apparent absence of legislative activity may be an outward sign of policy paralysis — with equally powerful and conflicting interests locked together in mortal combat behind the scenes (Hall *et al.* 1975), or it may simply be uncalculated maintenance of bureaucratic routines (Rose and Karran 1987). Post-war OECD experience suggests episodes of major tax reform may have been infrequent both because revenues were sufficient and because participants in the battles of fiscal politics were exhausted (Messere 1993; Peters 1991).

Hidden false assumptions about 'consensus' in conventional analyses of policy history can lead to superficial and inaccurate accounts of the proximate and fundamental factors behind institutional change (Hall *et al.* 1975). The 'taxation by political inertia' that shaped Commonwealth personal income tax progressivity raises questions, examined in this thesis,

about whether shifts in the tax burden are predominantly a passive reflection of economic and structural change or a deliberate and active choice of legislatures. Likewise, does the phenomenon of 'taxation by political inertia' signal the overriding strength of economic interests favoring the affluent or does it simply evidence institutional tendencies favoring the *status quo* in the behind-the scenes redistributional conflicts over taxation (Rose and Karran 1987)? Experience with personal income tax indexation during the 1970s and 1980s (Smith 1993b; Feenberg 1988) and with tax avoidance in Australia since at least the 1950s reinforces the story of the political benefit of tax policy inertia, and supports a contention that such inertia was a political choice in Australia. Whether it reflected mainly the power of vested interests or an over-sufficiency of tax revenues remains an open question that is addressed in Parts II and III of this thesis.

As highlighted by the findings of Chapter 3, the distributional character of income taxation earlier in the first four decades of the twentieth century depended on State rather than Commonwealth government policies. The pre-1942 State income tax policies were also directly formative in the character of the Commonwealth's post-1942 income tax. State income taxation is, however, a neglected area of Australian tax history, with only two published studies (Murphy 1980 [1928]; Van den Driesen and Fayle 1987) on State income taxes. Chapter 4 outlines the trends and features of the Australian States' income taxation in the period 1919 to 1942 and explores the connection to Commonwealth income tax policies from 1942. This addresses the broader question raised by Butlin *et. al.* (1982) of whether the Australian wage earner funded his own welfare state, but does so from a perspective acknowledging the importance of taxation by the States. It also draws on the insights provided by economic theories of federalism in focusing on the economic and constitutional constraints on expanding States' progressive taxation in the increasingly integrated national economy which developed after Federation in 1901. The perspective of this study emphasizes the hitherto unappreciated significance of States' income taxes in financing Australia's early welfare state. Chapter 4 suggests the Uniform Income Tax Plan was a response to a fundamental and longstanding tax problem — how to fund new social programs progressively, at comparable standards across the country, in a federal system where the Constitution's allocation of fiscal powers and factor mobility hindered strongly redistributive State taxation or social programs. It also shows that the Uniform Income Tax Plan of 1942 was a continuity, not a break with past tax history in Australia.

The growth of taxation in most industrialised countries over the twentieth century has been to fund expansion of the welfare state. In most countries — but not Australia — the financing mechanism has been some form of social insurance (Euzeby 1984). Castles (1985) suggests this represents a dimension of the Australian wage earners' welfare state, which provided income security and reduced inequality mainly through a strong labour market and wage regulation, and through a residual welfare system providing income support for those outside the labour market in the form of flat-rate, means-tested benefits. Jones (1980), Kewley (1969; 1973) and, more recently, Watts (1987) has provided a thorough historical analysis of the evolution of Australia's social security system, but not of its financing. To explore why Australia chose general taxation as an alternative funding mechanism for social insurance and redistribution, Chapter 5 examines the Australian history of payroll-type taxes as a way of financing new social assistance programs and considers the tax-transfer system in its role as an instrument of labour market and industry policy.

Payroll tax was first introduced in Australia as a levy on employers which was hypothecated to financing a new child endowment scheme in New South Wales in 1927; similar earmarked payroll levies characterise social insurance schemes in other countries (Peters 1991). The Commonwealth replicated this NSW financing model when introducing a national scheme of child endowment. Both schemes were aimed at wages policy objectives as much as at achieving explicitly social goals. The example of payroll tax/child endowment provides the opportunity to explore questions raised earlier about the relationship between Australia's distinctive publicly-funded system of means-tested social security, and the policy of 'New Protection'. This policy underpinned Australia's protective tariff policy and the related wage-fixing institutions of the Australian wage earners' welfare state from 1906 until it was

dismantled from the 1980s.[2] Assessing the actual economic motivations for the apparently progressive social reform of child endowment reveals important aspects of the political economy of Australia's tax-transfer system. Chapter 5 also draws the connections between Australia's early payroll taxes, its income taxes, and the unfulfilled plans for contributory social insurance. The analysis shows that financing child endowment through Commonwealth taxation rather than social insurance levies benefitted rural and manufacturing employers and industries, and aimed to reduce labour costs. An important implication of this chapter is that public policies regarding the nature and financing of Australia's tax and transfer system evolved in response to changing requirements of politically influential economic interests favoured by the Commonwealth's 'New Protection' policy.

An important theme of Chapters 4 and 5 relates to the 'earmarking' of taxes. Earmarking is a widely used political device for responding to strongly held philosophies of 'benefit' or 'user pays' taxation in order to increase tolerance of taxation. Chapter 5 shows that financing child endowment through an earmarked payroll tax was an important part of the political strategy which governments adopted to implement new taxes and, later, progressive financing of social spending. It also draws attention to the difficulties for Australia of using social security (which in Australia is tightly targeted to those with low or no incomes and financed by heavy income taxation of wage and salary earners) to influence wages policy through a corporatist 'social wage' model. Chapter 5 suggests that Australian wage earners are suspicious of higher taxation to fund social security because the experience of the labour movement has been that higher taxes on wage earners funded benefits which were restricted to those without market incomes rather than contributing to improvements in wage earners' own individual social security or social insurance entitlements.[3] Along with 'fiscal benefit confusion', discussed below in relation to Commonwealth–State finance, this helps explain Australia's relatively low tax and expenditure ranking among OECD countries.

The visibility of taxation is also an important aspect of practical tax policy, as is illustrated by J.S Mill's contention that the highly visible income tax would invoke greater scrutiny and economy in government spending (Mill 1848). Used by Victorian Treasurer George Turner to support the Government's new income tax during the 1890s (Mills 1925), this argument highlights a significant administrative innovation in Australian income taxation, which was the withholding tax on wages introduced in South Australia in 1932. This is identified as a important innovation in tax administration during this period, as it permitted the efficient income taxation of wage earners while reducing the visibility of the impost. While its initial import lay in governments' increased capacity to tax labour income, its longer term significance was that it was the forerunner of the Commonwealth government's 'Pay As You Earn' (PAYE) system operating from 1944–45 onwards. As the instrument that turned the 'class tax' of 1915 into the 'mass tax' of the post-war era, PAYE had major implications for the distributive character of income taxation in the post-war decades. As Hytten observed in 1932 (p. 286), the method of taxation at source had the great advantage of reducing 'the feeling of hurt' of the income tax.

While PAYE reduced income tax visibility and improved the tax compliance of the wage and salary earner population, its contribution to the success of 'taxation by political inertia', identified in Chapter 3, meant PAYE had profound long term implications for the political viability of income taxation, and also for the direct/indirect tax mix.

In the early decades of the century, the Australian labour movement was highly critical of hidden indirect taxes on the working classes. The structure and level of customs and excise

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[2] See Caplin and Galligan (1992) for an account of Australia's transition from a protective to a corrective state.

[3] Experience with the corporatist Prices and Incomes Accord from 1983 similarly illustrates how Australia's distinctive tax-transfer system explains the labour movement's ambivalent attitude to higher taxation and social spending as a redistributive strategy: despite its 'social justice' policy emphasis, the Hawke/Keating Labor Government (1982-1995) found it necessary by 1985 to pledge ceilings on taxation (the fiscal 'Trilogy), but its self-imposed fiscal constraint and narrow tax reform agenda produced ever-tighter 'targetting' of social security, which by the early 1990s severely constrained its ability to offer unions improvements in the social wage as a trade-off for wage restraint.

taxation was the central fiscal policy issue in the decades immediately before and after Federation, and its regressive incidence represented an underlying contradiction for Labor supporters of Australia's protectionist fiscal policies. An important motivation for successive Labor governments in introducing or expanding direct taxation from 1910 was to reduce reliance on a regressive form of taxation.

While much has been written on the history of the tariff as an instrument of industry protection there is little on its role as a tax. The heavy weight of tariff revenues in the early part of this century is not surprising given Australia's stage and pattern of development, in which imports played an important role (Butlin 1962). Theories of fiscal development (Hinrichs 1966) link different stages of industrial development with the opportunity for utilisation of different taxation instruments, suggesting the importance of customs and excise revenues would naturally decline as Australia's protective tariff encouraged import substitution. Because customs and excise was the only central government tax in 1901, this implies an underlying economic pressure for the Commonwealth to find new revenue sources over the first decades of the twentieth century. The Commonwealth also needed to respond to the destabilising effects of World War I and the 1929–32 Depression on imports and therefore its indirect tax revenues.

Available data do not permit a systematic statistical analysis of the trend or pattern of indirect tax policy in Australia. Chapter 4 points out that higher direct taxation funded the States' new social spending during the interwar period but the rising cost of Commonwealth age pensions from 1909 was in effect funded from increased indirect taxation. The heavy reliance on indirect taxation until World War II was seen by foreign observers as a paradox in view of the regressivity of the consumption tax base and the comparatively strong position of labour in Australia (Gilbert 1943). However, as seen Chapter 6[4], Labor representatives in the Commonwealth Parliament since 1901 had successfully reduced the regressive incidence of customs and excise taxes through exemptions for necessities (see Kakwani 1983; Groenewegen 1983a), and this policy continued with the wholesale sales tax (WST). Hastily introduced in 1930 to replace the tariff revenues lost as incomes, imports and consumption collapsed during 1929–30, the WST was designed to replicate the incidence of customs and excise taxes. Thus Chapter 6 examines indirect tax policy by proxy, analysing Commonwealth parliamentary debates on sales tax policy during 1930 and 1941. It illustrates the problems of taxation policy as articulated by the relevant actors during these national crises and shows the social and cultural values embedded in the design of Australia's major indirect taxes. Chapter 6 also shows how indirect tax design was influenced by the economic interests of primary producers, manufacturers and labour market institutions including the basic wage.

Although it is common in present-day discussion to justify replacing the WST with a goods and services tax (GST) by claiming the former was outdated and eroded by vested interests, the history of the sales tax in Chapter 6 provides a corrective to the Howard Government's 'outdated institution' and 'political rent seeking' argument for the GST. The equity and revenue implications of the rising services share of consumption, rather than political erosion of the sales tax base, are shown as the legitimate reasons for replacing the WST with a GST in June 2000. This study shows how both vested interests and social values shaped the original design of the WST. Written before and during debate on whether food should be exempted from the GST, this chapter argues that exempting food and other necessities from the GST base carries forward important social values that were embedded in the design of the sales tax.

The themes, contributions and connections of Part II

Following the Commonwealth's assumption of income taxation in 1942 the overall significance and consequences of Australia's federal finance arrangements became most apparent. Part II commences with an overview of Commonwealth–State financial arrangements from the

[4] An earlier version of Chapter 6 was published in 1999 as 'Is the only good tax an old tax? An historical perspective on the GST', *Discussion Papers*, no. 398, Centre for Economic Policy Research, Australian National University, Canberra.

perspective of how they affected progressive taxation and redistribution (Chapter 7).[5] This provides an economic and institutional framework for interpreting trends in State governments' tax policies, including tax problems faced by State governments in the inter-war period (identified in Chapter 4) and the related issues regarding how progressively Australian social security system would be financed (Chapter 5). Chapters 8–10 in Part II assess the distributional implications of the Commonwealth's post-war taxation dominance, and develop themes emerging from Chapter 7 on the spatial dimension of tax redistribution.

These chapters use insights from federal theory to help analyse how the tax system evolved from the decentralised political institutional structure envisaged in the Constitution in 1901 to Australia's highly centralised present-day system of taxation and social security. Chapters 8 and 9 analyse trends in and results for public infrastructure financing from a broad economic and institutional perspective, and Chapter 10 provides a broad ranging analysis of recent trends in gambling taxation — the causes and consequences.

The 1900 Constitution provides the basic institutional framework in which Australian tax policy is made. Federal finance theory argues for the redistribution function of government to be assigned to the central fiscal authority because it is difficult for provincial governments to redistribute (Rosen 1992; Razin and Sadka 1999). However, at the same time as withholding most redistributive expenditure functions from the Commonwealth Government, the Constitution gave it stronger tax powers than the States.

The extent of the imbalance in own-source revenues and spending responsibilities (generally referred to as the 'vertical fiscal imbalance' or VFI) has been one of the distinguishing features of Australian fiscal federalism during the post-war period (Mathews 1994). The other is the unique arrangement for redistributing fiscal resources from richer to poorer States ('horizontal equalisation'), centred on the Commonwealth Grants Commission.

A common interpretation of these institutions of Australian fiscal federal finance is that State governments are 'taxation shy', some more than others (May 1971). Another is that centralisation of revenues reflected ideological or strategic choices by a revenue-maximising Commonwealth government (Levi 1988b; Maddock 1982). The alternative perspective of Chapter 7 of this thesis is that these outcomes arose from the interaction of economic and social forces with incongruent political institutions. Chapter 7 thus develops in a slightly different direction the political economic argument by Groenewegen (1983b, p. 170) that

> the increasing complexities of economic life have been a far more powerful influence on the growth of central power than the political complexion of the government in Canberra, despite the strong centralist philosophies expressed in the ALP platform and verbally supported by Labor prime ministers.

As Musgrave (1986, p. 145) observed:

> The progressive income tax by its very nature is better suited for national administration. Distributional adjustments through progressive taxation cannot readily be applied on a regional basis but require national coverage. Capital income is derived from various parts of the nation and must be collected in a single return for global assessment. Decentralized taxation would thus involve all the difficulties encountered in the tax treatment of foreign source investment income, not to speak of the distortion in regional capital allocation due to differential rates. For these and other reason, progressive income taxation has to be applied largely at the national level, with regional income taxes limited to relatively low flat rates.

Graebner (1977) identifies incongruence between federal political institutions and the growth of national markets and businesses in the United States as a structural barrier to progressive reformers during the early decades of this century. Uniform state legislation was

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[5] Chapter is an revised version of that published in 2001 as 'From The Federation Debates to 1970', in *Financing the Federation*, J. Hancock and J. Smith (eds), South Australian Centre for Economic Studies, Adelaide, pp. 5–43.

one mechanism for dealing with this problem in the United States, and there are parallels with Australia's attempts to deal with the problems of income taxation through the uniform tax Act of 1936. The growth of Commonwealth power in Australia has been closely associated with the growth of the welfare state and social protection. It is suggested in Chapter 7 that the Constitution's assignment of revenue and redistributive functions was increasingly incongruent with the inherent instability of progressive tax-transfer systems in State jurisdictions and with the divergent capacity of individual States to finance their functions. It argues that, combined with widely held social expectations about standards of government services and taxation equity, these economic and institutional factors encouraged the process of centralisation of revenues and social services, beginning soon after Federation. As the Commonwealth's progressive tax-transfer system expanded from 1909,[6] the poorer States' fiscal interests in a progressive national tax-transfer system came increasingly to align with those of the Commonwealth in centralising taxation because centralisation enhanced Commonwealth resources available for special assistance, and because a progressive tax-transfer system redistributed income to poorer States as well as providing insurance against fluctuations in increasingly specialized regional economies.

The two redistributive institutions of Australian fiscal federalism — a centralised tax-transfer system and horizontal equalization — undoubtedly have significant economic implications. Chapters 7, 8 and 9 suggests that Australia's Commonwealth–State finance arrangements may have adverse effects on the economic cost-efficiency with which governments have pursued their redistributional goals. In particular, the 'vertical fiscal imbalance' is likely to have influenced both the level and the type of redistribution by governments. As the Commonwealth has only a minor role in the provision of public goods and services, its redistributional role is largely played out through the tax-transfer system. By contrast, the States provide the major mechanism for the public sector to affect the distribution of market incomes and economic opportunities, through providing access to public goods and services and public investments in physical and human capital. Commonwealth tax dominance and the States' vulnerability to Commonwealth fiscal constraints in the post war period may thus have raised the costs of redistribution by:

a) constraining States' borrowing and, therefore, the nation's public investment in economic and human capital, including schools, health services and housing;
b) shifting the emphasis of social expenditures to means-tested social security transfers, financed through heavy reliance on progressive income taxation and;

These arrangements may also reduce the public's perception of links between (mainly Commonwealth) income taxes paid and (mainly State and local government) public services received. Such 'fiscal benefit confusion' (along with wage earners' suspicion of tax-transfers) is argued in this thesis to have reduced public acceptance of taxation and contributed to rising tax resistance since the 1970s.

The over-reliance on progressive tax-transfers could be expected to increase the economic efficiency costs of redistribution, because firstly, means tested cash benefits and high income tax rates imply high effective marginal tax rates and disincentive effects compared to more widely accessed social services and public infrastructure, and, secondly, because public investment, including in social and human as well as physical capital, is now acknowledged to have significant implications for the productivity of private sector investment as well as for inequality.

Part II thus raises broad questions about whether the chosen institutions of Australian fiscal federalism have best balanced the demands of democratic parliaments for social protection against economic considerations of minimising the costs of redistribution (North 1978).

As seen in Chapter 3, the distributional importance of income taxation shifted because of its new role in financing public spending from the mid to late 1950s. Chapter 8 carries forward from Chapter 7 the argument that Commonwealth revenue dominance since 1942 has

[6] Commonwealth aged pensions were introduced in 1909, and a progressive Commonwealth land tax in 1910.

distorted the character and the efficiency of public spending in Australia. It shows that the level of public investment in Australia was a likely casualty of this imbalance because the Commonwealth used the copious income tax revenues of the 1960s to gain control of States' borrowing and investment (Mathews and Grewal 1997). The public sector has traditionally played an important role in providing economic and social infrastructure in Australia. However, this investment expenditure has mainly been by State and local governments. Chapter 8 examines trends in public investment since 1960 and raised questions about whether it was sufficient and the funds well spent. How public infrastructure is financed also has major equity implications that are generally neglected in the literature on this issue.

The contribution of Chapter 8[7] of this thesis is to examine public investment funding from the perspective of tax redistribution and show the connection between trends in public infrastructure financing and problems in Australia's institutions of federal finance. Writing during the Constitutional Convention debates in 1897, R.R. Garran predicted that the lack of a permanent resolution of the federal surplus problem would leave the Commonwealth government prone to 'extravagant expenditure' or 'reckless remission of taxation', as well as 'demoralise' the finances of the States (Garran 1897, p. 164). While public debate has given plenty of emphasis to the latter it has given little attention to the former (an exception being Mathews 1998). Commonwealth tax cuts since the 1980s and costly Commonwealth government tax subsidies encouraging private financing of public infrastructure (Chapter 8), private health insurance (Chapters 11) and private superannuation are reminiscent of Garran's predictions. So too are the effects of Commonwealth policies in 'demoralising' States' gambling and planning policies (Chapters 9 and 10) These explorations of the political economy of Commonwealth income tax subsidies and of States' pursuit of revenues through gambling deregulation also resonate with themes emerging from Chapters 5 and 6 regarding Australia's fiscal political economy during the interwar period.

Chapter 9, examining an 'urban consolidation' project funded under the Commonwealth government's 'Better Cities' program, provides a case study of the spatial dimension of the infrastructure financing problem discussed in Chapter 8. Chapter 9[8] shows how reduced returns to public investment may be an unintended result of the Commonwealth exercising its 'power of the purse' to direct States' investment policies. This study demonstrates how the financial dependency of State governments distorted public investment decisions and priorities towards some investments with a poor economic return and resulted in the privatisation of publicly owned land assets at well below their market value. With globalisation said to increase the importance of adequately resourced local governments (Tanzi 2000a), this chapter highlights the lack of strong local/regional government structure as a serious flaw in Australia's public finance structure.

Gambling deregulation and gambling tax expansion was an identifiable State government response to Commonwealth demands during the 1980s for an increased State government tax effort. The theme that Commonwealth domination of taxation revenues has reduced the redistributional capacity of taxation in Australia is thus continued in Chapter 10.[9] The first broad-ranging analysis of gambling taxation in Australia was a response to growing public concern about the rising trend during the 1990s (Smith 1998a). This history of gambling taxation in Australia shows how a tax source that was of little importance to States' revenues before World War II had become an important and expanding source of revenue from the mid 1980s. Gambling taxes originated in mainland Australia as a means of funding social services

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[7] This chapter is based on a study originally published in 1994 as 'Infrastructure funding in Australia', *Research Papers*, no. 14, Parliamentary Library, Canberra.

[8] An earlier version of chapter 9 was awarded the Australian National University's Peter Harrison Memorial Prize in the field of town planning, for the best tertiary student essay or project in Australia on the subject of the community basis of the planning and development of Canberra. It was published as M. Dunstone and J.P. Smith, 'Is urban consolidation economical? The ACT's North Watson case', *Urban Policy and Research*, 12: 222–38, 1994.

[9] Chapter 10 was published in 2000 as 'Gambling taxation: Public equity in the gambling business', *Australian Economic Review*, vol. 33 no. 2, June, pp. 120–44. In 1999 it was awarded the *Australian Institute for Gambling Research Brian Frost Prize*.

such as hospitals during the 1929–32 Depression and are a politically easy tax. Chapter 10 shows that gambling taxation was not only regressive but increasingly so as access to poker machines expanded. Commonwealth income taxation was being reduced in importance over this period (Mathews and Grewal 1997). Expanding State government 'equity' in the gambling industry in the form of taxation thus contributed to the reduced overall progressivity of Australian taxation. Chapter 10 also points out that the transition to the GST and adjustments to State taxes permitted the incidence of gambling taxation to be reformed without a transparent process and without specific representation of the public interest. The recent experience of gambling tax policy in Australia, with conflicting roles of governments as tax collectors or stakeholders as well as regulators in the gambling industry, gives force to arguments that State governments' gambling policies give excessive weight to industry interests and that this has contributed to public cynicism and reduced trust in government (McMillen 1996a, 1996b).

The themes, contributions and connections of Part III

Part III contains studies showing increasing trends in Australia's tax expenditures on health, a critique of proposals for expanded land taxation using historical analysis and an 'anti-rational fools' agenda (Sen 1977) for tax reform responding to the tax distributional problem of international factor mobility and globalisation (Tanzi 1998b).

The themes and subject matter of Part III provide a link between the historical material and the present and future problems of taxation. These chapters (11 to 13) support the overall theme of this thesis that the changing economy and demography are producing a new political economy of taxation in Australia (based around expanding service industries like private health insurance and superannuation). This carries forward in time the analysis of the political economy of the protective/wage earners' welfare state in Part I and links to the arguments in Part II (on the institutions of Australian fiscal federalism), that the Australian federation's tax history has implications concerning the redistributive potential of taxation in the present (and future) context of growing incongruence between (national) political institutions and an increasingly integrated (international) market economy.

The progressivity of taxation in the United States in particular has been shown to be dramatically affected by 'tax expenditures' (Musgrave 1986a [1959]; Surrey and McDaniel 1985).
The study of the American federal income tax by Witte (1985) highlights the extensive tax concessions put in place in the United States to favour particular groups of politically influential taxpayers or industries through what Witte describes as the 'pathology of tax politics' (p. 369). As Surrey and McDaniel (1985) point out, providing such subsidies through tax concessions often has a perverse distributional effect, because the greatest benefits often accrue to high income individuals. As observed earlier in this chapter, such policies in the Australian context might well be characterized as reckless remission of Commonwealth taxation or extravagant tax expenditures.

While Chapters 5 and 6 draw attention to the role played by manufacturing and rural interests in encouraging Australia's system of using general taxation to pay for social services targeted at low wage earners, Chapter 11[10] highlights the recent expansion of Commonwealth taxation concessions to encourage private financing of health costs and retirement income and the changing political economy of taxation and social security in Australia. This study draws on a previous study by Butler and Smith (1991) outlining the concept and practice of tax expenditure reporting. It contributes to this thesis by signalling the potential influence of tax concessions on tax progressivity and, more broadly, on the fiscal incidence of public spending programs, and as an example of 'reckless remission' of Commonwealth taxation. The 1991 study provided the first published historical series of data on the extent of tax expenditures on health in Australia; Chapter 11 analyses the income distribution of these tax concessions, and the implications for the progressivity of funding for national health spending. It supports the

[10] An earlier version of Chapter 11 was published in 2001 as 'Tax expenditures and public health financing in Australia', *Economic and Labour Relations Review*, vol. 12, no 2, December, pp. 239–62.

arguments of Part II regarding the consequences of the Commonwealth–State imbalance in access to taxation revenues.

Despite the Commonwealth policy emphasis on fiscal constraint, tax expenditures on health in Australia have expanded substantially since 1992 as a result of policies subsidising the cost of private health insurance. As noted in the litany of tax deficiencies in Chapter 13, a similar large tax expenditure underwrites private superannuation as an alternative to the public pension (Australia, Treasury 2001).[11] This trend has major implications for the redistributional role of taxation, as a high proportion of these tax subsidies accrue to the affluent. Government policy is based on a long held conservative philosophy which holds that subsidising private provision necessarily saves the public money (Chesterman 1999),[12] but also reflects growing international and finance sector influence on tax policy.

The tax reform debate in recent years has focussed on the introduction of a GST to replace the WST, and on the merits of consumption taxation rather than income taxation in order to improve economic incentives and national savings. During the 1990s tax reform debate, a tax on land rents was argued to be a more ethical, efficient and equitable tax than the 'confiscatory' GST. Despite the historical popularity in Australia of Henry George's single tax on unimproved land values, and the acknowledged merits of unimproved land value taxes, proponents of reformed land taxation achieved little prominence in this debate. Chapter 12 illustrates the political and economic realities of imposing the perfect tax — one on economic rents.

Land taxes are a close relation of the income tax in Australia (Van den Driesen and Fayle 1987; Smith 1993b). Originally conceived as a levy on the unearned increment in land values, these land taxes are the equivalent of a capital gains tax on accrued gains in unimproved land value (Prest 1983). The Commonwealth land tax was introduced amidst great controversy in 1910, to help finance the rising cost of the Commonwealth age pension without further regressive increases in customs and excise taxes and to reduce the concentration of Australia's land wealth. In a world of increasingly mobile capital and labour, land is one of the few immovable potential tax bases (Courchene 1993; Graetz 1985). The large extent of tax concessions built into State land taxes (Reece 1988; New South Wales, Tax Task Force 1988a, b; Maynard 1988) points to the political vulnerability of this tax, and to the comparable vulnerability of other progressive taxes on 'economic rents' such as capital gains tax, resources rent tax and inheritance taxes. Chapter 12[13] provides a brief interpretative (and somewhat 'tongue-in-cheek') history of such taxes in Australia, evaluating the argument that land value taxes are the perfect tax (Day *et al.* 1996). The erosion of unimproved land taxation in Australia is described and linked to the political weaknesses in its design and to the erosive effects of inflation, mediocre administration and, most of all, the exercise of political power by owners of realty. This account of the history of such taxes illustrates how inflation and economic fluctuations expose progressive taxes to political pressure for their erosion. It also shows the considerable ability of those urging 'the status quo' to shape the progressivity of direct taxes through inducing political paralysis. This chapter addresses the issue raised earlier regarding the

[11] Certain deductions for the costs of self-funding or insurance against medical costs or retirement income needs have long been allowed from the Australian income tax, as they have from its British progenitor. This reflects the influence of Mill's (1848) principles of income tax design (Sabine 1966; Shehab 1953). Deductibility was the appropriate tax treatment of savings for old age where income was not 'permanent', that is, derived from ownership of assets, but 'precarious', based on labour earnings. Equally, deductions of net medical costs originated from a principle of taxing only 'net' income; expenses from treating ill health were necessary to maintain taxpayers' income-earning capacity.

[12] It can be argued that the use of the Commonwealth's constitutional powers of taxation to coerce contributions to private superannuation and health insurance funds through the Superannuation Guarantee Levy and the Medicare levy surcharge is a further example of the co-option of the tax system in the interests of industry protection (Smith 2001). If these arrangements withstand legal challenge on constitutional grounds, they may portend similar arrangements in the future to encourage the privatisation of schooling, which has a similar basis in legal philosophy (Chesterman 1999).

[13] In 1998, an earlier version of Chapter 12 was joint winner of Land Values Research Group Prize for Tax Reform Challenge Competition, the judging panel chaired by Emeritus Professor R. L Mathews. It was published in 1999 as 'Australian land value taxation', *Centre for Economic Policy Research Discussion Paper,* no. 415, Australian National University, Canberra.

relative importance of powerful vested interests versus a sufficiency of tax revenues as the driving force behind taxation policy inertia and declining tax progressivity.

The joint business/welfare organisations' push for tax reform beginning in 1996 which culminated in the new tax system introduced in 1999 provides the background for Chapter 13.[14] This chapter maps the major deficiencies of the tax system at the end of the twentieth century and sets an agenda for tax reform. It observes the significance of the 'free rider' problem in taxation policy. Using Sen's critique of 'rational economic man' (1977) and Scholz's characterization of tax compliance as 'contingent consent' (1994), it outlines the problems that are created for tax administration both by blurred linkages between taxes paid and benefits received ('fiscal benefit confusion') and by tax avoidance. The chapter relates these problems to trends in Commonwealth income taxation and to weaknesses in Commonwealth–State financial arrangements. It points to the untapped opportunities for improved economic efficiency in Australia's tax treatment of resource rents, land and wealth, and, harking back to Chapters 10, 11, and 12, to the extent of lost public revenue due to tax concessions for politically powerful industries or constituencies and inaction against tax avoidance. It also outlines the challenges facing governments in maintaining a progressive tax system and concludes that central to the challenges faced by Australian tax policy is the difficulty in sustaining revenue and preventing tax avoidance in 'the global economy'.

This chapter has flagged the broad themes and connections between Chapters 3 to 13, which follow. Chapter 14 then sets out some concluding remarks which link the findings of this thesis on Australia's tax history with the present day problem of how governments might respond as globalisation and 'fiscal termites' threaten governments' role in financing social protection.

[14] Chapter 13 is an edited version of a paper presented by invitation to the National Tax Reform Summit, October 1996 and published as J.P. Smith, 1997, 'Deficiencies in the current tax system', *Economic and Labour Relations Review*, vol. 8, no. 1, pp. 57–77.

Chapter 3
Progressivity of the Commonwealth Personal Income Tax, 1917 to 1997*

Introduction

Although Barnard (1985) presents a statistical overview of Australian public finances since 1901, there is no such statistical review of tax progressivity. Analysing personal income tax data provides reasonable indication of long-term trends as there is only minimal scope for progressivity in indirect taxes like customs and excise. Income tax was an important if not dominant source of revenue over much of the period.

For at least five decades, economists have attempted to compare the progressivity of different tax systems through using global measures of tax progressivity (for example, see Musgrave and Thin 1986 [1948]). In Australia, existing studies estimate income tax progressivity for various periods in the post-war era up to 1989. None extends back beyond the early 1950s, although Commonwealth income taxation in Australia dates back to 1915.

Empirical estimates of tax progressivity using global progressivity indices are also confined to the post-war era. Recent cross-country comparisons of tax progressivity have evaluated these indices across very different income tax systems, such as for the United States and Mexico, highlighting issues that also arise in comparisons over time (Formby, Seaks and James-Smith 1981; Formby, Seaks and Smith 1984). However, there are as yet no overseas studies applying these indices to very long-term historical data.

The purpose of this chapter is, therefore, to measure long-term historical trends in the redistributional role of income taxation in Australia by estimating three well-known measures of tax progressivity, using annual official income tax statistics for the eighty years between 1917 and 1997. This has the objective of:

- identifying major periods of change and stability in tax progressivity as a guide-map for further historical investigation of Australian taxation policy;
- calculating a continuous series of tax progressivity estimates for Australia back to the inception of Commonwealth income taxation which are consistent with existing series from previous studies; and,
- illustrating through practical application to historical data the response of statistical indices with different theoretical properties to changes in economic conditions and income tax design or structure, and the issues that arise.

The progressivity of the tax system is mainly determined by the tax 'base', that is the type of taxes by which revenue is derived, rather than the extent of graduation in income tax rates. Hence, this chapter first provides a brief historical overview of progressive elements of the Australian tax system. It then surveys other relevant Australian studies of income tax progressivity. Various global measures of tax progressivity, and their important properties and caveats, are reviewed in the third section, which also describes the data used in the study, including their limitations. Results of calculations for the Commonwealth personal income tax for financial years 1916–17 to 1996–97 are then presented and discussed in the fourth and fifth sections respectively.

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* This chapter was published in 2001 as 'Progressivity of the Commonwealth personal income tax, 1917–1997', *Australian Economic Review*, vol. 34, pp. 263–78.

Historical overview of Australian progressive taxation

Historically, land and estate taxes as well as income taxes have been used to achieve tax progressivity in Australia. While the Commonwealth income tax has been the main instrument of progression in the national tax system since World War II, State income taxes were more important before that time.

The tax share of GDP has risen substantially over the century, from around 5 per cent at Federation to 22 per cent by 1955, and around 30 per cent by the late 1990s.[15] Over the same period, the former dominance of indirect taxes (mainly customs and excise duties and, from 1930, the wholesale sales tax) has been reversed. Expansion of income taxation was the main factor behind this reversal. As indirect taxes are less capable of distinguishing individual capacity to pay, the expanded revenue-raising role of the income tax in itself increases the overall progressivity of taxation.

Clearly, the evolution of progressive income taxation in Australia has been strongly shaped by periods of national crisis, namely the two world wars and the 1929–32 Depression. The Commonwealth Government introduced the first national income tax as a 'war tax' in 1915. However, the peace-time income tax dominance of State governments was restored during the Depression when State governments introduced special income and wage taxes on lower income ranges to finance unemployment relief and social assistance. By the mid 1930s, the revenue importance of such special income and wage taxes exceeded that of the States' ordinary income taxes.

This expansion of States' taxation of incomes reinforced their role as the primary income taxing authorities in Australia. In 1932–33, States' revenues from taxes on incomes were double the amount of Commonwealth income tax revenues; by 1938–39, the States were collecting around £30 million annually in income taxes compared to £12 million by the Commonwealth. By then, State governments collected around 40 per cent of Australian tax revenues despite Commonwealth access to large customs and excise and sales tax revenues. In 1942, the Commonwealth Government exercised its constitutional defence and grants powers to collect all income taxes in Australia. This was a massive structural reform of Australia's taxation and public finance system with no parallel in the post-war period.

During the post-war period, the income tax in Australia is said to have made the transition to being a 'mass tax' (Groenewegen 1988). There were some significant changes to the nature of income taxation between 1942 and 1955 but between 1954–55 and 1969–70 the Australian income tax schedules and structure were substantially unchanged. The only important legislative changes to income tax over that latter period were tax surcharges or rebates periodically introduced or removed to meet macroeconomic management objectives (Smith 1993b).

The lack of household expenditure data in Australia prior to the late 1960s precludes comprehensive analysis of tax incidence such as that by Bentley and others (Bentley, Collins and Drane 1974; Bentley, Collins and Rutledge 1975, 1979), or more recently by Warren (1989; 1997), which includes indirect taxation. Studies of longer-term trends in the progressivity of Australian taxation have, therefore, typically focused on direct taxation, in particular the Commonwealth income tax, and the use of various measures of tax progressivity to gauge trends over time. The following section considers the theoretical properties of the global tax indices used in existing studies of tax progressivity in Australia before presenting results of comprehensive estimates for essentially the whole period of Commonwealth income taxation since 1916.

[15] Historical data series on Australian public finances since Federation are found in Barnard (1985, 1986a, b).

Method

While identifying a tax as *progressive, proportional* or *regressive* is easy, measuring the *degree* of tax progressivity is more difficult.[16]

Both 'local' and 'global' measures are used to measure tax progressivity. However, only global tax progressivity measures can measure the degree of tax progression, or progressivity of the whole tax schedule. Global tax progressivity indices take account of both the tax rate structure and the underlying distribution of income and income-earners.[17]

Global tax indices fall into two categories: those measuring the relative deviations of tax paid from a yield-equivalent proportional tax, and those comparing shares of pre-tax income with shares of after-tax income. The former are based on normal tax concentration curves, known as 'Aggregate Tax Redistribution' (ATR) measures, while the latter are based on relative concentration curves and are denoted 'Aggregate Income Redistribution' (AIR) measures.[18]

The distinction between the ATR and AIR categories of global tax progressivity indices reflects two schools of thought on measuring tax progressivity. One view sees tax progressivity as how much the distribution of the tax burden deviates (in favour of lower income groups) from a proportional spread of taxation (Kakwani 1977a; Khetan and Poddar 1976; Suits 1977b). The measures of tax progressivity proposed by this view do not vary with the severity/level of taxation, so that an equi-proportional percentage change in tax rates has no effect on measured tax progression.

One example of this type of index is the K index, which compares the Gini coefficient for before-tax income, with a 'concentration curve of taxes' (Kakwani 1977a, 1977b). This index is implicitly weighted by population shares, and a value between 0 and 1 represents a progressive tax. The index shows a value of zero for a proportional tax, while a regressive tax has a negative value.

Another such index, the Suits measure (S), compares the concentration curve of taxes in relation to incomes with that given by a proportional distribution of the tax burden (Suits 1977b). It relates the cumulative distribution of taxes paid to the cumulative distribution of income. Although the S index is conceptually similar to the K measure, in quantifying the deviation from proportionality in the distribution of tax payments, it is implicitly weighted by income shares rather than by population. Unlike the K index which ranges in value between -2 and 1, the S index for a progressive tax ranges between 0 and 1, and for a regressive tax takes a negative value between 0 and -1.[19]

The income redistribution view, on the other hand, judges tax progressivity according to how much a given tax structure reduces the post-tax income inequality (Jacobsson 1976; Liu 1985; Musgrave and Thin 1986 [1948]). This implies the need for measures of tax progression that encompass the severity of taxation as well as its income elasticity. Proponents of this approach, Musgrave and Thin, argued that '... a direct measure of the equalising effects of a tax [is] after all, the essence of any progression policy' (1986 [1948], p. 148).

The M–T index is the most long-established global measure of tax progressivity. It compares the concentration of after-tax incomes as measured by a Gini (Lorenz) coefficient with that for the concentration of pre-tax incomes. Implicitly the measure is weighted by both income and population shares. A progressive tax has an M–T ratio greater than one, with a

[16] Progressivity is usually defined as where the average rate of taxation rises when moving up the income scale (Musgrave and Thin 1986 [1948]).

[17] The relation between local and global measures was clarified by Pfahler (1987): the different global measures are aggregates of corresponding local indices of tax progressivity, each using a unique set of weights.

[18] The two classes of global indices can also usefully be further classified into those using only income shares in their weighting functions, those using only population shares including those using both income and populations shares and those using tax shares (Cassady, Ruggeri and Wart 1996).

[19] These two indices, and their graphical representation, are compared in Formby, Seaks and James-Smith (1981) and Formby and Sykes (1984).

rising index over time implying increasing tax progressivity.[20] This approach focuses on the extent of redistribution due to taxation as evidenced in the distribution of post-tax incomes.

Because these three indices are measuring different things, they respond differently to tax changes. As the M–T index is sensitive to tax yield, it can rise without an increase in any marginal tax rate. It may take on a large value for a tax system that raises a large revenue even if the average tax rate rises with income relatively slowly. It will always be low for a tax that is too low to significantly influence the after-tax income distribution.

The S and K indices, by contrast, are unaffected by a constant rate tax surcharge. They will take on a large value for a tax which has little effect on the after tax distribution but for which the average tax rate increases steeply with income.

In times of rising incomes, M–T may move differently from S and K depending on whether yield effects or the 'compressing' effects of income inflation on the distribution of tax liabilities dominate the rise in tax liabilities.[21]

Empirical studies for North America have shown that the three tax progressivity indices will also not necessarily move in the same direction as the distribution of income varies (Formby, Seaks and James-Smith 1981; Formby and Sykes 1984). For example, the M–T index may move in the same direction as the K index if tax yield is constant, but not necessarily the same as the S index. The last, being weighted by income rather than population, responds differently to changes in the distribution of income and so may move in the opposite direction to K when pre-tax income inequality varies.

That is, all three indices are sensitive to changes in the shape of the underlying distribution of incomes, so that the possibility of changes in the income distribution must be borne in mind when interpreting long-term changes in the tax progressivity indices, as well as in cross-country comparisons. It should also be noted that global measures do not account for incentive effects of taxation, which may alter the level and distribution of pre-tax incomes.

During the 1980s there were attempts to provide a normative foundation for choosing between the measures.[22] Tax regimes affect social welfare by altering the level and distribution of after-tax incomes. Evaluating different tax regimes involves judging the resulting after-tax income distributions according to some consistent criteria.

As Atkinson (1970) showed, the degree of inequality cannot, in general, be measured without introducing social judgements. Measures such as the Gini coefficient embody implicit judgements about the weight to be attached to the inequality at different points on the income scale and are not purely 'statistical'. This also applies to indices evaluating tax progressivity where, for example, a tax system is progressive over one range of income distribution and regressive over another. If the curves intersect, summary indices do not permit valid judgements about relative degrees of inequality without knowing details of the social welfare function.

It has therefore been argued from cross-country and historical comparisons of tax progressivity that:

> A defensible procedure for using the summary measures would seem to require that a check for crossing be performed and that either the distributions or corresponding concentration curves should be reported so that policymakers

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[20] The M–T index can be represented graphically through using the familiar Lorenz curve. See Khetan and Poddar (1976) for detailed discussion of the graphical representation of this index.

[21] Khetan and Poddar (1976) discuss the different effects on tax progressivity of nominal income increases in the face of unchanged tax schedules. On the grounds of sensitivity to inflationary and growth effects on tax yield, they argue the superiority of the tax redistribution measures such as the K and S indices over the M–T index and related measures which respond to tax yield.

[22] Atkinson (1970), Blackorby and Donaldson (1984), and Kiefer (1985) have discussed tax progressivity measures based on an explicit social welfare function. Reflecting criticisms that certain global indices do not provide the basis to make consistent rankings of tax regimes, Blackorby and Donaldson (1984), along with Pfingsten (1986) and Ebert (1992) have taken an axiomatic approach to deriving global indices, identifying their desirable properties from basic social welfare principles.

and other users are aware of the underlying distributions (Formby and Sykes 1984, p. 311).

Musgrave and Thin foreshadowed this issue in a taxation context in 1948, noting that various interest groups responding to a tax increase will each attempt to justify shifting the burden to other income classes through proposals measured against criteria which minimise the change from the status quo: 'the rich man's order of preference for rate increase is the poor man's order of preference for rate reduction, and vice versa' (Musgrave and Thin 1986 [1948], p. 147).

Despite the early consensus favouring the K and S type indices (Kakwani 1977a, 1977b; Suits 1977b, 1980), there is a tendency in recent literature to prefer 'income redistributional' measures of tax progressivity of the M–T type because they are more suitable for evaluating non revenue-neutral changes, and, therefore, 'fiscal incidence' (Cassady, Ruggeri and Wart 1996).

Despite the limitations of global measures of tax progressivity, and although drawing inequality or welfare conclusions from a single summary measure of tax progressivity is probably too ambitious, such indices arose because they provided useful information on the redistribution impact of taxes (Cassady, Ruggeri and Wart 1996). The conflicting concepts of progressivity reflected in the different tax progressivity indices may be useful in analysing actual tax regimes precisely because of their differences. Careful supplementation of global tax progressivity measures with the use of local measures may remedy their deficiencies in gauging effects on inequality (Baum 1998; Musgrave and Thin 1986 [1948]; Tran-Nam 1992).

The M–T, S and K global tax progressivity indices have been used to investigate changes in progressivity over time and to make comparisons across countries and at the sub-national government level (Formby and Sykes 1984; Scott and Triest 1996).[23] The M–T, S and K indices have been applied to Australian personal income tax data for varying periods since the early 1950s. Hancock (1971) using a variant of the M–T index, Alchin (1983b), applying the S index, and Alchin (1984), using the K and M–T indices, found Commonwealth income tax progressivity declined during the 1950s and 1960s. Harris (1970), using an M–T type index, found progressivity increased slightly between 1955 and 1969–70, but this conflicting finding resulted from comparing just two points in time rather than examining a continuous series. Kakwani (1977b), in his international comparison, found little change in income tax progressivity in Australia for a five-year period from 1966–67. The declining tax progressivity identified in Australia by both Hancock and Alchin is evident for Canada and the United States over similar periods (Khetan and Poddar 1976; Silber 1994).

These estimates for Australia are replicated, extended, and assessed against the background of results from empirical evaluations of global tax progressivity indices in other countries in the following section.

Data

This study uses taxation statistics published annually in the reports of the Commonwealth Commissioner of Taxation since income year 1916–17. The data relate to taxable income of taxpayers and the amount of Commonwealth income tax paid, categorised by grade of income for individual taxpayers.

It is well recognized that such taxation statistics have some significant deficiencies, with potential for erroneous or biased results (for example, see Jones 1975 and Hancock 1971). Nevertheless, the paucity of other data for earlier historical periods forces a reliance on taxation statistics in a number of studies of tax progressivity and even income distribution both in Australia and overseas (Maddock *et al.* 1984).

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[23] While the latter simply apply global tax progressivity measures to State income tax regimes, to identify the extent to which States act to offset the effects of federal tax measures, Scott and Triest (1996) point out that the issue is more complex where State income taxes are deductible from federal taxes. Where a progressive federal income tax is increased, the value of deductions increases, thereby reducing the effective progressivity of progressive State income taxes.

The most significant deficiencies of these data for present purposes relate to the narrow definition of economic income measured in Commonwealth income taxation statistics, and the ambiguities associated with using the individual as the unit of analysis:

- The Commonwealth income tax has virtually since its inception applied to a very narrow definition of income compared to the Haig/Simons concept of economic income, and compared to that applied in other countries. In particular, capital gains tax has been included in Commonwealth individual income taxation statistics only from its introduction in 1986. Fringe benefits tax, which is a conceptually similar tax on economic income, has also only been levied since 1986, and is still not included in income tax statistics being imposed on employers rather than individuals.
- Related to the exclusion of capital gains from taxable income, there is a likely understatement of true incomes due to tax evasion or avoidance. The non-taxation of most capital gains, exploitation of negative gearing provisions, and the difficulties in preventing artificial income splitting or diversion of income to trusts or private companies have contributed to this problem.
- The statistics exclude a significant number of income-earners and income falling below the taxable threshold, as not all income-earners must file returns. The proportion of income-earners who are taxpayers varies substantially over time, especially if comparing the inter-war and the post-war periods. This is discussed further below.[24]
- Most welfare or equity debates assume the household is the economic unit. The redistributive impact of taxation on individuals may differ from its impact on households because households may have more than one income-earner. Ambiguities also arise because of the varying extent to which income taxation based *de jure* on an individual unit has recognised financial responsibility for supporting dependents. These issues become more important during recent decades of the last century compared with earlier decades because of the increased labour-force participation of married women with children since the 1960s.
- What is taxable will change from time to time, so that gross income will not always bear a consistent relationship to taxable income, and the distribution of gross income can vary from the distribution of taxable income. Hence changing levels and real values of statutory exemptions and other deductions such as for dependants, or the tax status of social security payments,[25] may bias or introduce measurement errors into estimates of tax progressivity.[26]

There are also specific deficiencies over certain periods. For example:

- The data for the first full year of operation of the income tax, the 1915–16 income year, are highly unreliable due to technical and legal difficulties in implementing the tax, and because the published data on taxpayers are incomplete.
- During and immediately after World War II, the data are somewhat incomplete and possibly biased by the exclusion of 'delayed assessments'.[27]

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[24] The proportion of income earners excluded from the statistics may vary due to tax measures affecting statutory exemptions, minimum taxable incomes, and concessional deductions or rebates. Shifts in economic and demographic variables such as rising incomes, or changing family size or composition will also influence the relative size and composition of the group defined as 'taxable individuals'.

[25] These were taxable from 1944.

[26] Over the period 1950–51 to 1966–67, the difference between the Gini coefficients of gross and taxable incomes estimated by Hancock (1971) does not exceed 2 per cent. However, the difference may be greater in the interwar period. From sporadic data available on gross incomes or the value of deductions from tax for 1918–19, 1921–22, 1935–36, 1939–40, and 1940–41, it seems the difference could range from around 10 per cent just after World War I to as much as 25 per cent on the eve of the World War II.

[27] These are returns assessed eighteen months or more after the end of the relevant income year. In the early 1950s these returns were unexpectedly found appreciable in number, and variable from year to year (Brown 1957). From this time 'final returns' were published in later taxation reports. However, as no final returns were available for the

- The data exclude the tax-exempted incomes of servicemen during wartime.
- Until 1921–22, income tax statistics were aggregated for all taxpayers, thus making it difficult to distinguish between company and individual taxpayers.
- Taxation statistics report little detail on the distribution of the War Tax imposed from the income year 1940–41, which applied to virtually all income above £156.[28]
- The data are grouped by taxable income categories until 1947–48, when categorisation by 'actual' (that is, gross) income is introduced. [29]

Results

Personal income tax progressivity for Australia for the income years 1916–17 to 1996–97 was measured by calculating the three indices of tax progressivity discussed above, using taxation statistics from annual reports of the Commissioner of Taxation. Table 3.1 reports these data and Figure 3.1 shows these trends graphically for the period 1916–17 to 1996–97.

Overall, tax progressivity peaked in either 1941–42, 1950–51, or 1974–75, depending on which index is used. All three indices indicate peaks in progressivity in 1941–42 and 1950–51, when rising average rates and a steepening tax scale were working in the same direction.

The most striking features of the data are:

- sharp fluctuations in tax progressivity during the Depression and World War II;
- the relative stability in Commonwealth income tax progressivity for most of the period prior to World War II and since the late-1970s;
- a peak in tax progressivity in the early-1950s, on the K or S measures, and a strong decline till the late-1970s;
- only slight, temporary increases in progressivity were associated with tax reforms in the mid-1970s and the mid-1980s;
- an ambiguous trend on the M–T index, which peaks in the early-1950s as well as in the mid-1970s and mid-1980s; and
- occasional divergent movements in the indices.

Interpretation of results

Interpretation of global measures may need to be supplemented by local measures and comparison of Lorenz curves (Baum 1998; Formby and Sykes 1984). An examination of the Lorenz curves associated with estimates of the S index is summarised in Figure 3.2.

It is concluded that:

- The shift to the left evident over time for all points on the curve between the 1916–17 income year and the 1995–96 income year shows an unambiguous decline in measured progressivity over that period.
- A similar unambiguous conclusion can be drawn regarding the decline in progressivity between 1995–96 and 1938–39, 1942–43 and 1951–52, and the higher progressivity in 1938–39 and 1951–52 than in 1942–43.

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earlier period covered by this study, it is considered preferable to rely on the incomplete data even for the years when final data were later published.

[28] The War Tax did not allow the deductions for dependants that were available under the ordinary income tax, and the statutory income tax exemption for a single person was £200, the War Tax applied to a significant number of individuals who were not subject to ordinary income taxation. To estimate the taxable income of the group brought into the tax field by this War Tax, it was necessary to derive it by multiplying the reported number of War Tax payers in this category by an average net income. This was assumed to be £100.

[29] This creates some difficulties in comparing pre-1947–48 global tax progressivity indices with the existing studies by Hancock and Alchin because those studies appear to estimate after-tax income by deducting tax paid from gross- rather than taxable income. However, this only affects comparisons with their estimates of the M–T index, as those studies used taxable income to estimate S and K.

Table 3.1
Global Tax Progressivity Indices, Australia, 1916–17 to 1996–97

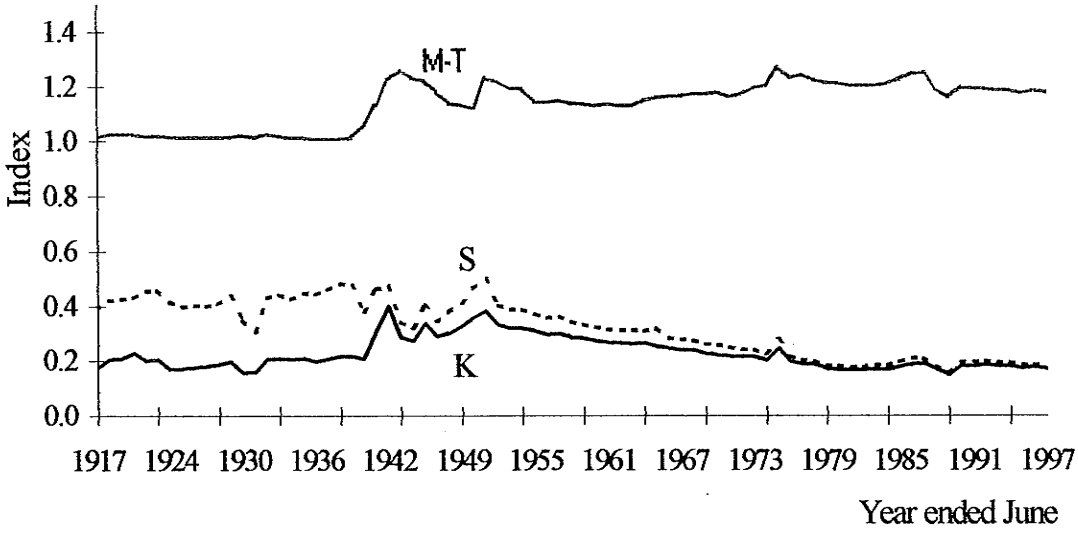
Year ending June	*M–T*	*K*	*S*	*Year ending June*	*M–T*	*K*	*S*
1917	1.017	0.173	0.392	1958	1.139	0.287	0.342
1918	1.028	0.204	0.421	1959	1.137	0.280	0.333
1919[a]	1.027	0.208	0.425	1960	1.129	0.271	0.324
1921	1.028	0.227	0.431	1961	1.136	0.268	0.315
1922	1.021	0.201	0.456	1962	1.128	0.265	0.312
1923	1.022	0.203	0.458	1963	1.128	0.260	0.311
1924	1.018	0.170	0.416	1964	1.148	0.263	0.308
1925	1.016	0.171	0.397	1965	1.158	0.250	0.317
1926	1.016	0.173	0.402	1966	1.163	0.244	0.284
1927	1.015	0.178	0.400	1967	1.166	0.238	0.277
1928	1.015	0.186	0.409	1968	1.172	0.237	0.274
1929	1.019	0.197	0.437	1969	1.170	0.226	0.261
1930	1.023	0.153	0.350	1970	1.177	0.221	0.257
1931	1.016	0.158	0.306	1971	1.161	0.214	0.251
1932	1.027	0.205	0.431	1972	1.171	0.212	0.240
1933	1.021	0.207	0.443	1973	1.191	0.213	0.240
1934	1.013	0.203	0.427	1974	1.202	0.201	0.226
1935	1.012	0.208	0.449	1975	1.265	0.244	0.275
1936	1.009	0.195	0.443	1976	1.229	0.195	0.214
1937	1.009	0.205	0.459	1977	1.242	0.187	0.203
1938	1.010	0.215	0.483	1978	1.220	0.186	0.199
1939	1.014	0.216	0.475	1979	1.210	0.172	0.181
1940	1.060	0.205	0.380	1980	1.208	0.167	0.181
1941	1.131	0.313	0.463	1981	1.198	0.164	0.176
1942	1.224	0.399	0.471	1982	1.200	0.163	0.176
1943	1.258	0.287	0.342	1983	1.199	0.169	0.185
1945[b]	1.231	0.271	0.321	1984	1.207	0.166	0.182
1946	1.221	0.335	0.402	1985	1.224	0.177	0.196
1947	1.179	0.289	0.344	1986	1.243	0.187	0.208
1948	1.138	0.300	0.377	1987	1.246	0.187	0.209
1949	1.129	0.325	0.412	1988	1.187	0.166	0.178
1950	1.122	0.357	0.464	1989	1.156	0.146	0.148
1951	1.228	0.381	0.497	1990	1.192	0.178	0.193
1952	1.216	0.329	0.404	1991	1.188	0.179	0.195
1953	1.192	0.319	0.387	1992	1.186	0.183	0.198
1954	1.192	0.319	0.386	1993	1.181	0.178	0.192
1955	1.144	0.309	0.372	1994	1.182	0.179	0.191
1956	1.140	0.296	0.357	1995	1.171	0.171	0.183
1957	1.147	0.299	0.362	1996	1.182	0.176	0.187
1958	1.139	0.287	0.342	1997	1.174	0.168	0.179

Notes: [a] Taxation statistics were not available for the income year 1919–20.

[b] To avoid levying two years of taxation on the same year of income with the introduction of PAYE in 1943–44, tax was substantially remitted so that income year is omitted here.

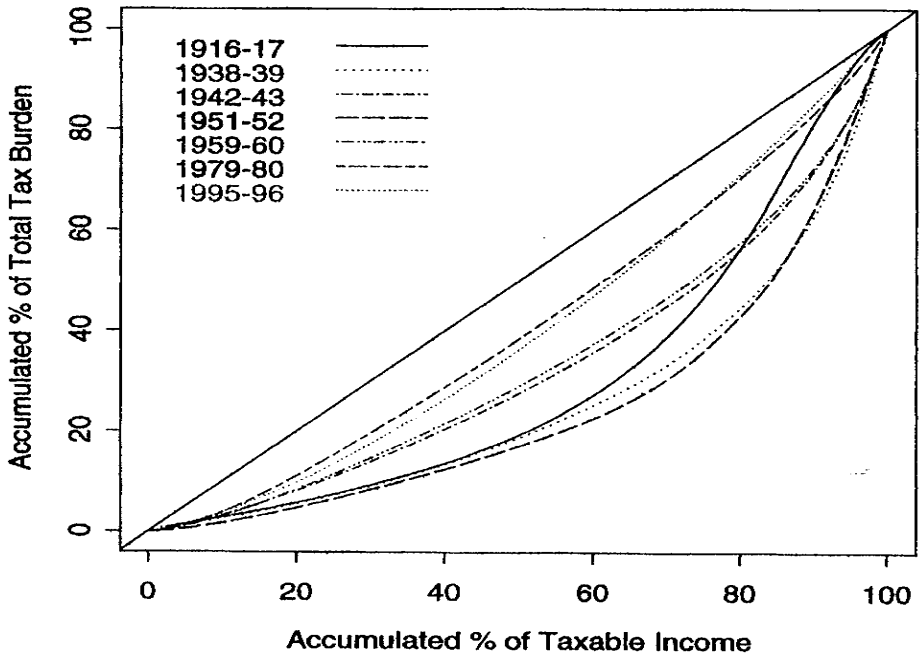
Source: Derived from Australia, Office of the Commissioner of Taxation, various years; ATO, various years.

Figure 3.1
Global Tax Progressivity Indices,
Australia, 1916–17 to 1996–97



Source: See Table 3.1.

Figure 3.2
Lorenz Curves for Suits Index of Tax Progressivity, Australia,
selected years 1916–17 to 1996–97



Source: See Table 3.1.

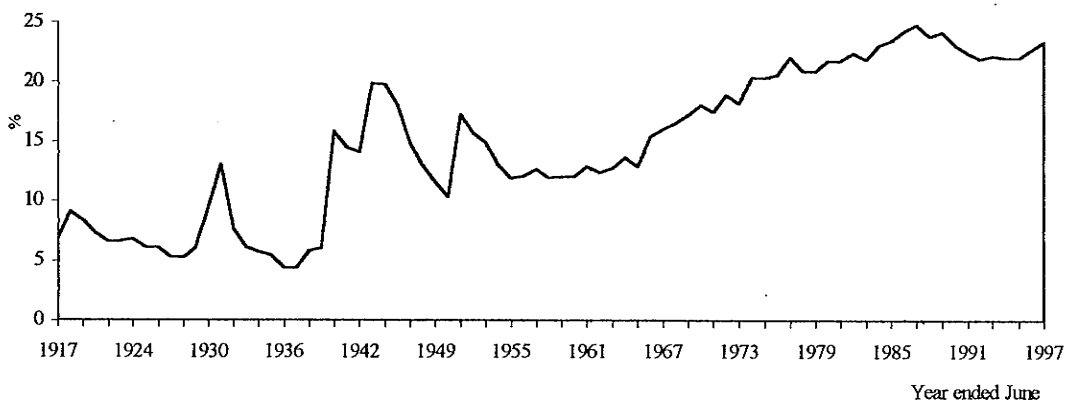
- However, where the curves cross, the rankings given by the S index are more ambiguous. For example, the direction of change implied by the S index between 1995–96 and 1979–80 depends on the weight one places on the slightly higher taxes paid by the very highest income brackets in the latter year as against the slightly lesser progressivity of the rest of the income range.
- Likewise, comparisons of progressivity ranking between 1916–17 and 1942–43, 1959–60 and 1979–80 produce ambiguous results.

Comparing movements in the indices (Figure 3.1) with average tax rates (Figure 3.3) shows patterns consistent with those noted in the 'Methods' section above and with the findings of other studies (Khetan and Poddar 1976) on the properties of the different measures.

The trend of the M–T index is dominated by changes in the structural progression of the income tax during the early decades of the century, when it moved closely with the other two indices. As revenues rose during the Depression due to the greater average severity of taxation the M–T index changed little despite the marked falls in tax progressivity suggested by the K and S indices.

As noted in the 'Methods' section above, the M–T index is sensitive to tax yield and rises with the average tax rate, even if the structural progression of the tax does not rise. Thus the trend in the M–T index diverges markedly from the S and K indices from the 1950s, with a rising average severity of income taxation. The M–T index reaches a maximum of 1.27 in the mid 1970s, when the average tax rate was close to a post-war peak and the income tax structure was at the same time restructured more progressively (Figure 3.1). This compares with a 50coefficient of 1.23 in 1950–51.[30] This pattern confirms the findings of other studies on the importance of average tax burden for the rankings given by the M–T measure.

Figure 3.3
Average Tax Rates on Taxable Income, Australia, 1916–17 to 1996–97



Source: See Table 3.1.

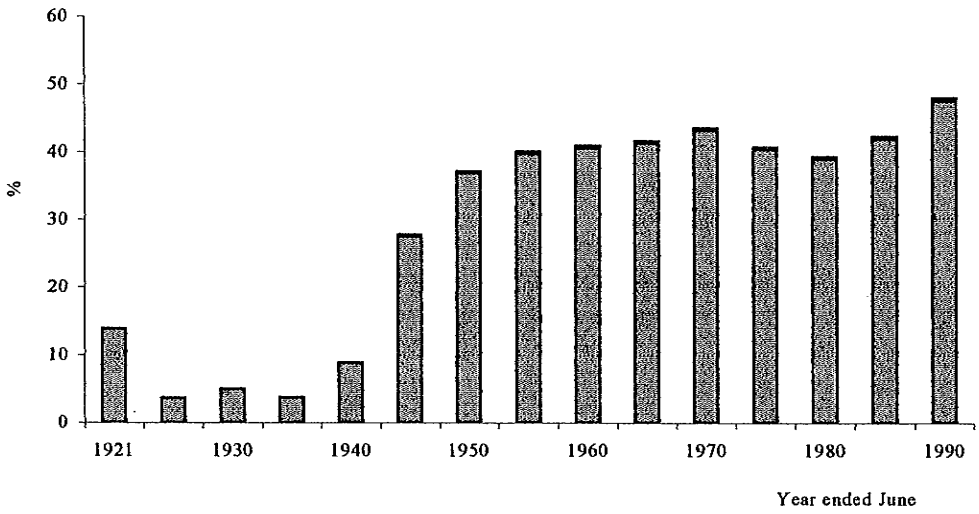
The K and S indices generally move closely together as expected. However, there are divergent movements in the S and K measures for some periods. This may reflect either tax policy changes affecting the distribution of taxable income or underlying changes in the measured distribution of incomes.

[30] A continued rise in average tax rates to the mid 1980s was partly offset by the decline in the progressivity of the income tax structure. Even so, the M–T index reached 1.24 in 1985–86 because of tax reforms following the National Tax Summit.

This highlights difficulties arising from inadequacies inherent in the taxation statistics. Where there are major changes in the scope of income taxation, the characteristics of the taxpayer income distribution, as measured by taxation statistics, may change dramatically. For example, changes to the minimum taxable income levels introduced for 1942–43 brought a large number of additional income-earners into the Commonwealth income tax system (around 300,000). The taxpayer proportion of the population consequently rose from around 5 to 10 per cent before World War II to around 50 per cent by 1947, and to some 60 per cent by the early 1950s. Such factors were clearly important from the beginning of World War II, when the income distribution characteristics of the Commonwealth taxpayer population altered substantially (Figure 3.4).

The substantial change in the proportion of incomes covered by income taxation over the eight decades under consideration affects interpretation of the tax progressivity indices. Ideally, income distribution surveys would allow adjustment for excluded incomes to ensure consistency over time in the population being considered. However, this is only possible for three years in the eighty-year period. These three years are those covered by the 1915 War Census, the 1933 Census, and a limited census taken during World War II. These can be supplemented by reports in official or academic studies relating to Commonwealth income taxation (see Brown 1957; Richardson and McLean 1986; and Jones 1975). Such approximate adjustment for excluded incomes and income-earners suggests our measures of Commonwealth income taxation progressivity would be considerably increased in the pre-1942 period if the exclusion of the large body of income-earners from taxation were taken into account.[31]

Figure 3.4
Taxpayer–Population Ratio,
1920–21 to 1989–90



Sources: Derived from Australia, Office of the Commissioner of Taxation, various years; ATO, various years; Vamplew (1987).

[31] This is because non-taxpaying individuals' share in the income-earning population is greater than their share of aggregate income and is substantially greater than their (zero) tax share. This makes the distribution of the tax burden more progressive — how much more so depends on how equally income was actually distributed among non-taxpayer income earners. These individuals are assumed here to have equal incomes, as information on income distribution within this income class is not available from the relevant censuses and surveys. This could bias adjusted tax progressivity measures upward.

Also, it is difficult to gauge the effect of the non-taxation of economic income such as capital gains. As noted earlier, the income tax in Australia has been very narrowly defined to exclude capital gains. Taxable income statistics will also understate economic income due to tax evasion or tax avoidance activities. This affects measures of tax progressivity because such unreported income is more likely to accrue to high income taxpayers, and can amount to a considerable proportion of their economic income. For example, Musgrave (Table 19.4, in 1989, p. 330) found for the early 1980s that between a quarter and a third of the reported income of high income individual taxpayers[32] in the US derived from sale of capital assets, while the average for US taxpayers generally was around 2.5 per cent of gross income.

The primary focus of this study is the trends over time, rather than the level of the tax progressivity indices at any particular point in time. In interpreting the estimates, attention should therefore focus on a) how the magnitude of such unreported income may have changed over time in relation to reported taxable income; b) how its distribution between the high income group and other taxpayers may have changed over time; and c) the share of such non-taxable income in the incomes of the high income group.

Some indication of the potential magnitude of such effects is given in Hancock's (1971) study, which compared reported taxable income with estimates of personal income derived from the national accounts for the period 1950-51 to 1966-67. The gap was around of 10-12 per cent. Hancock concluded that levels and trends in income tax progressivity indices would not be substantially altered by including unreported income during that period.

It is possible to gauge to some extent[33] the amount of previously untaxed capital gains and fringe benefits income from taxation statistics on reported capital gains and fringe benefits since the introduction of capital gains and fringe benefits taxation in 1985. For income year 1998-99, for example, taxpayers reported a total of $17.5 billion of net capital gains,[34] and the ATO collected fringe benefits tax on an estimated $6.8 billion of fringe benefits.[35] These added 1.9 and 2.4 per cent to total taxable income respectively. Consistent with data for the United States reported above, 56 per cent of net capital gains of individuals were by individuals with taxable incomes of $50,000 and above. Net capital gains were nearly 20 per cent of the taxable income of those earning $1 million or more and 10 per cent of taxable income for individuals earning between $500,000 and $999,999 of annual taxable income.

As there is little reason to expect accumulation of capital gains was less important in earlier decades, at least during the postwar period, this implies that excluded income such as capital gains is likely to have been a) sizeable and b) highly skewed over much of the period covered by this study, although it is not possible to determine the extent to which these patterns have changed over time. Assuming that income tax year 1998-99 reasonably represents the level and distribution of capital gains in earlier years, and that the income distribution of fringe benefits is similar to that for capital gains,[36] it is possible to recalculate the K, S and M-T indices to ascertain the sensitivity of results to the exclusion of such income. The M-T index would fall in progressivity from a value of 1.23 to around 1.18, the K index would fall from

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[32] Those earning US$500,000 or more in adjusted gross income in 1984.

[33] The capital gains tax regime remains highly concessional, being levied on a realisation not accrual basis, on a real, rather than nominal basis, excluding gains on owner occupied housing, and with substantial exemptions including on rollovers at death and divorce, and for small business owners. Assets acquired before introduction of capital gains taxation in 1985 remain exempt, although with turnover of assets since 1985, the significance of this exclusion is diminishing.

[34] Only around $5.6 billion of net capital gains were taxed in the hands of individual taxpayers: the rest accrued to companies and superannuation funds. However, it may be reasonably assumed that the income of superannuation funds and companies ultimately accrues to individuals in the form of benefit payments and dividends.

[35] This estimate is based on fringe benefits tax collections of $3.3 billion reported in the taxation statistics for that year, and a fringe benefits tax rate of 48.5% on the grossed up value of fringe benefits.

[36] This is a conservative assumption as fringe benefits paid to employees may be somewhat more evenly distributed than reported capital gains.

0.18 to around 0.15 and the S index would fall from 0.20 to 0.15 if an additional $4.8 billion[37] of taxable income had been attributed to taxpayers in the 1984-85 income year, the last year before capital gains and fringe benefits taxation was introduced. If capital gains accruing to superannuation funds and companies were attributed to individuals however, the impact is much greater, with the M-T index falling to 1.07 and the K and S indices falling to 0.09 and 0.06 respectively. That is, the income tax becomes virtually proportional in this case.

It would not be practical to extend such calculations to earlier periods because the income categories reported in earlier taxation statistics do not correspond sufficiently with those for later period. However, the above emphasises that the progressivity indices estimated in this study relate to a narrow share of the true income base. It might be assumed that the extent of excluded income in the form of capital gains and fringe benefits, and the distribution of such economic income has remained relatively constant over the period since 1917. It would be reasonable to expect that capital gains and fringe benefits were less important in the pre-1939 decades of low inflation and low marginal tax rates, and would become more important during periods when marginal tax rates were high and/or when inflation, and tax avoidance and evasion activity was increasing. This reinforces the suggestion that progressivity declined from the 1960s.

Furthermore, these long-term data relate only to trends in the Commonwealth income tax. As noted earlier, until 1942 this tax coexisted with State income taxes. Examination of State tax progressivity in Chapter 4 below indicates that State income taxes were more regressive than the Commonwealth tax. This was partly because of income tax policies adopted by States during the Depression (Bland 1976 [1934]), but also reflected an understanding reached during Commonwealth–State negotiations on taxation during the 1920s that the Commonwealth would restrict itself to taxing the highest incomes (Copland 1980b [1927]). The Uniform Income Tax of 1942 aimed to approximate the incidence of these existing State and Commonwealth income taxes. The apparent decline in the progressivity of the Commonwealth tax from 1942–43 is thus mainly due to its incorporating the less progressive State income and wage taxes.

Recognising the predominant role of the States in income taxation points to the 1930s Depression, rather than World War II, as a major turning point in policy on income taxation in Australia. During the Depression States expanded income taxation of wage earners to fund unemployment relief and social services. The predominant role of State income taxation before 1939 highlights its importance in determining long-term trends in progressivity of Australian income taxation.[38]

Despite these changes in the coverage of the income tax, valid comparisons may be made of changes in tax progressivity between some years in the pre-1942 period, and some years in the post-1942 period. Examination of the Lorenz curves for the S index suggests that comparison of 1995–96 with 1916–17 is also valid, subject to the approximations required to adjust for incomes excluded from taxation under the Commonwealth income tax until 1942.

The long-term trends suggest both a substantial degree of long-term stability in the taxation system and a change in the redistributional role of income taxation since the 1950s. From that time, the structural progression of the income tax diminished, while the redistributional effect of its enhanced revenue-raising role came to the fore. Over this period, the Commonwealth income tax became a 'mass tax' rather than the 'class tax' of the pre-1942 era.

The erosion of structural progressivity is substantially a reflection of an unchanged tax rate schedule in the face of accelerating nominal incomes growth during the three decades after World War II. A similar trend is evident for other countries such as Canada and the United States over the same period (Khetan and Poddar 1976; Musgrave 1987). This trend of

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[37] Assuming that the capital gains and fringe benefits taxes increased total taxable income by as much in 1984-85 as it did in 1998-99 (1.9 per cent and 2.4 per cent respectively).

[38] As State income taxes were deductible from Commonwealth income tax for most of the period, changes in the Commonwealth income tax also had direct implications for the effective progressivity of the State income taxes. See Scott and Triest (1996) for a contemporary examination of this issue in the North American context.

diminishing progressivity would be reinforced, rather than weakened, by the unmeasured growth of tax avoidance activities among high-income earners since the late 1950s. It is unlikely to be substantially altered by changes in the coverage of the Commonwealth income tax, as this was relatively stable at around 40 per cent for the three decades from the mid 1950s.

By contrast, the unambiguous shifts in measured income tax progressivity during the Depression and World War II arose from changes in tax laws deliberately enacted by the Commonwealth Parliament. For example, tax policy changes that measurably affected trends in tax progressivity were:

- the lowering of the exemption for property incomes (£200) and personal incomes (£250), and a 'further tax' surcharge of 7.5 to 10 per cent for property incomes, which combined with higher income tax rates, resulted in a less progressively distributed Commonwealth income tax burden during the Depression from 1929–30;
- the introduction of a reduced statutory exemption for ordinary income tax of £200, along with the lowering of the statutory exemption to £104 in 1942–43, which implied a drop in progressivity by all three measures;
- a reduction in the relatively regressive Social Security Contribution from 1946–47 and expansion of concessional rebates, producing a peak in tax progressivity in 1950–51;
- a change from personal rebates to deductions in 1950–51, along with an increase in the minimum tax threshold, a move to a stepped rate rather than continuously progressive tax scale, and replacement of differentially higher rates of taxation of property incomes with a 'further tax' which was abolished from 1955;
- the reform of income taxation rates and brackets in the 1974–75 income year;
- reforms to the income tax base, thresholds and rates between 1984–85 and 1986–87, including the introduction of a capital gains tax.

It can be seen from Figure 3.1 that the major decline in tax progressivity from the mid 1950s to the late 1970s dwarfs the effects of even the sharp reductions in progressivity brought about by the Menzies Government's tax reforms during the early 1950s. These changes included replacing tax rebates with deductions, abolishing differential taxation of 'earned' and 'unearned' incomes, and restructuring tax rates. Likewise, the Hawke Government's introduction of the capital gains tax was intended to protect vertical equity against flatter personal income tax scales, but the revenue it collected from high income earners made only a small and temporary impression on the overall progressivity of the Commonwealth personal income tax.[39]

Over this period, income tax progressivity as measured by the yield-invariant K and S indices was drastically reduced. The trend only stabilised from the late 1970s. The decline in measured income tax progression was attributable to the effects of rising money incomes — 'bracket creep' and 'fiscal drag' on the progressivity of income taxation during the 1950s and 1960s, pointing to the importance of interactions of the tax system with changes in the economy.[40]

It also draws attention to a phenomenon labelled 'tax policy inertia', identified in studies of fiscal politics in the United Kingdom (Rose and Karran 1987). The observed stability in tax systems led Head (1993a) to characterise taxation as 'quasi-constitutional' in nature, with

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[39] Fringe benefits tax may have at least equalled the importance of capital gains tax in maintaining progressivity, having a similar yield, and having been less subjected to erosion since its introduction. However, as noted earlier, fringe benefits tax is not included in individual income tax data and is not encompassed in the analysis in Table 3.1.

[40] In times of rising prices or real incomes, the changing value and income distributional effect of the benefit from rebates, deductions or exemptions is also a factor in declining progressivity, as the tax burden is reallocated among different income classes and household types even if real incomes are unchanged. The contribution to reduced progressivity and tax equity due to this factor as distinct from 'bracket creep' is beyond the scope of this chapter but warrants future investigation. See Khetan and Poddar (1976) for a discussion of this issue in the context of changes in the Canadian income tax over the 1950s and 1960s.

suggestions such stability is due to the fear of opening up a Pandora's box of redistributional conflict. Such an interpretation is reflected in the adage that 'the only good tax is an old tax'.

However, in this case, an alternative explanation perhaps lies in the high yield-elasticity of income taxation during the 1960s. The ease and invisibility with which governments could avoid the political pain of taxation increases (Peters 1991) by relying on a non-indexed income tax system in an inflationary environment are reflected in the automatic rise in revenues over that period. Between 1955–56 and 1969–70, a period when statutory rates were unchanged, the average levy imposed on taxable income by the Commonwealth income tax rose from 12 to 18 per cent, while income taxation rose from around a half to just under two-thirds of Commonwealth tax revenues.

The effects on both vertical and horizontal tax equity, as well as on the economy, were severe by the 1970s. As the 1975 Mathews Inquiry pointed out:

> Whatever measure of distribution is considered most appropriate, inflation results in a violation of legislated horizontal and vertical equity prescriptions ... it is unlikely that the personal tax redistributions caused by inflation are those intended or preferred by society (Australia, Committee of Inquiry into Inflation and Taxation 1975, p. 56).

The Committee recommended comprehensive indexation of the income tax, and some measures were implemented by the Fraser Government from 1976. However, the legislative response was only short-lived, with fiscal pressures and political considerations leading to the abolition of personal tax indexation in 1982 (Smith 1993b).

Conclusion

This chapter has estimated three widely used global indices of tax progressivity for Australian income taxation for the period 1916–17 to 1996–97 using the official Australian income taxation statistics. Different global indices of tax progressivity have different properties and characteristics. Values can intrude into the selection of indices and their interpretation. Changes in the distribution of taxation due to economic influences such as nominal income growth affect measures of tax progressivity in different ways depending on which index is used. Tax progressivity indices are also differently affected by changes in the underlying distributions of income earners and income.

Tax progressivity measures applied to an incomplete measure of economic income, that is, income defined as 'taxable' under Commonwealth income tax legislation, can give only a tentative picture of the changing progressivity of personal income taxation. In the absence of alternative sources of information on income, reliance on taxation statistics is unavoidable.

The limitations of taxation statistics are acknowledged and emphasised in this study, which nonetheless argues that the paucity of Australian income distribution data before the 1960s justifies the cautious use of taxation statistics and global progressivity indices for the limited purpose of analysing trends over time in the progressivity of the personal income tax instrument. This study uses three different, widely used indices to identify major periods of change and stability in income tax progressivity and in the redistributional role of the Commonwealth personal income tax. It finds that only limited intertemporal comparisons are valid because:

- there were major changes in coverage of the Commonwealth income tax before and after 1942; and
- when comparing some years, the direction of change in tax progressivity depends on judgements about whether higher taxes paid by the very wealthy outweigh the reduced progressivity within the remaining income range.

By applying global tax indices to a long-term historical data series, this study has illustrated for the Australian case the difficulties evidenced in cross-country studies using global tax indices.

Further work is needed to more accurately assess the effect of excluded gross incomes and taxpayers (including the income excluded through tax concessions and deductions, and statutory exemptions), and the effect this has on pre- and post-1942 comparisons. Investigation of the implications of important exclusions from taxable income, such as capital gains or that sheltered from taxation by avoidance or evasion activities, is also necessary before firm conclusions may be drawn.

More generally, the statistical trends in tax progressivity identified in this chapter emphasise the significance of the shift to 'mass taxation' following the unification of income tax in 1942. This chapter also underlines how little we know about the factors enabling this alteration in the character of income taxation, or about the relationship between the uniform income tax and the substantial State income taxes and payroll taxes that the 1942 Uniform Tax replaced. As the expanded personal income taxation on lower income earners was used to establish Australia's post-war social security system from 1944 and sounded the death knell for pre-war legislation for a social insurance scheme, this raises issues about how the debate over social insurance was resolved. The paradox of rising progressive direct taxation alongside increasingly heavy Commonwealth indirect taxation in the 1940s also raises the question of whether we can validly assume that the design of customs, excise and sales taxation was of no distributional significance in Australia's tax history. These questions are explored in Chapters 4, 5 and 6.

Despite the deficiencies in the data, and the limitations of analysis based on global tax indices, it is clear that, for a substantial period of Australia's tax history, a tax policy of 'benign neglect' has made a more substantial contribution to how the personal income tax burden is distributed than the most drastic policy changes forced by depression or war. 'Tax policy inertia' became, by default, a policy of reduced tax progressivity. This raises important questions about how tax policy is made over the longer term and, in particular, how 'benign' was the 'neglect'.

Chapter 4
Australian State Income Taxes and the Wage Earners' Welfare State, 1916 to 1942

Introduction

As shown in Chapter 3, wartime tax reforms fundamentally changed the character of the Commonwealth income tax, making it less steeply progressive in incidence and providing the basis for its post-war transition to a 'mass tax'. The Uniform Tax Plan of May 1942 replaced all existing State income taxes, and taxes on lower income earners were substantially increased the following year (Laffer 1980 [1942]; Carslaw 1980 [1942–47]). The expansion of Commonwealth income tax revenues after World War II effectively financed Australia's post-war welfare state.

It is common to assume, in line with experience in the United Kingdom (Peacock and Wiseman 1967), that such changes to taxation and social security originated from the crisis of World War II. For example, Butlin *et al.* (1982) and Watts (1987) emphasise the Commonwealth's wartime taxation policy reforms in the transition to mass income taxation. The conventional interpretation of tax unification in 1942 is that it arose from the need of the Commonwealth Government to finance war expenditures and was a natural outcome of the negotiations over the 'maddening maze' of State taxes (Bailey 1980 [1944], p. 309) and sharing of income tax powers from 1916 to 1941 (Laffer 1980 [1942]). Alternatively, Maddock (1982) has argued that, because the Uniform Tax Plan did not immediately increase the income tax burdens of lower income earners, tax unification reflected the ideological disposition of the Curtin Labor Government. A similar interpretation of uniform taxation as wartime political opportunism by the Commonwealth is drawn in Levi (1988b).

However, such interpretations of a 'war crisis' origin for the transition to mass income taxation focus excessively on specific events or political parties and ideologies. They ignore the significance of pre-existing State income taxation and the economic, social and institutional forces shaping it over a long period of time.

For example, on the eve of World War II, State income taxes accounted for nearly half of national tax revenues and three-quarters of all income taxation in Australia. During the 1920s and 1930s, increased government spending was driven by the need for higher social expenditures; it was the expansion of State income taxation that financed this. The growth in the States' income taxation occurred amidst almost continuous Commonwealth–State negotiations on taxation, as the open-ended financial provisions of the Constitution were interpreted and given practical effect from 1901. As early as 1928, respected economists such as R.C. Mills supported national unitary income taxation, with reimbursement of States for lost revenues (Mills 1980 [1928]. Within the bounds set by the Constitution, State income taxation had also been responding to the growing integration of the Australian economy and the massive economic shock of the 1929–32 Depression. The former made the States' taxation of higher incomes administratively complex and difficult to enforce: the latter meant the State treasurers had to reconcile these intractable economic constraints with the strong political imperatives to fund social relief through higher taxation.

Most importantly, when the Commonwealth Uniform Tax Plan was implemented in 1942, it was not based on a clean slate but on an income tax template designed by the State treasurers over the previous two or more decades. The 1942 Commonwealth income tax not only aimed to replicate the revenues of existing State taxes for that year, it also sought to do so with as little change as possible to the existing patterns of income taxation (Carslaw 1980 [1942–47]). As a result, Commonwealth income taxation from 1942 was significantly shaped by the design and incidence of the State income taxes that it incorporated.

Thus an exploration of State income taxation and its redistributional role is essential for understanding Commonwealth income tax policy in the period 1939–42 and its implications for the post-war expansion of social services. The character of pre-1942 State income taxation, and the timing of changes in their progressivity, also has a bearing on the debate on how the move to uniform taxation should be interpreted, and on the relevance of 'war crisis' theories of the growth of taxation to Australia.

The purpose of this chapter is to assess the constraints, trends and other features of State income taxation in the interwar period, and to explore the relationship between these State policies and Commonwealth income taxation from World War II.

Firstly, this chapter identifies some important institutional and economic constraints shaping interwar State income tax policies, while the second section outlines the main features and trends of the States' ordinary income taxes between the early 1920s and 1942 and attempts to statistically evaluate overall State income tax progressivity during the interwar period. The following section examines the special earmarked income and wage taxes introduced during the Depression. The significant tax administration issues raised by taxing wage earners are then considered and the implications for the Commonwealth's post-war income taxation explored.

Constraints on States' income taxation during the interwar period

At Federation in 1901 only 6 per cent of Australian tax revenues came from income taxes (Table 4.1). By 1939–40 income taxes were 34 per cent of national taxation and about three-quarters of this was levied at the State government level. The substantial expansion of State income tax revenues more than offset a Commonwealth Government policy of reducing its income taxation from 1922 (Barnard 1986a).

As the Commonwealth income tax levied higher and middle incomes relatively heavily, its declining role in Australian income taxation during this period indicates that aggregate income tax progressivity was diminishing *pari passu* with the expansion of States' taxation.

Table 4.1
Income Tax Share of Taxation 1901–1945

Year ending June	*Commonwealth income tax, percentage of total taxation*	*State income tax percentage of total taxation*	*Income tax, percentage of total taxation*
1901	0	6	6
1905	0	9	9
1910	0	8	8
1915	0	14	14
1920	27	11	38
1925	14	16	30
1930	12	16	28
1935	9	21	30
1940	11	23	34
1945	59	0	60

Source: Derived from Barnard 1985.

Contemporary observers attributed the strong interwar expansion of State income taxation to the States' heavy burden of post-war reconstruction and development and their

diminishing share of customs and excise revenues (Murphy 1980 [1928]).[41] Thus, with the Constitution barring States from imposing their own 'excise' taxes, it was mainly a £23 million expansion of their annual income tax revenues (Barnard 1986a) that financed the £43 million annual expansion of Australian social expenditures during the interwar period. Although the Commonwealth's annual spending on social programs rose by around £12 million between the world wars (1919–1938), most of the increase (£31 million) was by the States (Table 4.3). While higher direct taxation funded the States' new social spending, that of the Commonwealth was in effect funded from increased indirect (customs, excise and sales) taxation.[42] Meanwhile, taxation as a percentage of gross domestic product rose from around 8 to 15 per cent during this period (Barnard 1987).

Table 4.2
State Taxes on Incomes, 1919–20 to 1941–42
(£, 000)

Year ending June	*Income and dividend taxes*	*Other taxes on income*[a]	*Total State taxes on income*
1920	9,413	-	9,413
1923	9,549	-	9,549
1924	10,294	-	10,294
1925	11,775	-	11,777
1926	12,969	-	12,969
1927	15,189	-	15,189
1928	15,192	1,013	16,204
1929	15,630	53	15,682
1930	15,052	1,887	16,939
1931	14,033	6,876	20,909
1932	9,288	9,608	17,966
1933	9,607	13,167	20,284
1934	8,772	10,434	18,207
1935	9,794	10,480	20,236
1936	11,508	12,039	23,475
1937	13,706	12,832	26,514
1938	16,391	13,347	29,725
1939	17,270	12,526	29,791
1940	19,035	14,416	33,450
1941	21,684	13,775	35,459
1942	32,881	3,990	36,870

Note: [a] Family Endowment Tax was counted by the Statistician in 'other taxes on income' until 1941–42; also includes unemployment relief, social services, special income and wages, financial emergency, State development and hospital taxes.

Source: Commonwealth Bureau of Census and Statistics, *Finance Statistics*, various years.

The substantial expansion of State income taxation between the two world wars occurred in the context of two significant, and related, constraints.

[41] By the mid 1920s, post-war inflation had severely eroded the real value of the per capita payments to States agreed to in 1910 (May 1971). While Commonwealth customs and excise revenues rose from £17 million to £48 million between 1919 and 1938, Commonwealth payments to or for the States rose by only £9 million over the same period (Barnard 1987).

[42] The Commonwealth reduced its annual land and income taxes by £3 million between 1922 and 1938. See Chapter 6 for a discussion of the redistributional role of its indirect taxation, drawing on the case of sales taxation since 1930.

Firstly, the Commonwealth's income tax, introduced in 1915, constrained the States' taxation of middle and high income earners (Murphy 1980 [1928]). The problem arose from the distribution of taxing powers under the Commonwealth Constitution (Bailey 1980 [1944]). Since 1915 there had been complicated and difficult negotiations over how the direct tax field should be shared.[43] Despite the desire of the Commonwealth Treasurer to withdraw from taxing incomes,[44] the Commonwealth Government could not afford a complete retreat from the wartime tax regime because of the heavy cost of war debts and related obligations (Copland 1980). It was also increasingly evident by the mid 1920s that the Commonwealth needed to make some provision in its own finances for the deteriorating financial position of some States (see Gilbert 1973; May 1971). The Commonwealth had, therefore, tried to get the States to tax the lower end of the personal income range while it taxed higher personal and corporate incomes exceeding £2000 a year, but this was contentious (Gilbert 1973). While making sense in economic terms, it was politically favourable only to the Commonwealth. It meant that the States forewent the advantage of taxing companies and higher personal incomes, which were relatively constant and predictable in their political alignments as well as lucrative sources of revenue. On the other hand, most of the electorate would be subject to State taxation. That is, Commonwealth and the States each preferred to occupy the popular taxation fields and leave the most unpopular to the other. In 1926, tax negotiations were abandoned in favour of a Commonwealth take-over of the States' debts under the 1927 Financial Agreement. However, the key issues of direct tax assignment and the varying tax capacities of the States remained unresolved and the pressing problem of double taxation was untouched (Prest and Mathews 1980). As a leading economic commentator on taxation, Professor R.S. Mills, pointed out at the time, the agreement resulted in 'a certain maladjustment of financial means to political ends' (Mills 1980 [1928], p. 73). The Commonwealth Treasurer was frequently able to announce reductions in its income tax rates during the 1920s: 'State Treasurers have been forced to increase rates of taxation and have even explored new and unconstitutional avenues such as the petrol tax of South Australia and the newspaper tax of New South Wales' (Mills 1980 [1928], p. 73).

A second and growing difficulty for States was growing inter-State trade and investment, which implied stronger competitive pressures to reduce taxes. Already in the early 1920s, the growth of internal trade in Australia was seen as making State taxation of shareholder and company incomes increasingly complex and inequitable (Australia, Royal Commission into Taxation 1922) and led the Kerr Royal Commission to its recommendation that income taxation become the exclusive preserve of the Commonwealth. This recommendation was supported by leading economists (for example, Copland 1925, 1980a [1924], 1980b [1927], and Mills 1980 [1928], who noted that the States' income taxation had an inherently lower yield.[45] This was partly because aggregating incomes which were derived from more than one State produced significant revenue benefits under the strongly progressive Commonwealth income tax, but it was also because the yield of the separate State income taxes was increasingly constrained by tax avoidance and tax competition as the volume of inter-State trade rose.

Such economic pressures on tax policy are apparent in converging State income tax rates over this period. As interstate mobility increased, the States would have been drawn into more intense 'tax competition', either regarding the tax base or through competition on rates of tax.[46] Tax competition between the States could have been expected to be most intense regarding rates on mobile 'property' incomes and on higher income individuals.

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[43] See Australia, Royal Commission on Taxation (1934a, pp. 51–5) for a chronology, and Copland (1980 [1924]) and Mills (1980 [1928]) for contemporary commentary and analysis of these negotiations.

[44] The 1921–23 Royal Commission into Taxation recommended centralising income tax (Australia, Royal Commission into Taxation 1922). However, influenced by conservative fiscal ideologies and a rural and commercial political constituency that was antagonistic to direct taxes, Treasurer Earle Page reduced Commonwealth land and income taxes. He envisaged that creating room for the States to expand their income taxation would enable the Commonwealth to end the per capita payments to the States. See Chapter 7 regarding Commonwealth–State financial relations during this period.

[45] Mills was chosen by Chifley to chair the Uniform Income Tax Committee in 1942.

[46] Competition through rates may have been intensified during the 1920s by the cuts to Commonwealth income tax rates, which would increase the effective progression of the State schedules (Scott and Triest 1996). The

Tables 4.3-4.5 present data on the States' highest marginal tax rates on income from personal exertion and from property for selected years during the 1920s and 1930s and estimate the coefficient of variation for each of those years.

Table 4.3
Commonwealth and State Social Services, 1921–22 to 1940–41, (£ '000)

Year ending June	*Cwlth*	*NSW*	*Vic.*	*Qld.*	*SA*	*WA*	*Tas.*	*Total States*
1919	4,504	3,129	2,002	1,554	722	697	290	14,817
1921	12,369	5,819	2,828	2,234	989	862	471	27,493
1922	7,228	5,575	3,152	2,285	1,034	935	483	22,614
1923	6,593	5,286	3,288	2,142	1,020	954	463	21,669
1924	8,915	5,497	3,486	2,443	1,131	971	449	22,892
1925	8,689	5,701	3,851	2,205	1,243	1,008	484	23,181
1926	9,266	5,953	3,976	2,362	1,411	1,040	511	24,519
1927	10,477	6,089	4,271	2,173	1,617	1,087	494	26,208
1928	11,222	7,448	4,641	2,215	1,574	1,115	531	28,746
1929	12,459	9,543	4,649	2,589	1,659	1,171	562	32,632
1930	12,434	9,185	4,663	2,907	1,799	1,218	545	32,751
1931	12,497	7,649	5,460	2,681	2,225	1,526	539	32,577
1932	11,658	7,280	5,324	2,365	2,260	1,663	483	31,033
1933	12,248	15,704	6,633	2,442	1,981	1,326	478	40,812
1934	11,566	15,983	6,524	2,415	1,915	1,217	639	40,259
1935	12,368	15,031	6,821	2,617	1,812	1,224	767	40,640
1936	13,508	14,244	8,530	2,619	1,922	3,078	780	44,681
1937	14,702	13,258	7,941	2,747	1,891	2,914	893	44,346
1938	16,190	13,180	8,641	2,696	1,979	2,407	918	46,011
1939	16,424	12,727	7,946	3,701	2,170	2,523	995	46,486
1940	16,811	15,671	8,639	3,605	2,316	2,643	912	50,597
1941	17,729	16,130	7,321	3,583	2,268	2,405	884	50,320
1942	30,913	11,244	6,296	3,459	1,835	1,393	895	56,035
1943	36,586	10,918	6,474	3,218	1,833	1,621	861	61,511
1944	64,898	11,507	6,327	3,482	1,835	1,695	863	90,607
1945	66,703	12,185	7317	3,831	2610	1859	1061	95,566

Source: Barnard 1987.

It is evident from the declining coefficient of variation in both Tables 4.4 and 4.5 that differences in income tax rates on higher income earners did narrow, presumably encouraged by economic integration and State tax competition. It is also apparent in Table 4.5 that rates of taxation on property incomes, while slightly higher than on personal exertion income, were somewhat less variable between States than rates on personal exertion income. Furthermore, differences between the States converged more rapidly between 1921 and 1937 for rates on property incomes than on personal exertion incomes.

recommendations for more uniform tax bases by the Fergusson Royal Commission on Taxation in 1932–34 may also have discouraged further competition through the tax base during the 1930s.

Table 4.4
State Income Taxes, Highest Marginal Rates

	1921	*1933*	*1937*
New South Wales	13	29	21
Victoria	3	12	8
Queensland	27	43	36
South Australia	11	26	21
Western Australia	45	22	22
Tasmania	7	13	35
Unweighted average	18	24	24
Standard deviation	16	12	10
Coefficient of variation	89	48	43

Sources: Royal Commission into Taxation 1922, pp. 89, 95; South Australia, Office of the Government Statist 1924; New South Wales, Office of the Government Statistician 1928; Victoria, Office of the Government Statistician 1926; Queens land, Government Statistician's Office, *ABC of Queensland Statistics* 1933; *Queensland Year Book* 1939.

Table 4.5
State Income Taxes, Highest Marginal Rates on Property Incomes

	1921 %	*1933* %	*1937* %
New South Wales	16	29	25
Victoria	6	18	14
Queensland	27	45	36
South Australia	14	28	24
Western Australia	45	22	22
Tasmania	7	15	35
Unweighted average	19	26	26
Standard deviation	15	11	8
Coefficient of variation	77	42	32

Sources: See Table 4.4.

That tax competition constrained the States' income taxation of higher income earners is suggested also by the increased tax imposed on higher property incomes by the Commonwealth's revenue-neutral Uniform Tax Plan in 1942 (Bailey 1980 [1944]). Most States left considerable taxable capacity among higher income earners untouched, although the heavy taxation in Queensland prevented the Commonwealth from taxing this field more heavily until 1942 (Carslaw 1980 [1942–47]).

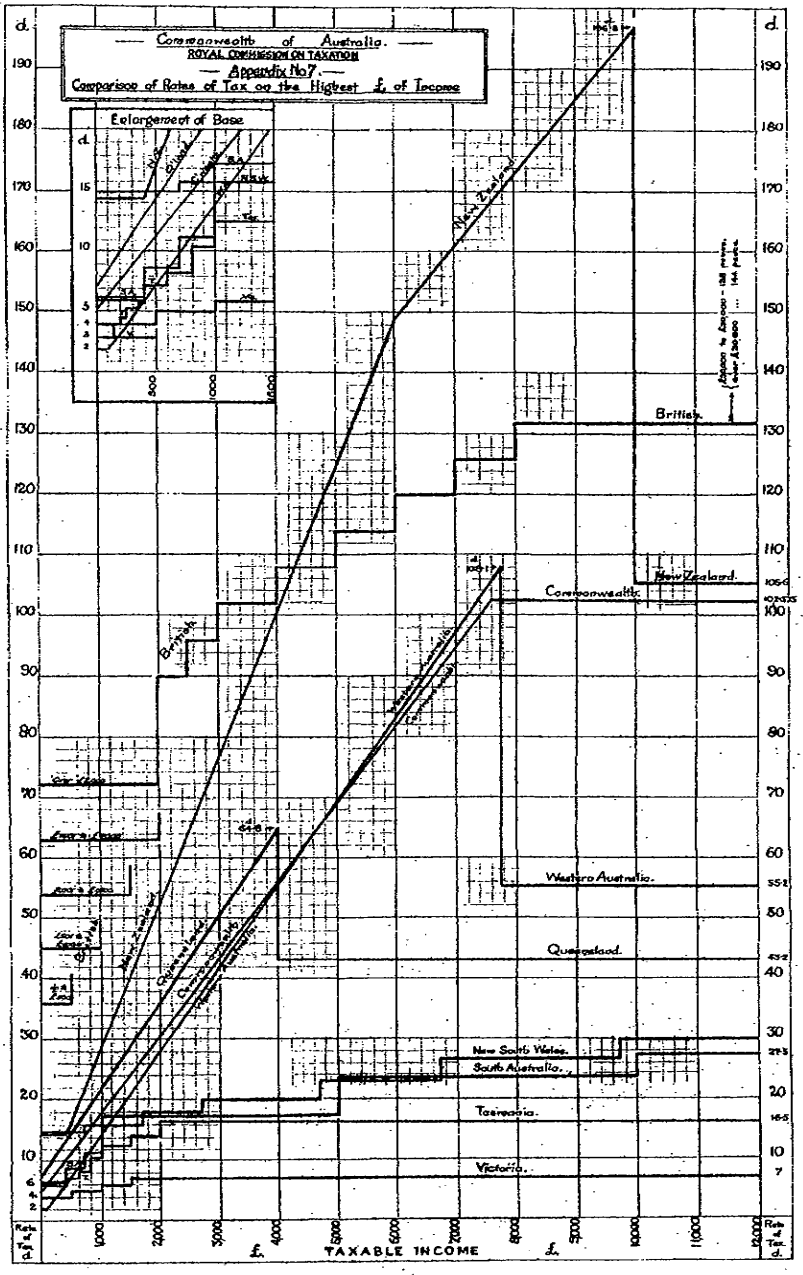
Thus it is apparent, that while economic and political constraints did not prevent expansion of the States' income tax revenues during the interwar period, they did shape its extent, its design and its incidence. State income taxation during the interwar period is discussed in more detail in the following two sections, the first of which looks at the States' use of ordinary income taxes to supplement their depleted revenues in the late 1920s, and the second examines the special Depression income and wage taxes — the States' preferred alternative to increasing income taxes on middle and high income earners.

The States' ordinary income taxes

There was little economic or political impetus for drastic changes to the incidence of State income taxes until the mid 1920s. Economic conditions were relatively stable, prices and

income growth moderate, and the levels and structures of income taxes were largely unaltered by the legislatures.

Figure 4.1
State Income Taxes, Highest Rate of Taxation



Source: Royal Commission into Taxation 1922, Appendix 7

Key features of State income taxes early in the 1920s are illustrated in Figure 4.1, which is reproduced from the 1922 report of the Royal Commission into Taxation. This supplements the information presented in Tables 4.4 and 4.5 showing the considerable diversity of State income tax policies during the early interwar period.

Despite the massive increase in the Commonwealth's income taxation after 1915, the States were again collecting more income tax than the Commonwealth by 1924–25. As the Commonwealth reduced its income taxation from the early 1920s, the States increased theirs. Table 4.6 shows the per capita income tax burden from the mid 1920s to World War II, with the rise in the severity of State income taxation clearly apparent.

Until the 1920s, State income taxation was broadly progressive, with a gradual convergence towards graduated rate structures after Federation. In keeping with the contemporary thinking on income tax design,[47] all States taxed property incomes more heavily than 'personal exertion' incomes.

However, later in the 1920s, differences in State income tax systems and policies multiplied (Murphy 1980 [1928]; Laffer 1980 [1942]; Groenewegen 1988). Those States with the least taxable capacity faced particularly serious financial difficulties, which were magnified by the Depression from 1929 (Giblin 1928, 1929, 1980a [1930]). The Depression also reopened tax conflict between the Commonwealth and the States.[48]

In Queensland until the mid 1920s, the statutory exemption was £250 (Queensland, Government Statistician's Office, *ABC of Australian and Queensland Statistics*, various years; *Queensland Year Book*, various years).[49] This was lowered to £150 p.a. during the Depression. At that time tax rates were increased sharply.[50]

South Australia, one of the poorer Australian States, began applying ordinary income taxes to annual incomes as low as £150 from 1917 (Office of the Government Statist, various years). The State also raised its rates of income tax from the mid 1920s.[51] From 1927–28, under severe financial stress (May 1971), the State began taxing all incomes above £100 p.a.

The more affluent States, on the other hand, expanded revenues during the 1920s mainly by imposing higher rates on existing taxpayers. This move was concentrated on single taxpayers earning more than £200 p.a. For example, from 1925–26 New South Wales increased the statutory deduction from £250 to £300 p.a. (New South Wales, Office of the Government Statistician, various years). Income tax rates were also briefly reduced[52] but were then raised again in the late 1920s, particularly on incomes above £500. In Victoria, the taxable income threshold remained at £200 p.a. throughout the 1920s, with revenues bolstered by increasing income tax rates (Victoria, Office of the Government Statistician, various years).[53]

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[47] See Smith (1993b) for an overview of the historical development of Australia's progressive taxes, Van den Driesen and Fayle (1987) for the early history of State income taxes, Murphy (1980 [1928]) and Groenewegen (1988) for analysis of key features and origins of Australian income tax design, and Shehab (1953) for a detailed analysis of how the progressive income tax principle evolved in the United Kingdom.

[48] As incomes fell dramatically, the Commonwealth sought to offset declining revenues by raising its income tax on the lower range of incomes already taxed by States. Although the States tried to boost declining revenues through taxing company and property incomes more fully, this worsened the problems of double taxation between the various income taxing authorities.

[49] Income taxation was comparatively heavy in Queensland, although the very highest incomes were quite lightly taxed.

[50] Rates on incomes up to £8000 were doubled to 6d in the pound, and rates also increased on higher incomes. A super tax of 20 per cent applied to those with net incomes above £438. 'Additional tax', with rates ranging from 15–27.5 per cent, applied to taxable incomes above £779 from 1930–31.

[51] From 1917–18 to 1925–26, rates of 5d in the pound applied to taxable incomes between £1 and £400, 7d applied to incomes from £401 to £700, and a rate of 1s 10d applied on incomes exceeding £10,000. Higher rates applied to property incomes. From 1916–17, 'bachelors' also paid a fixed tax of £1, while a super tax of between 6d and one 6d applied to incomes above £1000. The super tax became a surcharge of 25 per cent of the total amount of income tax from 1917–18. In 1925–26, tax rates were increased to commence at 5½d for the first pound of taxable income, increasing by ½d for each pounds up to £4400, and then a flat rate of 2s 3d in the pound. Higher rates applied to property income, which commenced at 11½d for the first pound of taxable income.

[52] The State traditionally taxed incomes relatively heavily, although with a generous statutory deduction and concessional allowances.

[53] Tax rates were increased by ½d for each of the 1924–25 and 1926–27 income years, again for 1928–29, and by 1d for 1930–31. A super tax on individuals' incomes also applied to incomes above £800 from 1923–24. For 1929–30, a further additional tax of 7½ per cent of total tax was imposed on all taxpayers. This was in addition to the former super-tax, which ranged between 10 per cent and 25 per cent for individuals with incomes above £800.

This brief chronology of State income tax changes shows that the seeds of 'mass' income taxation were sown in Australia from the mid 1920s when less prosperous States like Queensland and South Australia extended income taxation to low income earners, and as other States increased ordinary income tax rates to expand revenue during the Depression.

Data on the distribution of State personal income taxation also permit some systematic analysis of income tax progressivity during the interwar period by enabling the calculation of global indices of tax progressivity. Such data are available more or less continuously during the interwar period for Victoria, South Australia, and Queensland. In 1922–23, these States accounted for 29 per cent, 10 per cent and 8 per cent of Commonwealth taxable incomes respectively. Data are also available for 1920–21 in New South Wales, which accounted for 36 per cent. Patterns evident in these States are thus likely to be reasonably representative of aggregate patterns and trends for the States as a whole. Together with consideration of the special Depression taxes in the following section, these estimates provide some indication of how the redistributional role of State income taxation changed during the 1920s and 1930s. They also provide an incomplete but suggestive comparison with Commonwealth income tax progressivity in this period (see Chapter 3).[54]

Table 4.6
State Income Taxes Per Capita, 1926–27 to 1938–39
(£)

Year ending June	*Income and dividend taxes* £ s d	*Depression taxes* [a] £ s d	*Total State income taxes* [a] £ s d
1927	2/3/4	-	2/3/4
1920	2/6/11	0/5/11	2/12/10
1931	2/3/3	1/1/3	3/4/6
1932	1/8/6	1/9/6	2/18/-
1933	1/9/2	1/19/11	3/9/1
1934	1/6/5	1/11/5	2/17/10
1935	1/9/3	1/11/5	3/0/8
1936	1/14/2	1/15/9	3/9/11
1937	2/0/5	1/17/9	3/18/2
1938	2/7/10	1/19/-	4/6/10
1939	2/10/-	1/16/3	4/6/3

Note: [a] Includes Family Endowment Tax.

Source: Commonwealth Bureau of Census and Statistics, *Finance Bulletin*, various years.

Table 4.7 shows that the comparatively light Victorian income tax played only a minor redistributional role.[55] By contrast, the tax progressivity index for a single year, 1922–23, suggests New South Wales' income tax was about as progressive as the Commonwealth tax at the beginning of the 1920s (Table 4.8). This reflects both the high average tax rate in New South Wales and its progressive structure (as reflected in the S and K indices). Indices for

However, the effects of increased rates of taxation were partly offset for the many taxpayers with dependents by expanded concessional deductions.

[54] Global tax indices have been used extensively since the 1970s to compare different tax systems or changes over time in the progressivity of taxation. Commonly used indices include the M–T index, known as the 'coefficient of tax progression' (Musgrave and Thin 1986 [1948]), the K index (Kakwani 1977a, b), and the S index (Suits 1977b). The properties of these indices and issues in their interpretation are discussed in Chapter 3.

[55] However, this tax is not directly comparable with that of New South Wales, for example, because although around 15–20 per cent of income earners were taxpayers under the Victorian levy, around 50 per cent appear to have been subject to New South Wales income taxation.

Queensland (Table 4.9) likewise reveal a strongly progressive tax; rising S and K indices and a stable M–T index suggest that a steepening of progression in the tax burden offset a declining average income tax yield over time.[56]

Table 4.7
Indices of Global Tax Progressivity, Victorian Ordinary Income Tax, 1917–18 to 1938–39 (taxable income)

Year ending June	*M-T*	*S*	*K*	*Average tax rate per cent*
1918	1.01	0.22	0.17	2
1919	1.01	0.22	0.14	2
1923	1.00	0.18	0.12	2
1924	1.00	0.20	0.10	3
1925	1.00	0.19	0.10	3
1926	1.00	0.19	0.10	3
1927	1.00	0.17	0.09	3
1928	1.00	0.17	0.10	3
1929	1.01	0.17	0.09	4
1931	1.01	0.16	0.09	4
1932	1.01	0.15	0.08	4
1933	1.00	0.15	0.08	4
1934	1.00	0.14	0.08	4
1935	1.00	0.14	0.08	4
1936	1.00	0.14	0.07	4
1937	1.00	0.14	0.07	4
1939	1.01	0.18	0.13	5

Source: Victoria, Office of the Government Statistician, *Victorian Year Book*, various years.

Table 4.8
Indices of Global Tax Progressivity, New South Wales Ordinary Income Tax, 1920–21 (taxable income)

Year ending June	*M-T*	*S*	*K*	*Average tax rate per cent*
1921	1.03	0.43	0.23	6

Source: New South Wales, Office of the Government Statistician 1925.

[56] The sharp increase in progressivity in 1941–42 reflects uniform income taxation. This is because statistics reported for this year include both Commonwealth and Queensland income taxes. This indicates the overall progressivity of national income taxation before the structure and levels of Australia's income taxes were drastically altered by wartime tax increases and before the heavier Commonwealth taxation of lower incomes from 1943.

Table 4.9
Indices of Global Tax Progressivity, Queensland Ordinary Income Tax, 1917–18 to 1938–39[a]

Year ending June	*M-T*	*S*	*K*	*Average tax rate per cent*
1924	1.01	0.30	0.07	9
1927	1.00	0.41	0.09	8
1932	1.00	0.42	0.04	6
1933	1.00	0.51	0.05	7
1935	1.02	0.49	0.19	8
1936	1.01	0.53	0.16	7
1937	1.01	0.54	0.16	8
1938	1.02	0.38	0.17	7
1939	1.02	0.37	0.18	7
1942	1.67	0.43	0.35	12

Note: [a]Taxable income in 1924, 1938 and 1939; net income in 1933, 1935, 1936 and 1937; gross income in 1927 and 1932.

Source: Queensland, Government Statistician's Office, *ABC of Australian and Queensland Statistics*, various years and *Queensland Year Book*, various years.

Tax indices for South Australia (Table 4.10) also show a relatively stable income tax scheme throughout the 1920s. The decline in progressivity after 1930 reflects the regressive effect of the fixed tax introduced that year: the poll tax of £2 10s per taxpayer, which raised an additional £300,000 in revenue in 1930–31, made the South Australian income tax effectively proportional in incidence. Over the period 1930–35, around 43 per cent of personal income taxation in South Australia was paid by those earning less than £200, compared with 25 per cent in 1924–25 (South Australia, Office of the Government Statist, various years).

In States other than South Australia, the myriad of special taxes introduced during the Depression complicates the systematic comparison of States' income tax policies. Because South Australia raised all its additional income taxes through the ordinary tax, rather than by separate new taxes, trends in its ordinary income tax, therefore, provide the best indication of the extent to which State governments' responses to the financial crisis reduced the progressivity of their income taxes.[57]

[57] A difficulty in comparing trends in such indices over time or between States is that they are distorted by variation in the coverage of the income earners in tax statistics. Different policies on the threshold at which incomes became taxable can bias measures of tax progressivity. In the absence of reliable State data on these excluded incomes, some assessment can be made of the effects by using the incomes data from the 1915 War Census to approximately adjust the indices. For example, while the Commonwealth income tax covered around 15 per cent of Victorian income earners during the early 1920s, the State tax covered 20 per cent. In New South Wales, State income tax covered around 50 per cent of income earners; the proportion of State taxpaying income earners was probably at least as high in South Australia. Adjusting approximately for the different coverage of income tax in New South Wales, Victoria and the Commonwealth does not alter tax progressivity rankings in the 1920s, showing that the Commonwealth tax was slightly more progressive overall by all measures than the New South Wales tax. The Victorian tax, levied at low average rates and having a relatively flat rate scale, was the least progressive in structure and had little effect in altering the post-tax distribution of incomes.

Table 4.10
Indices of Global Tax Progressivity, South Australian Ordinary Income Tax, selected years 1918 to 1940 (taxable income)

Year ending June	*M–T*	*S*	*K*	*Average tax rate, per cent*
1926	1.01	0.29	0.16	4
1927	1.01	0.25	0.14	4
1928	1.01	0.23	0.14	4
1929	1.01	0.23	0.14	4
1920	1.01	0.22	0.13	5
1935	1.00	0.03	0.00	9
1940	1.01	0.07	0.04	8

Source: South Australia, Office of the Government Statist, various years.

The special Depression taxes of the other States are examined in more detail below in order to show the generally regressive character and the complexity of these taxes and the policy behind them.

The Depression taxes

With the disruption to public finances by the Depression from 1929, most States introduced various special taxes on incomes and wages. The average burden of these taxes per capita exceeded that of the States' ordinary income taxes in every year from 1931–32 to 1935–36 (Table 4.6).

These levies had quite a different incidence from the ordinary State income taxes, because they were typically designed to tax the previously untouched broad mass of wage earners and were fixed amount or proportional rate taxes. Furthermore, many were assessed on weekly earnings. As many workers could find only irregular employment, this increased the effective burden and raised the yield compared to equivalent rates of tax assessed on annual incomes.

While governments also increased tax on high income earners, the major contribution to revenue came from expanding tax coverage to the lower ranges of income. The high yielding but regressive taxes were typically earmarked to fund unemployment relief and social services (Bland 1976 [1934]). As such, they represented a substantial contribution from the wage-earning classes to the financing of growth in social welfare expenditures during the 1930s.

The Depression taxes are summarised in the *ABC of Australian and Queensland Statistics* and the *Queensland Year Book*. New South Wales, for example, imposed an 'Unemployment Relief Tax' in 1931 on weekly wages and incomes earned in 1930–31.[58] This was replaced from December 1933 by the 'Special Income Tax' and 'Wages Tax'. The revenues were used to fund unemployment relief, child endowment and other social services (Commonwealth Bureau of Census and Statistics, *Labour Report*, 1940; New South Wales, Office of the Government Statistician 1940). From 1939, these were superceded by the 'Unemployment Relief Tax' and 'Social Services Tax' (Sawkins 1933).

Likewise from the 1929–30 income year, the burden of income taxation was extended to the lower incomes in Victoria through the 'Unemployment Relief Tax', and, from 1931–32, by a 'Special Tax'. The 'Unemployment Relief Tax' was for the purpose of providing employment on relief works and sustenance for unemployed workers and their dependents; and in 1932–33 it applied at a rate of 10s per £100 for incomes up to £104, rising to a maximum rate of 118s 6d on incomes exceeding £3000. The minimum taxable income was £52 p.a. The Victorian

[58] After mid 1932, in accordance with the *Finances Adjustment Act*, the revenues were paid into consolidated revenue rather than administered off-Budget by the Unemployment Relief Council.

'Special Tax' applied to income earned by any person, with the minimum taxable income being £101. Rates ranged to 12s 6d where the taxable income exceeded £2500. The deductions allowed for ordinary income tax were not allowable for calculating taxable income for these taxes. Because of the large number of income earners subject to tax, the revenues mounted quickly.

Around 55 per cent of the 'Unemployment Relief Tax' came from those earning £500 p.a. or less, compared to 23 per cent of ordinary income tax assessed. While in 1924–25, those earning less than £200 p.a. paid 15 per cent of income taxes in Victoria, by 1932–33 they contributed 22 per cent of both the ordinary income tax and the new 'Unemployment Relief Tax'.

In Queensland the Depression was met by an 'Unemployment Relief Tax' in 1930, which was revamped from 1939 as the 'State Development Tax'. This flat tax started at 1d for every 6s 8d of earnings applied on all incomes between £104 and £208 p.a. It rose to 4d on each 6s 8d of earnings on incomes above £499 p.a.[59] Other low income groups which were previously exempt from income taxation were also brought into the tax field with a levy of 3d in the pound for incomes above £104 p.a. and 5½d on incomes above £104 p.a.

In Western Australia, a 'Hospital Tax' was imposed from early 1931 on all incomes except those less than £1 per week, and a 'Financial Emergency Tax' applied from the beginning of 1933. Tasmania supplemented State income tax revenues by its 'Special Income Tax' on non-employment incomes above £104 p.a. and a 'Wages Tax' on all weekly earnings above £3 10s.

With their low taxable thresholds and flat or proportional tax rates, and narrow tax base, the Depression income and wage taxes were clearly less progressive than the ordinary income taxes levied up to the late 1920s. Such taxes rapidly replaced ordinary income taxes as the major source of income tax revenues. In 1932–33, these special Depression taxes accounted for 65 per cent of all State revenues from taxing incomes.

These levies remained in place long after the Depression and were partly incorporated in the States' ordinary income taxes during the 1930s (Laffer 1980 [1942]; Bland 1976 [1934]). Their regressivity thus remained a feature of the States' income taxation until 1942 when the State taxes were incorporated into the Commonwealth income tax structure.

As seen in Table 4.2 some £13 million of the £18 million increase in State income taxation from the mid 1920s to the end of the 1930s, can be attributed directly to the regressive Depression taxes (Table 4.2). The Depression taxes can thus be said to have substantially contributed to funding the £23 million expansion of social services expenditures by States during the interwar period.

Taxing wage earners — Ways and means

Closely associated with these changes in the nature of income tax from the early 1930s was the introduction of a new tax collection mechanism — 'group schemes' — for collecting income tax on wages at source. This evolved into the Commonwealth's 'Pay as You Earn' (PAYE) system, introduced in 1944. The advent of the group schemes responded to the tax administration problems presented by the special Depression taxes.

Conventional wisdom and practice in regard to taxation policy in the early twentieth century, based on the benefit tradition in public finance, was that wage earners should bear tax because fiscal exemption bred political irresponsibility. For example, in 1910, liberal social reformer Lord Asquith told the United Kingdom Parliament that 'if we are to have social reform we must be ready to pay for it and when I say we, I mean the whole nation, the working and consuming classes as well as the wealthier class of direct taxpayers' (quoted in Sabine 1966, p.146).

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[59] Employers with ten or more employees were required to deduct and forward the tax deducted from employee wages.

Such themes were also evident in Australian debates on progressive income taxation (Groenewegen 1988).

However, others argued that most working-class people already paid excessively through indirect taxation (Sabine 1966). Labour scrutiny of the early twentieth-century tax system in Australia emphasised the heavy burden of indirect taxation on the wage earner (Groenewegen 1988). Furthermore, until the early decades of the twentieth century, direct taxation of wages was seen as inappropriate (Sabine 1966). Commodity taxation of these lower incomes was considered preferable, as it allowed those of limited means to choose their level of tax contribution by directing consumption to untaxed necessities.[60]

At that time in the UK, the low average rates of income taxation meant it was not cost-effective to tax lower income earners. According to Gladstone,

> there was a certain point in the progress down the scale of direct taxation beyond which it was not advisable to pass. The sums to be levied, for instance, might be so small that they would not pay the cost of collection, or if they were collected, the vexation attending it would be such that it would not be expedient to attempt it (quoted in Sabine 1966, p. 95).

Income taxation at source had originated in Pitt's English income tax of 1803, which nearly doubled revenue collections compared to the 1801–02 income tax (Australia, Royal Commission into Taxation 1922). The first tax withholding schemes were limited to the British Civil Service, and the Royal Household from the 1850s (Australia, Royal Commission into Taxation 1922; Shehab 1953). Adverse court decisions discouraged experiments in widening the scope of tax withholding to other wage and salary incomes (Sabine 1966, pp. 96–7).

Despite the arguments of proponents in favour of the benefits for revenue flows, reduced evasion, and convenience to taxpayers, and a dissenting minority report favourable to extending 'taxation at source', the 1921–23 Kerr Royal Commission into Taxation in Australia had recommended against wider application of taxation at source (Australia, Royal Commission into Taxation 1922). Its second report argued that a withholding system, along the lines of that in the United Kingdom, would produce unacceptable inequities and complexities because of the steep graduation in rates under the Commonwealth income tax.

> There are at least two general objections to the system of taxation at the source. First it involves the collection by the Crown of large amounts of money which in some cases it is not entitled to retain, and which in other cases are in excess of what it is entitled to retain, thus depriving a considerable body of taxpayers of the use of their money for varying periods; and, second, some revenue gain (it is difficult to estimate how much) will be due to the failure of taxpayers, either through ignorance or neglect, to make and establish their claims for refund or credit (Australia, Royal Commission into Taxation 1922, p. 84).

They considered the system should be only narrowly applied, if at all, 'lest some day public complacency may permit revenue gain to outweigh every other consideration, even that of an equitable distribution of the burdens of taxation' (Australia, Royal Commission into Taxation 1922, p. 84).

The Commissioner of Taxation submitted that taxation of wage earners at source was probably not cost-effective because of the need for end-of-year-tax adjustments arising from the progressive Commonwealth income tax structure. Hence the system 'would not pay unless the

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[60] Concern over the regressive burden of indirect taxation was an important element in the thinking of the Commonwealth Labor Party, including for example, Attorney-General W. M Hughes, who had been closely involved with introducing both the Commonwealth land tax of 1910 and the 1915 income tax. However, the philosophy that the wage earner was best taxed through indirect taxes continued to have adherents in the Commonwealth Parliament throughout the 1930s and into World War II. As noted earlier in this chapter, Commonwealth indirect taxation expanded considerably during the interwar period (see Chapter 6 for further discussion).

present minimum rates of Income Tax were considerably increased' (Australia, Royal Commission into Taxation 1922, p. 83).

> The only remedy [to evasion] lies in legislation which would provide that the tax at a flat rate should be deducted from wages as they are paid. It would be necessary, however, to provide expensive machinery for adjusting the total amount of tax paid during a year, to the actual amount payable by each person so taxed. The question, therefore, to be decided is whether or not the tax collectable would be sufficient to pay for the additional adjustment machinery (Australia, Royal Commission into Taxation 1922, p. 83).

Witnesses to the inquiry also gave evidence of the strident opposition of employers to the 'deduction at source' system in the United States, because of the high costs it imposed on the businesses required to collect and forward the tax.

By the early 1930s, expenditure taxation by State governments in Australia appeared, 'for the time being', to have reached its limits (Hytten 1980 [1934], p. 284). As shown earlier in this chapter, State governments turned to wage and income taxation.

In 1930, South Australia was forced, 'by the extraordinarily high rates of taxation imposed in that year', to adopt a new method of tax administration, known as 'group schemes' (Hytten 1980 [1934], p. 284). That year, the State had imposed its fixed tax of £2 /10/- per taxpayer, which included incomes as low as £101 p.a. A periodic withholding scheme was an essential practical requirement for collecting the tax from low wage earners, as many taxpayers had found it impossible to meet their liabilities in a lump sum. The group schemes involved employees in an establishment periodically remitting installments of their income tax through a representative. After the success of the initial schemes in government offices and in a number of large private businesses, the South Australia Government introduced more comprehensive arrangements. Employers were required to deduct 5 per cent from cash payments to employees in excess of 10s and to issue tax stamps to the employee corresponding to the value of deductions.

The success of the South Australian scheme was judged in terms of the regular flow of revenue, with 85 per cent of estimated yield of the tax being collected, compared to 67 per cent at the same time in the previous year (Hytten 1980 [1934]). It also unexpectedly disclosed a great deal of evasion, with a number of cases identified where returns for previous years had not been lodged. There were some additional costs of collection, which were impossible to estimate but were believed to be trivial compared to the additional revenue collected. In 1932, Hytten wrote that:

> The general feeling in South Australia is one of satisfaction, on the part of both the government and the taxpayers. It suits the great majority of taxpayers, who find a difficulty in paying the heavy tax in one lump sum at 30 days notice, which, owing to the frailty of human nature, always seems far too short. To put it briefly, the method had given our most important direct tax the feature that has always made indirect taxes so dear to the hearts of financiers: the feature of causing the minimum 'feeling of hurt' to the victim (Hytten 1980 [1934], p. 286).

'Deduction at source' also commenced in Victoria in November 1932, as a component of the new 'Unemployment Relief Tax'. The scheme had as its object 'the assisting of taxpayers in the payment of their taxes' (Victoria, Office of the Government Statistician 1937, p. 289). Regular deductions were to be made 'from the salaries and wages of those constituting the majority of taxpayers and were the classes most requiring assistance of this character'.[61]

A number of States experimented with various arrangements for collecting the special wage taxes. In the early 1930s, the Fergusson Royal Commission on Taxation considered the

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[61] As in South Australia, the employer making the deduction provided the employee with tax installment stamps to the value of the tax deducted. The employee produced these stamps, which provided credit towards the tax liability after receiving the tax assessment. If the value of stamps exceeded the tax liability, a refund was made. The general public apart from salary and wage earners could also participate in the system.

experience of the various States, and commented favourably on the method adopted in South Australia and Victoria, compared to the weekly wage taxes in some other States.

> Although certain difficulties were experienced at its inception, these appear to have been overcome. The system is giving general satisfaction in those States, and is extremely popular with those whose tax is so assessed (Australia, Royal Commission on Taxation 1934b, p. 136).

The operation and equitable impact of the 'group schemes' in Australia had been facilitated by the rise in steady employment, including in the formal manufacturing sector during the 1930s, and by the general rise in incomes after the Depression.

The Fergusson Royal Commission found the following distinct advantages of collecting the tax on wages and salaries at source;

- regular flow of revenue
- tax could be collected from those who have hitherto evaded their obligation
- the taxpayer who was able to pay tax by small regular installments instead of being asked to make an inconveniently large single payment was thereby assisted.

However, the Commissioners were reluctant to recommend such a scheme for the Commonwealth income tax. This again reflected an attachment to the principle of progression:

> The taxation systems of Great Britain and Australia are fundamentally different. Taxation by deduction at the source lies at the very root of the British system. It is based upon a flat rate of tax which is deducted by the payer, as, for example, by a company on dividends paid to its shareholders. Incomes not exceeding a certain amount are taxable at half the standard rate, and hence in such cases, and in others where the recipient is not taxable, refunds and adjustments have to be made. But because the deductions are always made at a flat rate such adjustments are easy to make. Australian tax systems, however, are all based upon a graduated rate of tax, commencing from the lowest point. If, therefore, an attempt were made to apply taxation at the source to Australian conditions, would be necessary to repeal all the Commonwealth and State Acts relating to Income Tax, and completely alter existing methods of administration (Australia, Royal Commission on Taxation 1934b, p. 136).

Like their predecessors in 1922, the Commissioners saw 'deduction at source' as unfair for the casual worker who received wages at a fairly high rate for a few weeks, and then suffered a long period of idleness (Australia, Royal Commission on Taxation 1934b, p. 136). Deduction at source was also considered inequitable because it imposed the same tax on a given amount 'whether the recipient is a single man without responsibilities, or a married man with a family' (p. 137). The Report observed that many employees would be exempt from Commonwealth tax owing to the statutory exemption and the concessional deductions to which they are entitled.

> The [married man with a family] is not likely to be satisfied with the explanation that the rate is calculated at an average applicable to all workers, for he can reasonably maintain that his domestic responsibilities entitle him to greater consideration than the taxpayer without any (Australia, Royal Commission on Taxation 1934b, p. 137).

For such reasons it rejected the scheme put forward by the Taxpayers' Association of Victoria for a 'graduated stamp tax' at a rate equal to half the personal exertion rate on all salary and wages below £400 p.a. The Taxpayers' Association, a group representing mainly high income business professionals and property owners, had proposed a 'final' withholding tax. This was to be deducted without assessment or end-of-year adjustment, and without a statutory exemption or concessional deductions such as allowed for wife and children, life insurance, medical expenses, under the ordinary income tax. According to the Royal Commission: 'Simplicity is not the only consideration, and we are not prepared to recommend any method of

collecting tax on wages at the source that does not provide for an eventual adjustment of over or under payments' (Australia, Royal Commission on Taxation 1934b, p. 137).

Deduction of tax at a flat rate was said to run counter to the principle of progression, because whatever withholding rate was adopted would be too high for some taxpayers and too low for others. As numerous adjustments would be required and an elaborate refund department necessary, procedures would not be simplified nor the cost of administration reduced. The Royal Commission, therefore, concluded that taxation at the source as applied in Great Britain could not be generally adapted to Australian conditions (Australia, Royal Commission on Taxation 1934b, p. 136).

In 1944, the Commonwealth introduced a 'Pay As You Earn' (PAYE) scheme, which first applied for the 1944–45 income year (Carslaw 1980 [1942–47]).[62] The introduction of 'collection at source' was associated with heavy Commonwealth income tax increases including on low and middle income earners. All incomes above £104 p.a. (formerly £156 p.a. were now taxed.

PAYE, along with heavier taxation of wage earners, was directly linked to the establishment of the National Welfare Fund to finance new social security measures (Carslaw 1980 [1942–47]; Butlin and Schedvin 1977).[63] The National Welfare Fund was to provide for national child endowment, the new widows' pension and unemployment benefits.[64]

Meanwhile under the Uniform Income Tax Plan, the States' loss of their income tax powers effectively pegged their expansion of social services expenditures at the pre-war level (Laffer 1980 [1942]; Bailey 1980 [1944]). The principle of reducing income tax compensation where States were relieved from the cost of providing such services was endorsed by the Committee on Uniform Taxation (Australia, Committee on Uniform Taxation 1942) and implemented by the Government (Butlin and Schedvin 1977, fn 4, p. 333), but, in the longer term, the basis for distributing grants to the States created pressures for the Commonwealth to expand social services to achieve uniform standards across the country (Bailey 1980 [1944]).

The new PAYE system was significant because it facilitated an enhanced revenue raising function of the Commonwealth income tax. Most importantly, as Hytten (1980 [1934]) had observed in regard to the earlier State schemes, it introduced the feature of political invisibility to the income taxation of low and middle income earners — reducing the 'feeling of hurt' of the victim.

It may have also had other long-term implications for Commonwealth income tax progressivity. As the Royal Commission on Taxation had recognised in the 1920s (1922, pp. 81, 84), the more progressive the tax structure, the greater the tax administration and employer compliance costs of such a 'taxation at source' system. This implies that the PAYE system may have encouraged the development of an employer and business constituency for the flatter personal income tax structure that appeared to emerge more or less by default in the post-war period (see Chapter 3).

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[62] This was based on the recommendations by a Joint Parliamentary Committee of Inquiry chaired by Treasurer Chifley (Australia, Parliament, Joint Committee Appointed to Inquire into the Advisability of Basing the Liability for Income Tax for Each Financial Year on the Income of that Year 1944).

[63] Meanwhile PAYE was also introduced in the United Kingdom and the United States in 1943 (see Witte (1985, pp. 117–20) on the United States, and Sabine (1966, p. 201) and Sayers (1956, pp. 99–101) regarding the United Kingdom). In the United Kingdom, the British Chancellor argued for the introduction of PAYE partly to continue access to taxing this section of the population after World War II: 'it seemed most important that the present conditions, under which the wage earners as a whole were making a contribution to the affairs of the State through direct taxation, should be maintained' (quoted in Sayers 1956, p. 99).

[64] In 1946, this informal earmarking of the higher wartime income taxes on low incomes and wage earners was formalised through introduction of a 'Social Security Contribution'. The object was to reduce inflationary pressures and provide for the future funding of the National Welfare Fund (Kewley 1973).

Conclusion

This chapter has explored the changing role and character of States' income taxation during the interwar period, and the relationship between their income tax policies and the Commonwealth's income taxation from 1939. It has also assessed the economic and other constraints on State income taxation during the 1920s and 1930s.

The chapter has identified a significant shift in the level and character of the States' income taxation during these years and shown that this explains national trends, the States being the dominant income taxing authorities. This shift to higher and more regressive taxes reflected pressures on the States to provide expanded social services during the depression years and responded to problems created by the Constitution regarding the sharing of taxation powers between the Commonwealth and State Governments. Factor mobility was an increasing constraint on State income taxation from the 1920s, especially in taxing the higher incomes. The States' tax rates on higher income tax payers showed a tendency to converge. This study shows that State income taxes were already more regressive than those of the Commonwealth during the 1920s; this difference was amplified during the Depression as the States brought in new more, regressive income taxes to fund unemployment relief. Significantly, the first moves in the direction of taxing low income earners were made by the less affluent States of South Australia and Western Australia in the late 1920s.

Contrary to interpretations of the Uniform Tax Plan as an act of ideology or political opportunism (Maddock 1982; Levi 1988b), this study concludes that tax unification occurred at that particular time because longstanding constitutional and economic barriers to resolving the pressing problems of tax revenue, tax equity and tax complexity were removed by the wider authority acquired by the Commonwealth after the bombing of Pearl Harbour. With regulatory options for restraining inflation running out by early 1942, the arguments for increased taxes to restrain demand became compelling. For a Labor Government, the extent of the necessary increase in taxation on wage earners was acceptable only if accompanied by higher taxation of the wealthy, a move that could occur only if the Commonwealth were unconstrained by the very high income taxes levied on the wealthy in Queensland. Fundamentally, as Bailey has commented, uniform income taxation was 'an attempt by the Treasury to grapple with a problem set by the Constitution' (1980 [1944], p. 309), interacting, it might be added, with the economic problem of tax competition.

By limiting the yield of both State and Commonwealth income taxes, these barriers to tax reform had previously prevented both State and Commonwealth Governments from responding to public pressures for expanded social services. This aspect is considered more fully in Chapter 5, on the payroll tax and child endowment.

These findings also suggest pre-war State income tax policies led the way for Commonwealth income tax policy with tax unification from 1942. As far as possible, the Commonwealth's uniform income tax schedules in 1942 integrated existing State income tax schedules, incorporating with only minimum change the States' regressive Depression income and wage taxes (Australia, Committee on Uniform Taxation 1942; Carslaw, 1980 [1941-47] p. 335). Furthermore, significant innovations in tax administration had occurred during the Depression due to States' income tax policies shifting focus onto wage earners. This study shows that South Australia, pressured by severe fiscal difficulties by the mid 1920s, was the first to experiment with 'taxation at source'; this system was better suited to South Australia's flatter tax schedule than the graduated scales of other Australian income taxes. For the Commonwealth to tax low wage earners efficiently, it too needed to introduce wage withholding, which it did in 1944 through the PAYE system. From the 1950s, as evident in Chapter 3, PAYE was a key component of the unannounced post-war transition to less progressive 'mass taxation'. PAYE revenues enlarged the National Welfare Fund to finance the new Commonwealth unemployment benefit and most importantly, made this new income taxation less politically visible and less painful to the taxpayer. Commonwealth income tax policies and the tax-financing of social security from 1942 were thus continuous in principle with the pre-war income tax policies of State Governments and, as Chapter 5 will show,

uniform income taxation in effect substituted Commonwealth for State income tax financing and provision of social services.

This study further suggests that interpreting uniform taxation as ideologically motivated is overly simplistic. The past practice of linking such taxation with provision of social services meant the Commonwealth Government was expected to balance any increased taxation of low income earners with expanded social services. Legal and political considerations favoured only modest change to the level and distribution of income tax burdens in 1942 (Butlin and Schedvin 1977, p. 332-335). The Labor Government's reluctance to immediately exploit the capacity created by the Uniform Income Tax Plan to increase tax burdens on low income wage-earners in 1942 also reflected, in part, the substantial tax increases that had already occurred on low and middle income earners since 1939, the excessive burden of taxes already carried by wage earners through the States' income taxes and the rise that had occurred in the Commonwealth's regressive indirect taxation (see Chapter 6). Furthermore, the Commonwealth's practical capacity to impose substantial income taxation on low income earners was constrained until the introduction of PAYE in 1944 by the limited saving capacity of the wage-earning population.

Ordinary income tax was clearly not a 'mass tax' during the interwar period in Australia. However, this study shows that Australian income taxation began the transition from a 'class tax' to a 'mass tax' during the Depression rather than in 1942, and that this occurred at the State rather than the Commonwealth Government level. In addition to reducing the visibility of income taxation through the PAYE scheme, earmarking income tax revenues to expand social services was a key strategy used by both State and Commonwealth Governments to fund social services through additional taxation during the first half of the twentieth century, a theme developed in the next chapter.

Chapter 5
Payroll Taxation, Earmarking and Social Security

> Those who can get work are to be paid fair wages but those who are excluded from the artificially restricted circle of employment are to be maintained at the expense of their neighbours. Of the reasonableness of this please I have nothing to say at present, but it may be taken for granted if a living wage is to be given (Reverend R. Stephen 1895, quoted in Goodwin 1966, p. 384).

Introduction

As most Western countries adopted contributory social insurance as the basis for social security, Australia's tax-financed system of social security system, based on heavy reliance on personal income taxation, is somewhat exceptional. The reasons for Australia's unusual financing mechanism have rarely been considered, especially within an economic framework. Based on European experience, non-contributory schemes such as that in Australia are simply characterised as 'derived from poor relief' (Mouton 1984, p. 6).

As observed in Chapters 1 and 2, this distinctiveness is partly due to Australia's heavy reliance on labour market and wage fixing regulation to achieve greater income equality and social protection; social security in Australia was mainly for those outside the formal labour market, notably unsupported women with dependent children, and the aged. As is well recognized, the 'Bismarkian' contributory schemes common in industrialized European countries evolved to suit their labour-intensive manufacturing economies, and were less beneficial to agrarian exporting interests. Employers had an interest in social security payments as these could increase or reduce overall wages costs, depending on which workers were eligible and how the scheme was financed. This raises the question of how much Australia's economic structure influenced its distinctive approach to financing social security. In what ways and through what mechanisms did such economic interests shape the tax and social security system, and how did this relate to redistribution through the 'needs based' wages system, that is, the wage earners' welfare state (Castles 1985)? This in turn is pertinent to the broader distributional question posed by Butlin *et al.* (1982) and raised in Chapter 1, of how progressively the growth of Australia's social security system was financed.

Australia is also distinctive because it relies heavily on general income taxation rather than earmarked taxes or contributory levies. Despite the appeal of tax earmarking as a way of reducing the political costs of taxation, Australia's original earmarking of tax revenues, such as for child endowment and widows pensions, was abandoned two decades after its introduction. What role did tax earmarking play in the evolution of Australia's tax system, and how did this relate to its distinctive financing system?

To explore why social security in Australia has been tax-financed rather than contributory, to identify the major vested interests shaping this system, and to further understanding of how tax earmarking might be connected to the adoption of this financing system, this chapter examines the early history of Australia's payroll taxes. The payroll tax provides a useful case study. Its introduction by the Commonwealth Government to finance national child endowment in 1941culminated nearly three decades of debate on whether endowment should be financed by employers, by employees, or by the public from general taxation. Both the 1925 NSW and the Commonwealth's wartime payroll taxes were soon replaced by income tax financing of child endowment. Debate over whether or not child endowment should be financed by a payroll tax closely parallelled the debates over Australian contributory social insurance proposals. The several child endowment schemes that were proposed at the State government level from 1919 onwards arose from governments' desires to restrain rising wage costs during a period of faltering economic growth, as well as from pro-natalist concerns and the issue of poverty among families without a male breadwinner. Proposals to fund child endowment through reducing

award wages risked undermining redistribution through the wage earners' welfare state by reducing the aggregate income share of wage earners. The controversies over these schemes represent the playing out of a more fundamental conflict over how the economic costs of producing and maintaining human capital would be shared between the market, the household and the public sector in the wage earners' welfare state.

This chapter will firstly review the history of how payroll tax and child endowment were introduced in Australia, demonstrating the wages policy context for the child endowment scheme introduced in NSW in 1925, and assessing the likely economic incidence of the payroll tax which funded the scheme.

The next section, on 'the political economy of payroll taxation', will examine the position taken by major interest groups at the Commonwealth Royal Commission on Child Endowment from 1927 to 1929. It identifies the discourse and interests of the various players in order to show why the cost of child endowment was later met from income taxation, rather than from a payroll tax on employers.

The third section' on 'social insurance and the Depression' will relate how special income and wage taxes replaced payroll tax in NSW and explore the connection of this to debates on Commonwealth Government proposals for contributory social insurance. It will assess whether expanded State income taxation provided a more progressive basis for funding child endowment than the payroll tax. Along with the final section on the Commonwealth's scheme, it will also examine the use of 'user pays' taxes as a political tool for neutralizing opposition to higher taxation.

The final section will examine the national payroll tax introduced by the Commonwealth to fund child endowment and avoid a Commonwealth basic wage increase in 1941. This will permit some judgement on whether or not Australia's system of financing child endowment through expanded income taxation was more progressive than financing it through the available alternatives — contributory social insurance, payroll taxation or higher indirect taxation.

Child endowment experiments: context and contenders

The wages policy context for the introduction of child endowment both in NSW and at the Commonwealth level is well illustrated in Cass's history of child endowment in Australia (1983), in Jelly (1977) and in Watts (1987). Inflation and industrial unrest precipitated proposals and various interest groups sought to shape the schemes to achieve their particular ends. Social reformers and unions aimed to protect the living standards of wage earners with children, while employers sought to cut wage costs by making child support a public responsibility.

Payroll tax was introduced in NSW in 1927 by the Lang Labor Government to fund child endowment. The scheme was considerably modified from the original proposal, reflecting the controversy that greeted its introduction in the Legislative Council.

By the 1920s, child endowment or family allowances were being advocated in the United States and the United Kingdom, with two distinct agendas. Some proponents, like Rathbone (1924), saw child endowment or family allowances as a progressive social reform aimed at redistributing income to women and children, reducing family poverty and acknowledging the social and economic value of women's unpaid work in the home (see Land 1975). Others favoured schemes run by employers, which reduced potential for strikes (Douglas 1925).

Like existing overseas schemes,[65] Australian proposals for child endowment during the 1920s emerged from a background of challenges to the established 'family wage' concept.[66]

[65] By the mid 1920s, voluntary child endowment schemes were already being operated by employers in various European countries (especially in mining and engineering industries or for State or bank employees). However, New Zealand financed its scheme, introduced in 1926, from general revenue: endowment was paid for all children after the second, the basic wage unit in New Zealand being a man, wife and two children (Australia, Royal Commission on Child Endowment 1929a).

[66] For example, see Charteris 1976 [1927], Sawkins 1933, Commonwealth Bureau of Census and Statistics, *Labour Report*, 1929).

Relatively high wartime inflation in Australia during World War 1 created considerable industrial unrest among workers who perceived the purchasing power of their wages to have been eroded by wartime price rises. Wage earners with children were worst affected, having relatively high expenditures compared to those without dependents. Employers, on the other hand, claimed the family wage was beyond the capacity of industry to pay and sought to dampen wage demands through child endowment. According to Schedvin (1970), this was a period when unbalanced growth and high protection produced slow productivity gains and undermined industry's ability to meet overseas competition.

The Holman Nationalist Government had in 1919 introduced a Bill for child endowment of 5 shillings per child for adult male employees, funded by a contribution from employers.[67] This was to be an alternative to a spectacular 28 per cent increase in the adult basic wage (Sawkins 1933) and involved redefining the basic wage unit as a couple, rather than a family of four (Commonwealth Bureau of Census and Statistics *Labour Report*, 1926, 1927). The move was also intended to protect NSW from increased costs that might force industries to close or move interstate (Evatt 1979). However, the Labor Party and unions saw the scheme as an attempt to 'filch' an expected basic wage increase. Employers in secondary and rural industries were unconvinced that it would reduce wage costs and uncompromisingly opposed the Bill. Conservatives opposed it not just on the grounds of cost but because it would undermine parental, especially paternal, responsibility to maintain children and thus also weaken work incentives (Cass 1983). The Bill scraped through the Assembly, but was blocked by the Legislative Council (Kewley 1973).[68]

Like that of the failed 1919 Bill, the immediate context for J.T. Lang's 1927 initiative was a determination of the NSW Industrial Commission,[69] chaired by Justice Piddington. A Commission Inquiry in 1926 found that restoring the real value of the pre-war basic wage (£5/6/-) required a large increase in the basic wage. The Commission ruled in favour of a wage increase to £4/4/- to bring a man and wife and one child up to pre-war real basic wage levels, and strongly recommended the Government introduce child endowment to protect the purchasing power of those with more than one child. Employers would benefit from not having to pay a family wage to those without dependents, even if they were required to finance the payment of child endowment for second and subsequent children through introduction of a payroll levy.

Women's organizations within the Labor Party were pressing for child endowment even before W.A. Holman's 1919 proposal (Cass 1983). They viewed child endowment as a prerequisite for women's equal pay, as well as an acknowledgment of women's economic contribution through non-market work and of the right of women and children to income separable from their husband/father's right to a living wage. Lang was lobbied to introduce such a measure immediately on attaining office in 1926 (Melville 1954). The labour movement's conception of such a measure was that it should be financed through progressive taxation and paid for all children in a family, with an income ceiling high enough to make it available to most wage earners. Unions conceived of child endowment as an addition to, not replacement for, a family component in the basic wage.[70] However, the labour movement was rarely in position to implement its policies through conservative-dominated Australian legislatures.

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[67] Rural workers, the self-employed, domestic servants, and those on incomes exceeding £400 p.a. were excluded, and payment was to be withheld where the husband was on strike (Jelly 1977).

[68] In 1921, the Storey Labor Government proposed a similar scheme, this time more overtly motivated by social and pro-natalist sentiments (Whalley 1972) but this Labor measure was also dropped in similar circumstances to those of Holman's Bill. The original intention had been to fund the scheme through a state lottery, but maintaining children from their elders' gambling was considered objectionable (Kewley 1973).

[69] In 1926, the Industrial Commission succeeded the Board of Trade as the wage-fixing authority in NSW.

[70] Along with aged and invalid pensions, it was, in the words of Cass (1983, p. 61), 'redistribution of income to those periods of the life-cycle which, by the necessities of modern industrial production and the state-regulated labour market, are typically spent outside of income earning activity. Policies of this nature, envisaged by the labour movement as both horizontally and vertically redistributive through the parallel operation of a progressive taxation system, were intended to subsidise or at best, fully cover the periods of apparently natural dependence associated with childhood, youth, old age and incapacity for labour.'

Such labour and social welfare groups were incensed when the *Family Endowment Act* of 1927 only partially met the child component of the wage increase that had been foregone as a result of the 1926 Industrial Commission ruling (Cass 1983).[71] The Government's original Bill had proposed a 6 per cent payroll tax and a child endowment payment of 6 shillings. Incomes up to £364 p.a. had been eligible. However, as passed, the Act provided only a 5 shilling per child payment and drastically limited eligibility to families on the basic wage or below, that is, on less than £221 p.a. The payroll tax was now also to be used to fund endowment for children of non-wage earners, such as 'farmers, dairymen, fruit-growers, self-employees, professional men and traders in a small way of business' (Charteris 1976 [1927], p. 153).[72] Only around 28,000 of 712,000 children in 1927–28 would now receive endowment.

Sustained pressure by employer groups also resulted in the levy being reduced to 3 per cent. From 31 October 1927, three months after its introduction, the levy was suspended (NSW, Office of the Government Statistician 1933). The Family Allowance Tax was not levied again until 1 April 1929 when it applied at a rate of 2 per cent; this was further reduced to 1 per cent from January 1930.[73] At the end of 1933, the tax was abolished and child endowment was funded along with unemployment relief and other social services by special Depression taxes.

Whether the child endowment scheme met the NSW Government's wages policy objectives depended on whether its introduction held wages down.[74] It is difficult to draw strong empirical conclusions, especially as there is no consensus among economic historians about whether wage tribunal decisions determined market wages, or vice versa. However, some official data are available on award wages, which allows comparison with wage trends in other States over the same period (Table 5.1 and Figures 5.1 and 5.2).

This shows a lower rate of increase in the NSW basic wage than in other States throughout the 1920s (Table 5.1 and Figures 5.1 and 5.2). Alternatively, the payroll tax may have been passed on in higher prices. The price effects of the levy are perhaps evident in the slightly lesser decline in Sydney food and grocery prices from 1927 to 1933 (Table 5.2).

Unless the payroll levy reduced profits, this suggests that in NSW in 1925 child endowment was effectively funded in a regressive manner.

The political economy of payroll taxes: Submissions to the Royal Commission on Child Endowment

By the mid 1920s, political support for national child endowment was increasing. A conservative Commonwealth government, under pressure to take the lead in financing a national child endowment scheme from its taxation revenues, established a Royal Commission in 1927. The following sketches the political and policy context for Commonwealth involvement, then examines the debate on child endowment and its financing at the Royal Commission.

Prime Minister W.M. Hughes had appointed a Royal Commission of Inquiry into the Commonwealth basic wage in 1919, responding to severe industrial unrest and inflation and amidst the controversy surrounding Holman's proposal for child endowment (Sawkins 1933). The Royal Commission, chaired by Justice A.B. Piddington, proposed changing wage fixing arrangements by replacing the family element of the basic wage paid to all (male) workers, with or without dependents, by a child endowment paid only to those with child dependents,

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[71] The judgment implied an amount of 10–11 shillings per child.

[72] Commissioner Piddington had recommended this be financed from consolidated revenue.

[73] Meanwhile, a large deficit accumulated in the fund, met by advances at interest from the Treasury (NSW, Office of the Government Statistician 1933).

[74] NSW remained the only State to introduce payroll taxation and a system of child endowment, although Queensland and South Australia considered legislation and a Victorian parliamentary committee examined the issue in 1939 (Kewley 1973).

financed by a levy on employers. The Commonwealth government did not accept these recommendations.[75]

In June 1927, the Bruce–Page Government[76] called a conference of State Premiers to consider establishing a national scheme of child endowment. This action was prompted by the unilateral NSW move and the need to address the potential for industrial chaos that it created (Charteris 1976 [1927]; Fitzpatrick 1969). In addressing the Premiers' Conference, Prime Minister S.M. Bruce cited his 1925 election commitment to child endowment and wage arbitration reform. At the Conference, he proposed a unified system for child endowment of 5 shillings per week. However, Bruce was unwilling to establish a national child endowment scheme while the States retained control over wage regulation, and he sought uniform State legislation on the basic wage unit. The Prime Minister envisaged financing child endowment through a redistribution of existing wages, with a reduction in the basic wage to follow from defining the wage unit as excluding children (Watts 1987). Bruce opposed financing child endowment through general taxation, arguing that the necessary doubling of Commonwealth income tax would increase inflation and make mothers worse off (NSW Legislative Assembly 1927). The Government's position was constrained by pressures from its coalition partner and rural and business constituency, which were opposed to any additional calls on general revenue.[77] Country Party Treasurer Earle Page was also intent on reducing the Commonwealth's direct taxation towards pre-war levels to reduce State government dependence on Commonwealth government grants (p. 1963).

A group of hostile Labor States rejected Bruce's proposal (Kewley 1973; Watts 1987).[78] The Premiers considered the Commonwealth should pay for child endowment, and saw reducing State basic wages to fund a voluntary State scheme as politically unattractive. As a way out of this impasse, the Commonwealth Government appointed a Royal Commission. Established in September 1927, the Commission reported in March 1929 (Australia, Royal Commission on Child Endowment or Family Allowances 1929a).

Those supporting child endowment before the Royal Commission were mainly trade unions, child welfare organisations, charitable organisations and women's groups. Trade unions and women's groups typically urged paying the full cost of maintenance, at least 10 shillings per child, for all children under fifteen, who were not included in the terms of the basic wage. They challenged the assumption that the basic wage was based on the needs of a family, arguing that the Harvester Judgment of 1907 reflected ruling wage rates, and pointed to the results of inquiries such as the 1920 Basic Wage Inquiry, which found existing wages inadequate for those with children. Such advocates of child endowment nearly all argued the cost should be met from Commonwealth progressive taxation, although a small number of women's groups favoured a redistribution of wages from single persons to married men with dependents.

Other key interest groups were employer organisations, including business or industry associations and rural producer groups, State governments, academics and legal and economic

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[75] However, it introduced such a scheme for its own workforce from 1920. Until 1923, the Commonwealth paid the £4 per week basic wage recommended by Piddington in the 1920 Royal Commission, with a child endowment of 5 shillings (not Piddington's 12 shillings) for officers with children whose income, including endowment, was less than £300 (later £400) p.a. The amount averaged £10 p.a. per employee. This scheme was introduced as an alternative to a general wage increase in 1920. From 1923, an £11 p.a. levy on all Commonwealth officers was used to create a fund out of which was paid an allowance of £13 p.a. to officers with dependent children.

[76] This was a Nationalist and Country Party coalition, formed in 1923.

[77] The Bruce–Page Government was heavily dependent on support from rural producers, who lobbied the Government vigorously about the arbitration system (Cumpston 1989) and about reducing the burden of direct taxation and high wages on primary producers (Robertson 1974). Bruce was a Melbourne importer with a strong commitment to reducing what he saw as the inefficiency and waste of the overlapping and conflicting State and federal arbitration systems (Cumpston 1989). Promoted by Nationalist party backers concerned by government extravagance, Bruce's emphasis on improving government financial management also attracted support from the Country Party.

[78] This was expected to cost between around £7 million and £24 million, depending on whether all children in a family were included or only those after the first. How tightly it was means tested also affected the range of savings (Commonwealth Bureau of Census and Statistics, *Labour Report*, 1928).

experts. Some employer and business groups opposed child endowment, or argued any such scheme should be funded from a 'redistribution of the wage fund' (Table 5.3). [79]

The most vociferous critics of the principle of child endowment were the Retail Traders' Association of NSW, the Victorian Chamber of Manufactures, the Primary Producers/Pastoralists' Association of WA, the Employers' Federation of WA and the Victorian Taxpayers' Association (the last largely comprising commercial and professional interests). Such groups objected to the proposal on both moral and economic grounds, fearing that raising the income of the family man would reduce his incentive to work or to better himself. They also argued that the financing of the scheme, whether from taxation or industry levies, would impose an unaffordable economic burden on industry and the national income.

Table 5.1
Male Basic Wage Declarations,
NSW, Victoria, Queensland and South Australia, 1922–1933

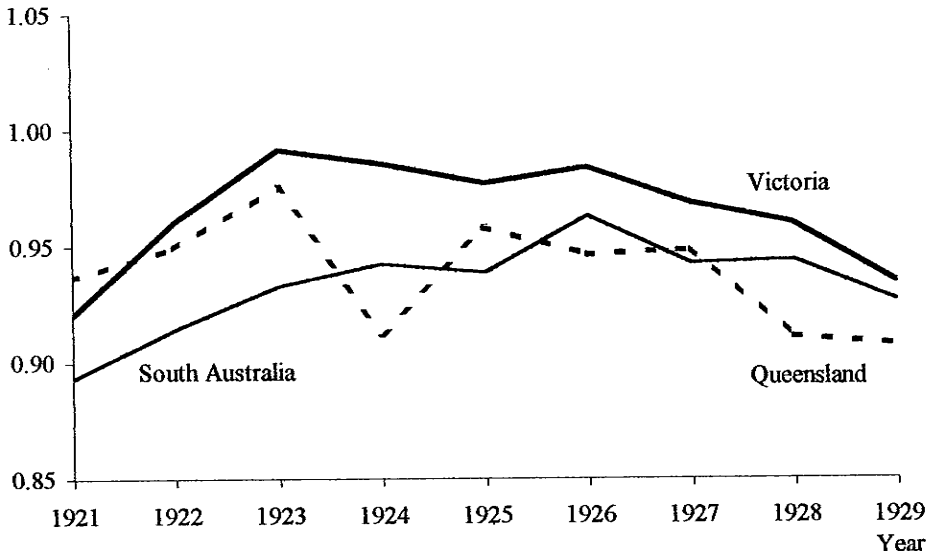
Year	*NSW* £ s d	*Victoria*[a] £ s d	*Queensland* £ s d	*SA* £ s d
1918	3			
1919	3/17/-			
1920	4/5s			
1921	4/2/-		4/5/-	3/19/6
1922	3/18/-s[b]	4/1/-	4/-	3/17/6
1923	3/19/-[b]			
1923	4/2/-[b]			3/18/6
1924				4/2/-
1925	4/4/-		4/5/-	4/5/6[b)]
1926	4/4s[c]			
1927	4/5/-[d]			
1929	4/2/6[e]	4/9/6		
1930			4/-[f]	3/15/-
1931		3/13/-	3/14/-	3/3/-
1932	3/10/-			3/3/-
1933	3/8/6			
1933	3/6/6			

Notes:
[a] Federal award for Victoria. There was no basic wage for Victoria, but Victorian Wages Boards followed federal awards.
[b] For couple and two children.
[c] A 'transitional declaration' was made for a couple and one child, pending legislation for child endowment, with an alternative declaration foreshadowed of £5/6/- if there was no child endowment implied at around 10–11s per child. Legislation introduced in 1927 provided for a 5 shilling per child allowance and a 3% levy on payrolls.
[d] for couple only.
[e] For couple and one child. The legislation was changed to forestall an imminent declaration of a basic wage for a couple of £3/12/6 (Sawkins 1933).
[f] A 'further wage declaration in the same year reduced the basic wage to £3/17/-

Sources: Commonwealth Bureau of Census and Statistics, *Labour Report*, 1940, p. 81; NSW Office of the Government Statistician 1933, p. 76.

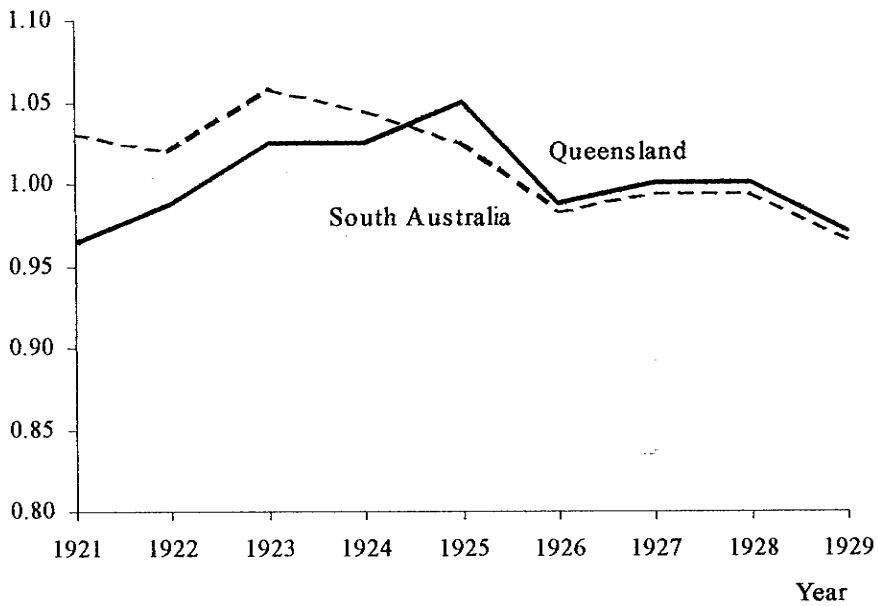
[79] This meant redefining the domestic unit used by wage fixing authorities to effect a reduction in the basic wage for single wage earners.

Figure 5.1
NSW Average Earnings as Ratio of
Average Earnings in South Australia, Queensland and Victoria



Source: Derived from Vamplew 1987.

Figure 5.2
NSW Basic Wage
as Ratio of South Australian and Queensland Basic Wages



Source: Derived from Commonwealth Bureau of Census and Statistics, *Labour Report*, various years; NSW, Office of the Government Statistician, various years.

Table 5.2
Change in Prices, 'B' Series, Food and Groceries Only, Capital Cities

	Sydney	Melbourne	Brisbane	Adelaide	Perth	Hobart
			% change in price index			
1919	15	11	18	11	19	7
1920	20	27	16	24	16	24
1921	-12	-8	-12	-11	-3	-6
1922	-10	-14	-11	-10	-11	-11
1923	7	10	5	6	3	4
1924	-5	-7	0	-2	3	-1
1925	3	4	3	3	2	-2
1926	5	1	3	2	-4	3
1927	-1	-2	-6	-1	-4	-4
1928	-1	-3	-1	-4	5	-3
1929	7	7	2	6	3	6
1930	-10	-9	-11	-11	-11	-7
1931	-11	-13	-8	-16	-13	-14
1932	-3	-4	-5	-4	-4	-2
1933	-6	-6	-5	-4	-6	-5
% change, 1926–1933	-23	-28	-30	-30	-28	-28
% change, 1918–1925	15	19	16	18	30	11

Source: Commonwealth Bureau of Census and Statistics, *Labour Report*, 1945.

Other industry groups, notably those employing married men on low wages and producing basic consumer goods, saw an economic advantage in child endowment, as it would reduce wage costs and pressures and increase demand for their products. Significantly, employers of skilled workers were keen that any such scheme would not exclude those earning above the basic wage, and thereby reduce incentives for skill.

Some other business and employer groups saw a potential advantage if child endowment were financed through a 'redistribution of wages', that is, child endowment accompanied by a reduction in the basic wage for those without dependents. For example, the Queensland Graziers' Association, the Queensland Colliery Proprietors', the Queensland Employers' Federation, the Queensland Taxpayers' Association, the Primary Producers' Association of WA, the Sugar Producers' Association of NSW and the Tasmanian and NSW Chambers of Commerce saw this as an acceptable approach. The NSW Shoe Manufacturers' Association and the NSW Metal Trades Association favoured wage redistribution, with the former also anticipating child endowment would increase demand for their products. It was commonly held that any attempt to reduce ruling wage rates for single persons and those without dependents would fail: only the Queensland Graziers' Association and the Sugar Producers' Association of NSW appeared to view a reduction in wage costs as a practical proposition. Urban industrialists were skeptical that a reduction in wages could be achieved in practice. They feared that in Australia such a scheme would result in severe industrial disputation and loss of work incentive. With only a remote potential reduction in wage costs, nearly all industry and employer groups favoured financing any scheme of child endowment from general taxation, not from a levy on industry or employers. The Queensland Taxpayers' Association, presumably reflecting the interests of wealthy land and income taxpayers, was the only advocate for financing by employers.

Table 5.3
Industry Submissions on Child Endowment

	Ambiguous	*Support*	*Oppose*
View on principle of child endowment	Chamber of Commerce, NSW Taxpayers Assoc., Qld. Farmers & Settlers Assoc., NSW Graziers' Assoc., NSW Shoe Manufactures Assoc., NSW Metal Trades Employers, NSW Timber Mill, WA Employers Federation, Qld.	Sugar Producers, NSW Chamber of Manufactures, Hobart Master Tanners & Leather Manufactures Assoc., NSW Graziers' Assoc., Qld	Retail Traders, NSW Employers Federation, WA Taxpayers' Assoc., Vic Chamber of Manufactures, Vic Primary Producers/Pastoralists' Assoc., WA
View on scope of scheme	***Non-employees to be included*** Taxpayers Assoc., Qld. Graziers' Assoc., NSW Primary Producers, WA	***Endowment to be means-tested*** Chamber of Commerce, NSW Taxpayers' Assoc., Qld. Shoe Manufactures Assoc., NSW Employers' Federation, Qld.	***Universal entitlement*** Graziers' Assoc., NSW
How scheme should be financed	***General Tax*** Master Tanners & Leather Manufactures Assoc., NSW Farmers & Settlers Assoc., NSW Shoe Manufactures Assoc., NSW Timber Mill, Perth Employers Federation, Qld. Queensland Colliery Owners Graziers' Assoc., Qld.	***Industry Levy*** Taxpayers' Assoc., Qld. Assoc., WA	***Wage Redistribution*** Taxpayers' Assoc., Qld. *Metal Trades Employers, NSW* Shoe Manufactures Assoc., NSW Primary Producers/Pastoralists' Sugar Producers, NSW Chamber of Manufactures, Hobart Graziers' Assoc., Qld. Employers' Federation, Qld. Queensland Colliery Owners Chamber of Commerce, NSW
Direct Tax Shoe Manufactures, NSW Primary Producers/Pastoralists' Assoc., WA Employers' Fed, Qld. Queensland Colliery Owners Graziers' Assoc., Qld.[b]	***Indirect Tax*** Metal Trades Employers, NSW[a]	***Can't cut wages*** Metal Trades Employers, NSW Master Tanners & Leather Manufac. Assoc., NSW Timber Mill, Perth Chamber of Manufactures, Vic. Employers' Federation, SA Chamber of Manufactures, Hobart	***Can cut wages*** Graziers' Assoc., Qld. Sugar Producers, NSW

Notes: [a] Import tariff
[b] Special levy, bachelor tax, contributory

Source: Analysis of Australia, Royal Commission on Child Endowment or Family Allowances 1929b.

Significantly, rural industries and small business organisations sought to ensure the child endowment scheme was extended to include non-wage earners. The NSW Graziers' Association advocated a scheme with no income test for eligibility. Other primary producers also joined urban industries and employers in opposing industry schemes financed by direct levies on payrolls. They saw such schemes as increasing the cost of inputs to rural industry and excluding most rural workers and primary producers. Based on their experience in NSW, groups such as the Farmers and Settlers' Association, the Master Tanners and Leather Manufactures' Association, the Shoe Manufactures Association, as well as the Queensland Colliery Proprietors, the Queensland Graziers' Association and the Western Australian Timber Mills, argued that any scheme should be paid from general revenue, rather than from a special levy on non-wage earners. Industry levies were criticised as highly inequitable, providing no benefit for employers with mainly single workers and excluding small businesses and farmers. They were also seen as inflationary; NSW experience was said to show such levies were usually passed on in prices.

In summary, industry, business and other employers considered any scheme had to be national to prevent non-uniform State schemes affecting interstate competition, and Commonwealth income tax was the preferred financing instrument. Many had no strong objection to child endowment unless it was financed by a levy on industry or employers. Industries exposed to interstate or overseas competition had strong objections, believing that higher taxation, including on incomes, fed through into costs and prices and reduced their competitiveness in local and international markets. Most agreed any scheme of endowment should be extended to all children, and many supported a generous means test so that it included skilled workers.

The Royal Commission explored the issue of child endowment with several economic experts.[80] These witnesses generally considered it possible to raise around £2–£10 million in taxation for child endowment, although Brigden, Sutcliffe and Copland argued that some re-distribution of wages was essential.[81] Recognising that reducing wages for single workers would be difficult, they suggested timing such a scheme for when prices were rising; it could then substitute for a wage increase. Others such as Wood and Mills opposed 'wages redistribution' as unjust and inequitable, as they considered that award wage rates reflected market reality.

Income taxation was the favoured financing instrument, with, for example, Mills and Copland suggesting extending its scope to single people on incomes as low as the basic wage. The economists were critical of industry levies for their inequity and inflationary effects, and were unanimous that income taxes were less likely to be passed on into prices. The alternative of increasing Commonwealth customs and excise revenues to finance child endowment was criticised as self-defeating in its distributional effect. Copland noted the merits of uniform Commonwealth and State income tax[82] and was critical of the Government's policy of reducing Commonwealth income tax.

Copland advised on general principles for assessing how much taxation might be levied. He emphasised four elements that determined tax capacity. The first was the level of national income, with a richer nation more able than a poorer one to bear heavier taxation without ill effects. Secondly, the degree of inequality of incomes determined the amount of taxable 'surplus' available, a more equal distribution leaving less scope for taxation than a highly concentrated one. The existing tax mix was Copland's third element: heavy reliance on indirect taxation indicated further scope for revenue raising through direct taxation of the untouched

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[80] Prominent economists, such as R.C. Mills, D.B. Copland, J.T. Sutcliffe, J.B. Brigden, G.L. Wood, F.C. Benham and E.O.G. Shann, made submissions (for biographical details see Groenewegen and McFarlane 1990). Their submissions have particular significance as several (notably Mills, Copland and Brigden) would become influential wartime economic policy advisers to the Commonwealth government, on issues such as social insurance, taxation, wages and child endowment.

[81] Brigden, Copland, and Sutcliffe accepted that wage regulation was effective in injecting 'needs' into wages paid. Other economists were more skeptical that wage arbitration rather than the market determined the overall wage level.

[82] See particularly Murphy 1980 [1928] and Mills 1980 [1928].

'surplus' of the wealthy. In the context of child endowment, Copland emphasized, fourthly, that taxable capacity depended on 'public psychology', in particular on 'whether [the public] have sufficiently grasped the social value of the expenditure for which the taxes are raised'. He judged that 'a moderate sum spent on child endowment should appeal to the average taxpayer' (Copland, in Australia, Royal Commission on Child Endowment or Family Allowances 1929b, p. 1253).

The economic experts generally argued that reducing inequality of incomes was economically beneficial if not offset by the adverse effects on production arising from higher taxation on savings or the possible work disincentive effects from raising family incomes. They argued that the financing cost of the scheme was best kept down by limiting it to the later children in a family rather than by the NSW method of restricting it to basic wage earners; the latter method reduced incentives for skill.[83]

Possible beneficial effects related to the switching of consumption from frivolous or luxury spending to essentials, such as food and clothing, and to the increased future production capacity of labour from better care in childhood. Wood, for example, gave evidence that

> the ordinary play of economic forces tends to limit investment in the persons and capacities of wage earners, with the result that the marginal returns to resources invested in the poor and their children would promise to be higher than the marginal return to resources invested in machinery and plant (Wood, in Australia, Royal Commission on Child Endowment or Family Allowances 1929b, p. 106).

Shann also argued that 'the human capital of the country is as likely to respond to further investment as its fields and factories' (Shann in Australia, Royal Commission on Child Endowment or Family Allowances 1929b, p. 107).

The Majority Report of the Royal Commission (Australia, Royal Commission on Child Endowment or Family Allowances 1929a, pp. 9–102) provided a comprehensive summary of the prevailing conservative arguments against child endowment. It challenged the need for child endowment, arguing that current wages provided adequately for children, and that public money would be used more beneficially in perfecting other social services. Pointing to the reduced productivity of industry since the war, the Commissioners, Mills and Evans, roundly condemned a national scheme of child endowment financed by an employer levy for the 'injurious result' it would have for industry (p. 9). At the same time, the Report closed off the option of a scheme financed from general revenue by declaring the consequences from such an increase in taxation would be 'disastrous' (p. 9), especially in the light of the increased taxation of the previous five years. A scheme which was additional to wages would boost 'extravagant' family spending and also inflation (p. 100).[84] The scheme also was eschewed for removing financial responsibility from parents and, thereby, their incentive to effort on behalf of their children (p. 71). The 'unity of interest' of parents was also threatened by paying endowment to mothers (p. 72), with the threat of increased numbers of deserting wives. Reporting doubts about the Commonwealth's constitutional powers over endowment and wage fixing,[85] and determining that a Commonwealth scheme was the only real option, the Majority Report

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[83] Significantly in the light of the approach taken in 1941, they supported abolishing the income tax deduction for dependent children as a possible minor offset to the cost of child endowment. They agreed that as this was a form of child endowment, the current proposal for child endowment was effectively a proposal for extending this allowance to non-income taxpayers.

[84] The Majority Report found only one existing child endowment scheme that it considered to be operating 'successfully' and without friction. This was the Commonwealth Public Service scheme, funded by a deduction from wages and salaries and based on the contributory principle.

[85] The Minority Report relied on the legal advice of R.R. Garran, former Commonwealth Solicitor-General, that there was no constitutional limit on the purposes for which Commonwealth taxation could be raised and no limit on what it could spend it on. Section 81 was an absolute power of appropriation for general purposes, 'and the Commonwealth Parliament has always acted on that supposition' (Australia, Royal Commission on Child Endowment or Family Allowances, 1929a, p. 108).

concluded that industrial disputes would increase in number and intensity unless the Commonwealth controlled national wage fixing as well as child endowment.

The Minority Report of John Curtin and Florence Muscio (Australia, Royal Commission on Child Endowment or Family Allowances 1929a, pp. 103–25) argued against this that a 'moderate' scheme financed from progressive taxation would be a good investment for the community. It noted that existing tax deductions for dependent children recognised the value of the money and services expended in rearing and training children and were a form of family allowances.[86] It argued that the 'family wage' was a convenient fiction and that wage fixing authorities were largely guided by market rates. For larger families especially, the basic wage provided an inadequate standard of living. The minority Commissioners reported that income tax was the preferred financing instrument as it had recently been reduced and was less likely to pass into the cost of living than other proposed levies, including a luxuries tax, or a poll tax. Another advantage noted was that the poorer States would pay relatively less in taxation but receive the same endowment per child as the other States, thus assisting in the automatic adjustment of the 'disabilities' experienced by some States.[87] A Commonwealth scheme met from general revenue would facilitate including non-wage earners and would, thereby, avoid creating incentives for preferring wage-work to self-employment. The financing scheme proposed in the Minority Report would redistribute income from those with the greatest capacity to pay tax to families in the greatest need, throughout the life cycle, and from those without dependent children to those with. The cost should not be met by altering the basic wage or the nature of the wage unit. The Minority Report cited the views of economists that taxation could be increased for a moderate scheme of child allowances without ill effects and rejected the Majority Report's argument that any national scheme should await comprehensive Commonwealth control of wage fixation. It also disputed that child endowment was a lower priority than improved housing and other social services, arguing that an adequate income could prevent the need for many expenses such as health care. Apart from the uniformity provided by a Commonwealth scheme, the Minority Report also favoured a national scheme because:

> State Governments may lead the way in proposals which show some definite development to social theory, but ideally such measures should be for the benefit of all Australian citizens. Moreover, such action by one State, if not adopted by its neighbours, penalises that State industrially in competition with others (Australia, Royal Commission on Child Endowment or Family Allowances, 1929a, p. 107).

The Minority Report proposed a benefit of £10 per annum for each child after the second for all families, including non-employees, with incomes up to £300 p.a.[88] This was justified as improving the economic welfare of large families, as well as providing a regular income for the children of the unemployed, widows, deserted wives and others without a male breadwinner. The necessary revenue would be raised through lowering the income tax exemption for persons without dependents to £200 p.a. and increasing the progressivity of tax rates on higher incomes.[89] This was, as Watts points out, 'a prefigurement of the reality of the later welfare State' (Watts 1987, p. 52).

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[86] Their proposal was similar to the scheme operating in New Zealand, which paid endowment of 2 shillings per week for children in excess of two in low wage families, financed from general taxation. Although the scheme was estimated to cost £250,000 for the 20,000 children eligible, applications and expenditures were far below that in its first year of operation (Australia, Royal Commission on Child Endowment or Family Allowances, 1929a, p. 29).

[87] This spatial effect of taxing according to ability and distributing revenues according to need had been identified by Giblin (1980a [1926]) (see also Chapter 7). Economists giving evidence to the Royal Commission had drawn attention to the distributional effect of a Commonwealth tax-financed scheme in transferring income from wealthy to poorer States.

[88] Some 92 per cent of children of wage and salary earners were said to be in families with incomes below £300 p.a., as were 85 per cent of those in the families of non-wage earners.

[89] The cost was estimated at between £4.5–£6 million p.a., depending on whether it was income tested at £250 p.a. or not. Extending the NSW scheme throughout the Commonwealth would cost around £4.2 million.

The Bruce–Page Government unsurprisingly accepted the Majority Report view that child endowment should not be separated from wage regulation. Prime Minister S.M. Bruce would only support a system of child endowment that involved a reduction in wages (Kewley 1973). At a conference of Ministers in 1929, the States refused Bruce's request to relinquish their industrial powers to the Commonwealth to further such a scheme (NSW Legislative Assembly, 1929). With the States retaining wage regulation, the Commonwealth Government would proceed no further (Kewley 1973; Commonwealth Bureau of Census and Statistics, *Labour Report*, 1929).

By this time, Australian governments were increasingly preoccupied with the slide into depression. The Bruce–Page Government was replaced by the Scullin Government at the election in late 1929, not long after announcing the Commonwealth's substantial withdrawal from wage arbitration. Action on national child endowment stalled until early in World War II.

Social insurance and the Depression

At the time of the Royal Commission into Child Endowment, the Commonwealth Government was considering its response to the findings of the Royal Commission on Social Insurance. The debate on social insurance during the 1920s set the groundwork for a new type of income taxation to finance social services — taxation on a 'regressive, flat rate basis designed to ensure in practice that the poor paid for the needs of the poor' (Dickey 1980, p. 163–65). During the Depression, governments instituted various new flat or proportional levies on wages and income, earmarked to fund unemployment relief and social services (Bland 1976 [1934]) and, thereby, established the principle of levying wage earners to pay for unemployment relief and social services. This section traces how special income and wages taxes replaced payroll tax-financing of child endowment in NSW and draws the links to the interwar debates on social insurance.

As shown in Chapter 4, Australia's poorer States found it necessary to tax the incomes of the low paid before the Depression. NSW imposed an unemployment relief tax in 1931, levied on weekly wages and incomes. These special taxes are summarised in Tables 5.4a and 5.4b.

From July 1932, revenues from the family allowance tax were paid into consolidated revenue along with those from the unemployment relief tax (NSW, Office of the Government Statistician 1933). Both taxes were abolished and replaced by the special 'income' and 'wages' taxes introduced in 1933 (Bland 1976 [1934]). From 1933–34 the revenues from these taxes were used to fund unemployment relief, child endowment and other social services, taxing low wage earners through the first-named levy, and other low income earners through the latter (Commonwealth Bureau of Census and Statistics, *Labour Report*, 1937; 1940).

Table 5.4a
Receipts of Special Unemployment Relief Taxation

	1931–32 £m	*1932–33* £m
NSW	6.04	6.53
Victoria	1.54	1.81
SA	1.08	1.08
Queensland	n.a.	n.a.
WA	n.a.	n.a.
Tasmania	n.a.	n.a.

Source: Bland 1976 [1934].

Table 5.4b
Rates of Special Unemployment Relief Taxation, 1932–33

	Rate per £	*Incomes on which the tax was imposed*
NSW	1s	£2 per week and over; reduction in rate where income £3/10/- per week or less.
Victoria	1.2d to 14.22d	£52 p.a. and over: a graduated rate commencing at 1.2d in the pound, with a maximum of 14.22d in the pound on incomes in excess of £3000.
Queensland	3d	Up to £104 p.a.
	6d	Over £104 and up to £208.
	9d	Over £208 and up to £499.
	1s	Over £499.
SA	Nil	
WA	Nil	'Hospital tax' of 1½ in the pound applied to incomes over one pound per week replaced by a similar 'financial emergency tax' of 4½d in the pound operated from 1 December 1932.
Tasmania	4d	On first £312.
	5d	On £313 to £520.
	9d	On £520 to £1500.
	1s	Over £1500.

Source: Bland 1976 [1934].

Whether the incidence of the payroll tax was borne by employers, firms, or employees from 1927, it is clear that from trends in revenues and expenditures (Tables 5.5 and 5.6) that, as a consequence of tax changes during the Depression, low wage earners in NSW were now directly contributing to the cost of child endowment and unemployment relief. Contemporary observers explicitly acknowledged this (Bland 1976 [1934]; Commonwealth Bureau of Census and Statistics, *Labour Report,* 1941).

However, it is likely to be somewhat more progressive than the previous financing scheme, as an income tax, which included incomes other than wages, would have been more progressive than a proportional tax on wages or consumption.

Throughout this period, taxation policy was strongly influenced by the debate on contributory social insurance. Social insurance has been characterised as the conservative response to concerns that creating an entitlement to public assistance would weaken moral values of thrift and self respect; contributions were felt to ensure recipients were not pauperised or stigmatized (Dickey 1980; Mouton 1984). Musgrave (1959) has argued that historically, social services were paid for by earmarked contributions to reduce its political costs as this appealed to a particular 'benefit' conception of equitable taxation. Between 1913 and 1939, several schemes for social insurance were considered in detail in Australia, against the background of the spread of social insurance schemes overseas. The prospect of publicly funded social security appears to have been increasingly attractive to employers in the 1920s as such a scheme would relieve the wages system of the responsibility for family and other needs of employees at a time when the inherent conflict between 'needs' and 'capacity to pay' was becoming increasingly apparent. The hearings of the Royal Commission on Child Endowment were conducted in the context of the Government's preparation of a Bill for social insurance.[90]

[90] In 1913, the Commonwealth Statistician G. H. Knibbs had conducted an inquiry into social insurance, although nothing came of his report.

Table 5.5
NSW Taxation, 1926–27 to 1940–41, Selected Years
(£)

Year ending June	*1927*	*1928*	*1929*	*1930*	*1931*	*1932*	*1933*	*1934*	*1935*	*1936*	*1937*	*1938*	*1939*
Family Allowance Tax	1,012,758	52,813	1,886,715	558,555	930,264	2,409,034	998,914	37,778	71,132	24,523	13,671	5,584	
Unemployment Relief Tax & Social Services Taxes					4,735,803	5,799,519	6,702,439	2,197,583	171,295			6,367,046	6,339,215
Special Income Tax								1,477,300	1,971,292	2,826,210	3,242,336		
Wages Tax								1,573,404	3,120,034	3,364,082	3,559,553		
Total Income Taxes	7,739,627	6,382,467	7,343,049	7,084,465	6,183,481	3,411,146	3,870,616	2,808,851	3,146,495	4,088,164	5,186,972	6,367,046	6,339,215
Total State Taxation	12,698,642	12,204,243	13,551,589	15,170,582	16,183,229	14,855,306	18,052,925	14,198,932	13,990,771	16,289,727	18,726,372	20,504,734	20,262,919

Source: Commonwealth Bureau of Census and Statistics, *Finance Bulletin*, various years

Table 5.6
Child Endowment Expenditures in NSW, 1927–1941

Year ending June for child (£)	*Annual liability endowment*
1928	814,518
1929	1,553,986
1930	1,261,202
1931	1,196,484
1932	1,805,685
1933	2,105,659
1934	1,960,972
1935	1,898,315
1936	1,804,392
1937	1,595,183
1938	1,469,932
1939	1,363,833
1940	1,337,020
1941	1,337,489

Source: NSW, Office of the Government Statistician, various years.

In 1928, responding to the Report of the Royal Commission on National Insurance (Australia, Royal Commission on National Insurance 1927), the Bruce–Page Government tabled a Bill proposing a limited social insurance scheme to provide income support for the sick, disabled, widows and orphans, although the benefits were not specified (Kewley 1973). It proposed the scheme be financed by an equal levy of 1s per week on employees and employers for each male worker earning less than £416 p.a.: the Government would contribute only in the early years when the scheme was in deficit. The scheme was attacked on all fronts, including by friendly societies and insurance companies which feared the competition, and employers, who were unwilling to accept responsibility for a share of the costs (Dickey 1980; Kewley 1969). It was mainly conservative opposition that caused the scheme to be abandoned, the labour movement having mixed views on the issue at this time (Kewley 1973). By the late 1930s, the Labor Party had also come to strongly oppose contributory insurance, its position represented by John Curtin. Curtin noted that contributory schemes excluded many groups and taxed others unfairly:

> the bill [for social insurance] contemplates an anomalous system of class taxation. Its benefits are not equally shared, and its burdens are not equally distributed. ... I decline to delude myself with the idea that a contribution is not a tax. We are taxing the employers, and we are taxing the employees. This principle of sectional taxation in a national health and pensions system appears to be fundamentally unsound. ... The Labor Party expresses its utter condemnation of the individual contributions as a principle in regard to invalidity, old age and widows' pensions. These services should be a charge upon the consolidated revenue of the Commonwealth. To impose special levies either on workers or employers is unjust (Australia, Parliament, Parliamentary Debates (Hansard) 1938, quoted in Kewley 1973, p. 61).

By the eve of the World War II, a national insurance Act had been passed and had received assent. However, it was never implemented. Unlike previous proposals, it provided for a government contribution, making it into the 'tripartite' financing scheme common in Europe (Mouton 1984). In 1939, the Treasury strongly objected to its cost (Watts 1987). Like its 1928 predecessor, the scheme excluded unwaged workers caring for dependents, the self-employed

and the unemployed. The emerging international situation and political maneuvering in 1939 distracted political attention and disturbed the fragile political consensus that had been carrying the scheme forward. A fiscal debate triggered by Treasury's opposition renewed concerns from the Country Party and imposed severe strains on an already troubled coalition Government. In June 1939, the Act was suspended and the scheme was abandoned (Watts 1987).

Commonwealth child endowment and wartime tax policy

The outbreak of war in 1939 brought the issue of child endowment to the fore both because of wages policy and the industrial relations aspects of child endowment and because of its relevance for the pressing problems of demand management and taxation policy (Watts 1987).[91] Around the same time, institutional obstacles to a national scheme were removed by war regulations based on the Commonwealth's constitutional defence power (Butlin 1955).[92] The Basic Wage Case of 1940 prompted a specific focus on child endowment because from mid 1940, the Commonwealth Conciliation and Arbitration Court was under strong pressure to increase the Commonwealth basic wage. Child endowment was raised in late 1940 as the centerpiece of a scheme for industry harmony when the Chief Justice of the Court, George Beeby, commented that

> a really comprehensive scheme of child endowment would secure industrial peace for a long time. The real source of industrial grievance today is the inadequacy of the basic wage for family allowance (quoted in Watts 1987, p. 56).

During January 1941, Judge Beeby also privately suggested to the Government that a child endowment scheme funded by an earmarked payroll levy along the lines of Piddington's 1921 scheme might satisfy unions, as 'capital' would be seen to be disbursing some of its income to labour (Watts 1987).

The Court announced in February 1941 that it would defer its decision on a basic wage increase until June. The delay provided the opportunity for the Menzies Government to present its child endowment scheme to Parliament (Commonwealth Bureau of Census and Statistics, *Labour Report*, 1941).[93] Menzies' scheme provided for payment of 5 shillings for each child aged under sixteen after the first child, and a 2.5 per cent earmarked tax on the value of employers' payrolls above £1040 p.a. or £20 weekly. Most of the total estimated cost of £13 million was met from the levy on payrolls. A contribution out of general revenue was to cover the one–third of recipients who were not employees. The legislation provided for the tax to be paid into general revenue but appropriated to a National Welfare Fund as a charge against a new system of national child endowment. It was to take effect from 1 July (Commonwealth Bureau of Census and Statistics, *Labour Report*, 1941).

Although the public generally welcomed child endowment, the payroll levy was highly controversial. Employers, including State governments and business groups, objected strongly to the tax (Kewley 1973; Watts 1987). Unions were aggrieved by the implications of the scheme for the Arbitration Court's rulings on wages and suspicious that the Court's 'deal' with the conservative Government was at their expense. Nevertheless, as Beeby had anticipated, the levy

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[91] As has been observed of the introduction of UK family allowances, 'a social policy which becomes relevant to a government's economic policy gains enormously in priority' (Land 1975, p. 197).

[92] The December 1940 promulgation of the National (Industrial Peace) Regulations allowed the Commonwealth Government to regulate wages nationally. A key obstacle to a national scheme in 1929 had been the difficulty of coordinating the decisions of various State arbitration tribunals and wages boards. The Commonwealth could now go ahead with a coordinated child endowment and wages scheme without seeking the States' cooperation and without any concerns about its constitutional powers to do so.

[93] The importance of labour market issues in this initiative is highlighted by the key role played by the Department of Labour and National Service, and the Financial and Economic (F&E) Committee in both initiating and developing the scheme (Watts 1987). For example, some economic advisers opposed means testing endowment as it reduced incentives for skill. The scheme was limited to second and subsequent children, thereby halving costs, in response to pressures from the Treasury. It was also argued that the first child was adequately provided for in wages (Cass 1983). However, rather than reducing costs by means-testing the allowance, the Government achieved a similar but less obvious result by abolishing dependent child tax deductions.

on employers effectively subdued union criticism of the child endowment/wages trade-off (Watts 1987).

However, according to Butlin, these arrangements were only intended as transitional. The arrangement was recognised by the public 'as one installment of a political bargain with a view to extending taxation to lower incomes' (Butlin 1955, p. 383). By late 1939, the Government's economic advisers[94] had been concerned at the imminent need to raise taxation to restrain unnecessary consumption and ensure maximum production for the war effort without provoking inflation or industrial unrest.[95] Their advice to raise taxation, including on lower income earners, represented a major political problem because, in 1941, the political position of Menzies' minority government was highly precarious (Sawer 1963). The Financial and Economic (F&E) Committee advised the Government that the payroll tax be replaced and the burden shifted as quickly as possible to taxes falling on individual surplus income. The problem was that the Labor Party was unlikely to agree to such a policy of extending taxation to the lower incomes, even if necessary for wartime economic management, without action to tax higher incomes, at that time a contentious issue with the States (Butlin 1955).[96] The payroll tax was thus a holding operation until these problems were settled. Child endowment was seen to have the advantage of giving the Government greater political freedom to raise income taxes, being an additional bargaining factor in obtaining Labor acceptance of 'substantial taxation on lower incomes' (Copland, quoted in Watts 1987, p. 58).

Federal Labor policy was that child endowment should be funded through an increase in progressive taxation. However, there was no opposition to Menzies' proposal when the legislation was put before Parliament in late March. Scullin, reflecting the general Labor view, welcomed the proposal for child endowment as a social reform that was long overdue (Watts 1987). Labor also supported abolishing the dependent child deduction.[97] Curtin restated Labor's objection to the payroll tax as a means of financing the scheme.[98] However, the Labor Party's position was that child endowment was a desirable social reform and a principle it would support. For this reason it would not object to the contributory aspect of the financing, which would be debated separately.

Meanwhile, the government's economic advisers were continuing to press for increased taxation on lower and middle incomes, which was becoming more urgent as the economy reached full employment from 1941. After the election of the Curtin Labor Government in late 1941, uniform taxation was introduced in May 1942 following the report of the (Mills)

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[94] Since the Depression, a small number of leading Australian economists, operating through the F&E Committee had earned the trust and respect of both sides of politics and were displacing the Commonwealth Treasury as a source of economic and financial policy advice. These officials, including D.B. Copland, L.F. Giblin, and H.C. Coombs, were closely in touch with the ideas of J.M. Keynes and sympathetic to the economic and social philosophy behind them (Maddock and Penny 1983).

[95] A similar issue was at that time exercising the minds of economic advisers in the UK. In his influential *How to Pay for the War* published in 1940, Keynes had raised the possibility of managing excess demand during the war by extending taxation on lower incomes, while protecting the consumption standards of the most vulnerable, including children in low wage families, through a system of family allowances. Keynes had previously presented his arguments in *The Times* in two articles during November 1939 (cited in Sayers 1956).

[96] The disparate State income tax schedules were seen as an insurmountable obstacle to higher taxation at that time (Laffer 1980 [1942]). Strongly progressive tax scales in one or two States limited the Commonwealth's ability to raise taxes on the higher incomes; in some States taxpayers already faced marginal tax rates in excess of 100 per cent. The situation meant that, after taking Commonwealth income tax into account, higher income earners were lightly taxed in some States but very heavily taxed in others.

[97] Scullin had long been highly critical of the unfairness of allowing high income taxpayers to receive what was essentially a form of child endowment, when lower income earners received no such allowance (Robertson 1974). Furthermore, the benefit of the deduction was greater the higher the marginal rate of the taxpayer. See Dowsett (1941) for a contemporary analysis of this issue.

[98] Curtin reiterated his concerns, expressed in the 1929 Minority Report on Child Endowment, that the payroll tax was inequitable in incidence and offended against the principle of ability to pay. He also argued that it discouraged higher wages and the employment of skilled men. Similar concerns were raised by some Government members (Kewley 1973).

Committee on Uniform Taxation (Australia, Committee on Uniform Taxation 1942).[99] Although the uniform tax scale of 1942 increased taxation on the lower incomes[100] this mainly reflected the structure of the superseded State income taxes (see Chapter 4); compared to the pre-1942 Commonwealth income tax, and to Fadden's tax proposals, uniform taxation eased the relative tax burden on lower income earners (Maddock 1982).[101] Because most States had tax allowances for dependents, the new Commonwealth schedule also reintroduced provision for child dependents, in the form of a dependent child rebate.[102]

Significantly, the Government decided to link the new tax arrangements to the establishment of a new social service (Bailey 1980 [1944]). Contemporary commentary, recorded in the *Economic Record,* was that 'the decision [to introduce] a pension for widows, was ... no doubt influenced by the political desire to enlarge the range of support for the Plan' (Bailey 1980 [1944], p. 317).

With child endowment in place and uniform taxation now permitting heavier national taxation of the higher incomes, the Labor Government was more able politically to contemplate the increased taxation of the lower paid that its advisers considered essential. In 1943, the Government announced substantial increases in taxation, including on the lower incomes. In particular, the exemption was lowered from £156 to £104, below the basic wage. The increased taxation of lower income earners was planned to raise the bulk of the £42 million additional income tax revenue needed for that financial year, with advisers having earlier estimated that for 1941–42 between £24 and £34 million might come from extending Commonwealth income tax to lower incomes (Butlin 1955).

To soften criticisms of the tax increase on lower income earners, it was linked to immediate and future improvements in social services (Bailey 1980 [1944]). A new maternity benefit and funeral benefits for aged and invalid pensioners were funded from the increased revenues that went into the National Welfare Fund.

Also, significantly, the Government sought to legitimise its financing of these new social programs to conservatives in the Commonwealth Parliament by reference to the findings of the 1942 Report of the Joint Parliamentary Committee on Social Security. This report had rejected social insurance for Australia, but argued that 'the counterpart to the right of everyone in the community to protection against loss of income due to unemployment is the obligation of all the potential beneficiaries to contribute to the scheme' (Australia, Parliament, Joint Parliamentary Committee on Social Security 1942, p. 4). Because of the difficulties of covering non-employees under the conventional contributory arrangements, the Committee had concluded that 'the simplest and most equitable plan in the present circumstances is to impose a general tax on every income earner in the community, with the exception of those on the lowest scale' (Australia, Parliament, Joint Parliamentary Committee on Social Security 1942, p. 4). It recommended a special social security tax on individuals or the earmarking of a portion of each individual's income tax for social security.

The Curtin Labor Government remained opposed to the contributory principle, arguing that this financing method placed an excessive burden on lower income groups, and did not spread the load according to ability to pay. It observed that the effective incidence of the conventional tripartite financing fell heavily on the individual, as the employers contribution was passed on in prices and the government's share came from taxation, ultimately from the 'citizen/consumer'. The Government was also concerned that many groups were excluded from such a contributory scheme (Kewley 1973).

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[99] The Fadden Government proposed to tax the lower incomes heavily through a tax credit scheme announced in its 1941–42 Budget. However, it lost office over the Budget and Labor took office in October 1941.

[100] Curtin had promised at the 1941 election not to tax low income earners, and made a further commitment not to increase income tax rates as part of the May 1942 move to uniform taxation (Watts 1987).

[101] For a brief review of the previous efforts to secure income tax uniformity, see Laffer (1980 [1942]).

[102] The *Income Tax Amendment Act* (No 22 of 1942), which implemented Uniform Taxation, introduced tax rebates for dependent children with a maximum rebate of £45 for the first child and £5 for each other child.

The explicitly 'contributory' approach awaited Treasurer J. B. Chifley's[103] ascendancy to leadership of the Government in 1945.[104] That year, the Labor Government labelled a portion of the income tax a 'Social Services Contribution' (Kewley 1973). Significantly, the Social Services Contribution was earmarked along with payroll tax for the National Welfare Fund for social services expenditures, which from 1945 included child endowment, age, invalid and widows pensions, as well as unemployment benefits (introduced in 1944).

The payroll tax remained in place until the Commonwealth vacated the field in favour of the States in the early 1970s (Smith 1993b), and the National Welfare Fund accounting was abolished in 1952, cutting the link between payroll tax and child endowment. The 1945 Social Services Contribution was absorbed into general income taxation in the early 1960s. As Kewley observes (1973, p. 245), the Social Services Contribution had served a useful purpose, 'its operation during the early postwar years [having] gained political acceptance for the payment of income tax in peace-time by persons in the lower income group'. The post-1943 increase in taxation and the associated National Welfare Fund were accepted by the public despite criticism that much of the extra £40 million of revenue raised in 1943–44 came from wage earners on low to moderate incomes.

A key critic within the Government, A. Calwell, argued that the National Welfare Fund set a precedent for maintaining high taxation on the low incomes, 'so that the worker will pay for his own old age pension and other benefits out of his basic wage' (quoted in Kewley 1973, p. 235).

However, it can be concluded that the 1941 payroll tax was less likely than its NSW predecessor to fall on wages or prices, and more likely to fall on profits, because of the more prosperous economic conditions, and wartime price and profit controls: financing child endowment from Commonwealth income tax revenues from 1942 was probably more progressive than either the NSW or Commonwealth payroll tax arrangements.

There can also be little doubt that even Chifley's 'contributory' scheme of 1945 was more progressive than the main practical alternative at that time, social insurance, as a proportional tax on all incomes is more progressive than such a tax levied on wage and salary incomes only.[105]

Conclusion

This chapter has explored the evolution between 1919 and 1945 of the payroll tax and child endowment in Australia and has drawn connections between income taxation, the earmarked 'social services' taxes, and contributory social insurance proposals. It has assessed the likely incidence of the early payroll taxes and identified the positions of major interest groups regarding how child endowment should be financed. It has also examined the significance of the 'earmarking' of tax revenues for the transition to financing social services from progressive Commonwealth income taxes.

This chapter has shown that in 1925 and in 1941 the predominant policy objective for conservative governments introducing child endowment was to substitute for a wage rise by

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[103]The National Welfare Fund of 1943 and the 1945 'Social Services Contribution' apparently originated in the Treasury. There was also tentative support for the contributory principle by some F&E economists, who were advising Chifley. Chifley did not have strong objections to the principle, seeing a contributory social services tax as one of the best 'political and psychological' devices to protect against irresponsible increases in the generosity of social security (Kewley 1973, p. 243).

[104] As early as 1940, the government's economic advisers had examined whether unemployment insurance could be used as a sweetener for higher taxation of the lower incomes and foreshadowed dividing taxation into an income tax and a social security tax; but the F&E Committee were skeptical about whether the package would make higher taxation more politically acceptable. The move also risked accusations that lower earners brought into taxation for the first time were paying the full cost of social insurance. When closer analysis revealed unemployment insurance would make no substantial contribution to the economic policy objective of reducing consumption, the F&E Committee lost interest (Watts 1987)

[105] This is the typical character of social security taxes or contributions (Peters 1991).

imposing instead a comparatively less onerous payroll tax. This example of child endowment suggests that Australia's non-contributory social security system originated not from 'poor relief', but from government labour market interventions. Child endowment policies were intended to reconcile conflicting demands for 'a living wage' and industry demands for wage restraint by reallocating a component of labour costs.

This chapter also concludes that the distinctive Australian system of financing means-tested social security benefits from general taxation was as much a result of industry (in alliance with primary producers and exporters) shifting the cost of producing and maintaining 'human capital' as it was a reflection of the strength of progressive labour or welfare advocacy. Analysis of the public debate on financing child endowment during the 1920s has shown that employers wanted any scheme of scheme of child endowment to be national and financed from general taxation rather than from levies on industry or employers. An industrially strong labour movement was suspicious of the incidence of these payroll levies or social insurance, but until the election of the Curtin Government in late 1941, lacked the effective power in Australian parliaments to embed progressive taxation in legislation as the means of financing social services. Labour interests opposing contributory social insurance schemes found parliamentary allies in the influential Country Party representatives of rural industry, who argued that employer levies raised primary producers' costs in the world market and also excluded farmers and the self-employed from its benefits. The interests of women's groups advocating publicly funded child endowment as a right of citizenship rather than as an adjunct to male wages were also aligned, to a degree, with both labour and rural interests.

Payroll tax is theoretically passed onto consumers in the long run. However, as Musgrave wrote, 'the effects of a tax depend upon what it is, not what it is meant to be' (1959, p. v). Indeed, 'economists would be ill advised to write off [alternative views on payroll tax incidence] as economic illiteracy' (Musgrave and Musgrave 1989, p. 442).[106] Butlin, *et. al.* concluded that while many employees and perhaps labour leaders in Australia believed the burden of the NSW Family Endowment Tax fell on employers and profit, in fact:

> the probable ability of employers (except in export industries) to pass on a good deal of the tax to consumers, the shifting definition of the basic wage and the associated lags between movement in wage rates and in prices ensured that endowment was predominantly a transfer of real income between different low income families (Butlin *et al.* 1982, p. 181).

This chapter has provided empirical support for the view that NSW child endowment and, probably, the 1941 Commonwealth scheme were originally financed regressively. If child endowment did hold down the basic wage, low wage earners did carry a disproportionate share of its cost. A payroll tax that was passed on into prices or basic wages would have been as regressive as a consumption tax.

The findings of this chapter on the transition to income taxation to fund child endowment are also pertinent to broader distributional question posed by Butlin *et al.* (1982), of whether the wage earner paid for his own welfare state through higher income taxation. Fitzpatrick (1969) suggests that when the NSW payroll tax was replaced by Depression income taxes in 1932, the burden of payment was transferred from employers to employees. Butlin, *et al.* focus on the tax changes of the 1939–45 period in questioning whether the post-war financing of social services was more progressive than the pre-war financing. This study points to the 1929–32 Depression as the formative period for the financing principles of Australia's

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[106] In a competitive market, the tax will be distributed according to the relative elasticities of demand and supply in the labour market. It is generally assumed the approximate incidence of payroll tax, whether levied on the employee or the employer, is on wages and employment, not profits (Musgrave and Musgrave 1989). In reality, payroll tax may be passed on to consumers, with an incidence somewhat like that of a consumption tax, or fall on profits if, for example, there are adjustment lags due to long-term wage contracts. Market imperfections also affect the outcome. As is shown here, unions may strongly resist cuts in wages, including those resulting from tax increases, yet accept earmarked payroll taxes (or employer social security contributions) as an alternative to wage rises.

welfare state. However, it suggests that the regressive new income taxes introduced during the Depression or from 1942 to finance new social services were unlikely to have been more regressive than payroll taxation. As long as the previous payroll tax approach mainly flowed through into lower wages or raised prices, rather than lower profits, then financing it through a broad income tax base which included non-labour income was less regressive. Similarly, to judge the progressivity of the financing of child endowment from the NSW special income and wage taxes from 1933, and through expanded Commonwealth income taxation after 1943, one must consider whether alternative financing schemes, such as higher indirect taxes or contributory social insurance, would have had a more progressive incidence. It is concluded here that that would be unlikely.

Thirdly, this history of payroll tax in Australia has highlighted the public uncertainty over the actual economic incidence of the payroll tax, and the significance of earmarking as a political strategy. Earmarking is said to have wide political appeal (Peters 1991), appealing to a 'benefit' or 'user pays' conception of equitable taxation (Buchanan 1963).[107] It has drawn attention to the use of earmarked payroll and wages taxes and later 'contributory' income taxes to achieve public acceptance for a process by which industry gradually reallocated responsibility for providing for wider social needs or risks from the wage system to the general taxpayer. Using payroll tax revenues to fund a popularly supported social reform aided public acceptance of the new tax in 1925 and 1941. Confusion over tax incidence is not surprising given the use of earmarking to achieve various ends: governments used the device both to overcome conservative opposition to social spending and to obfuscate the unions who were concerned about government policies holding down wages. Relieving pressures on employers to pay higher wages on account of the needs of families muted business opposition to the child endowment/payroll tax package. On the other hand, earmarking payroll tax revenues to fund child endowment, which unions generally supported, softened union opposition to foregoing a wage increase. As shown in Chapter 4, conservative parliamentarians and governments were willing to support extending social services during the Depression and World War II if this were paid for by the regressive new income taxes, as this meant the poor were effectively funding the cost of their own welfare system. Labor's wartime tax policies can be seen as the means of finally heading off the contributory approach to social security in that it required lower incomes to 'contribute' through income taxation. The 1945 'Social Services Contribution' formalised the income tax levy on low income earners and signalled the end of a thirty-year debate. With lower income earners henceforth visibly contributing to social services through direct taxation, the contributory principle had been met. This sounded the death knell for conservatives' advocacy of social insurance in Australia (Butlin *et al.* 1982; Kewley 1969, 1973).

Wage earners, who were effectively financing these new social services through lower wages or higher taxes, were understandably unenthusiastic about sacrificing wages to fund schemes mainly benefitting non-wage earners, notably women and children and, from 1944, the unemployed. This history may thus explain the ambivalent view of the Australian labour movement towards the high taxation/high spending strategies adopted in some northern European countries as a means of effecting redistribution, and Australia's frugal and distinctive tax-transfer system.

Income distribution surveys in the 1960s showed Australia's means-tested social security was strongly redistributive (Bentley, Collins and Rutledge 1975; Podder and Kakwani 1975; Warren 1979). International comparisons suggest Australia's means-tested system of social security remains more redistributive than those countries with social insurance schemes (Castles and Mitchell 1992; Mitchell, Harding and Gruen 1994). Until the early 1970s, expanding income tax revenues financed social services spending by Australian governments (Butlin, *et al.* 1982).[108] While Australia's tax system as a whole is essentially flat across a broad range of incomes (Warren 1997), at high income levels its relatively heavy personal income tax

[107] However, it is contrary to the politically influential administrative concerns of treasuries. See, for example, Australia, Treasury (1996) and Smith (1993a).

[108] See also Chapter 3 regarding the changing progressivity of personal income taxation between 1917 and 1997.

has contributed significantly to vertical equity compared to a flat rate income tax such as a social security tax (Head and Krever 1997).

Hence, those who criticise the pre-1945 extension of income taxation to lower incomes because it represented wage earners financing their own 'class', with the inference that it was a retrograde or even regressive step, have to show that this was more regressive than the practical alternatives — payroll taxation, higher sales or excise taxes, or flat-rate contributory social insurance levies on labour incomes.

Chapter 6
Is the Only Good Tax an Old Tax?
An Historical Perspective on the GST debate*

Introduction

The saying that 'the only good tax is an old tax' reflects the reality that social values and political and economic forces shape the tax system over a long period of time. One of Australia's 'old' taxes is the wholesale sales tax (WST), introduced in 1930. It was replaced by a goods and services tax (GST) in June 2000.

The move to a comprehensive GST was defended by claims that WST was an outdated and unfair tax reflecting the economic circumstances and values of bygone days and the *ad hoc* results of political 'rent-seeking'. A Commonwealth Treasury article, for example, purported to draw on historical analysis 'to demonstrate that some of the original motivations for the design of the tax may no longer be relevant' (Australia, Treasury 1998, p. 23). Its features were characterised as unintended consequences of socially inefficient lobbying in the post-war period, without significant implications for the equity of the tax system.

Such sentiments were also presented in the Howard Government's 1998 election tax policy statement (Commonwealth of Australia 1998), and in the Treasurer's second reading speech on the Bill to abolish the wholesale sales tax (Australia, Parliament, House of Representatives (Hansard) 1998). According to the Treasurer, the WST was appropriate for a 1930s economy, but the economy had changed. Furthermore, 'the wholesale sales tax needs to be abolished because it has no logic or design' (p. 862).

While it may be true that changes in the economy have affected the yield of the tax, and anomalies have arisen over time, the proposition that this old tax has 'no logic or design' needs to be challenged. One purpose of this chapter is to examine the reasons for introduction of and subsequent changes in the WST, and to show that Treasury's assertions are unsustainable. A second purpose is to provide a more general critique of the Howard Government's indirect tax reforms.

The present WST was introduced in 1930 at a single rate of 2.5 per cent. This was raised to 8⅓ per cent within a decade. A multiple rate system of sales taxation was introduced in November 1940. In 1998 there were five different sales tax schedules, excluding the exempt category. In arguing for a comprehensive GST, the Commonwealth Treasury's 'history' of sales tax compares its multiple rate and narrow base unfavourably with the presumed ideal of a uniform rate, broad-based consumption tax.[109]

Treasury has argued that the former WST's narrow base was an unintended consequence of the encouragement of socially unproductive rent-seeking provided by exemptions and differential tax rates (Australia, Treasury 1998, p. 30).

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[109] While it is not the central purpose of this study to debate optimal tax theory, it must be pointed out that a uniform rate comprehensive tax is far from 'perfect' in theory and in practice. Optimal tax theory points to differential tax rates to minimise economic distortions. However, in practice, there are always at least two rates of GST, one on marketed and one on non-marketed goods and services produced by households for themselves. Practical difficulties in taxing financial services and some other publicly provided services ensure a multiplicity of effective rates of GST (see Quiggin 1998). Furthermore, the theoretical ideal is also severely compromised in practice because social values accept heavy taxation on alcohol, tobacco and gambling and because such taxes are highly productive of revenue. The uniform rate tax is only 'ideal' from the viewpoint of minimizing compliance costs. The proscription of differential tax rates in favour of a uniform rate for commodity taxation rests on judgements about encouragements to rent-seeking, or on presumptions that the information requirements of Ramsey-type consumption taxation are excessive (see Stigler 1988).

Like Sawer (1963), who characterises the Commonwealth sales tax as 'a regressive impost which infringes the principles of taxation in accordance with ability to pay' (p. 10), Treasury dismissed the possibility of sales tax design reflecting any distributional objectives. It also argues multiple rates of sales taxation are 'a response to the specific circumstances of the war' (Australia, Treasury 1998, p. 26), intended to direct resources into war production, rather than reflecting social objectives of taxing luxuries more heavily. Multiple rates were said to reflect 'special circumstances that no longer apply' (p. 33).

This Treasury view corresponds to the conventional wisdom that the WST commenced on a broad base and has been eroded mainly in recent decades. For example, Collins and Warren (1998, p. 17) assert that

> the Commonwealth government introduced the Wholesale Sales Tax in 1930 on a fairly broad base, and at a uniform rate. However from the 1940s onwards, it was characterised by a narrowing of its base and the adoption of multiple rates.

However, this is conjecture rather than fact: public finance policy during the Depression years is largely unexplored (Groenewegen 1983b).

As is evident in Table 6.1, much 'erosion' of the WST in fact occurred early in its history. Contrary to the conventional view that it was initially a broad based tax, the WST covered only a third of private consumption spending (PFCE) when it was introduced. It fell to around 23 per cent of spending in the late 1940s and, after briefly rising during its heyday as a tool of stabilisation policy in the 1950s, remained at around 18 to 22 per cent of spending for most of the period since. Likewise, it commenced with a coverage equivalent to around 22 per cent of GDP, and by 1945 had fallen to about the same share of GDP as it was in the 1990s.[110]

Table 6.1
Long–Term Trends in the Sales Tax Base, 1930–31 to 1995–96, selected years

Year ending June	*Taxable sales/ private consumption (PFCE)* (%)	*Taxable sales/ GDP* (%)	*Private consumption (PFCE/GDP)* (%)
1931	28	22	77
1932	32	24	75
1935	28	22	77
1940	28	19	70
1945	27	15	58
1950	25	17	68
1955	23	15	67
1960	22	14	65
1965	21	13	62
1970	20	12	60
1975	20	11	58
1980	19	11	59
1985	21	13	60
1990	26	15	59
1995	22	14	62

Sources: Butlin and Schedvin 1977; Foster and Stewart 1991; Groenewegen 1983a; Warren 1996.

[110]By comparison, a comprehensive GST of the type originally proposed by the Howard Government would have covered around 80 per cent of the consumption base, representing around half of GDP (Warren 1998).

Furthermore, during the 1980s and 1990s, WST revenue collections reached historical peaks as a percentage of GDP (Table 6.2).

Table 6.2
Sales Tax Collections as a Share of Private Spending and GDP, 1940

Year ending June	*Sales tax collections/private consumption (PFCE) (%)*	*Sales tax collections/GDP (%)*
1931	1	
1932	2	1
1935	2	1
1940	2	1
1945	4	2
1950	2	2
1955	3	2
1960	4	2
1965	3	2
1970	3	2
1975	3	2
1980	3	2
1985	4	2
1990	5	3
1995	4	3

Source: Groenewegen 1983a; Foster and Stewart 1991;
ABS, *Taxation Revenue Australia*, various years.

The conventional analysis, therefore, raises important questions about the origins and evolution of sales taxation in Australia. Did the Scullin Government introduce sales tax during the worst depression the twentieth century without regard to its distributional impact? Did the sales tax base shrink simply because unprincipled governments were corrupted by pressures from special interest lobbying? And do multiple rates of sales tax reflect only the special circumstances of World War II, a legacy of wartime economic management objectives? Does the Australian sales tax really have no design or logic, other than to raise revenue? Has economic and social change really made it irrelevant? What are the implications of its history for the debate on the merits of a GST to meet Australia's pressing revenue needs?[111]

These questions are addressed below. This Chapter firstly examines the parliamentary debates during the 1930s, when the essential structure of the current sales tax was put in place, to see how if at all, the distributional effects entered into the selection and design of the tax. Then, it looks at sales taxation during World War II to see why multiple rates were introduced, and how sales taxation was to fit into the nation's post-war taxation structure. The sales tax is then surveyed statistically to explain trends in the sales tax base and explore whether economic change has fundamentally altered the relevance of the WST since 1930. Finally, this chapter assesses the implications for the debate over the Howard Government's GST package.

[111]See also Chapter 13.

The choice of sales tax as a new federal revenue tool: sales tax policy in the 1930s

The design of Scullin's 1930 sales tax

Parliamentary debate on the WST commenced with its announcement in the 1930–31 Budget in early July 1930 (Australia, Parliament, Senate and House of Representatives (Hansard) 1930a). The second reading of the relevant legislation took place from 30 July (Australia, Parliament, Senate and House of Representatives (Hansard) 1930b). The Scullin Labor Government was severely chastised by the parliamentary Opposition and accused of hypocrisy for changing its former critical stance on indirect taxation.[112] The Labor platform had been that indirect taxation was wrong because the burden fell chiefly on the poorer people, and particularly on families in which there were most mouths to feed. Scullin's indirect tax measures were said to sin against all accepted principles of tax policy, in particular 'ability to pay'. However, the debates reveal that the Opposition's alternative policy was not necessarily more progressive, and the Scullin Government specifically designed the sales tax to reduce its regressivity.

In 1930–31, the Scullin Government faced an expected deficit of £14 million in the absence of new tax measures. The proposed 2.5 per cent sales tax was expected to contribute £5 million in new revenue, alongside additional customs and excise taxes of £5.7 million, and higher federal income taxation adding £850,000.

The Commonwealth's main practical revenue alternative to the sales tax was lowering its income tax threshold from around £300 to around £150 pa, with much heavier burdens on lower and middle incomes. Direct taxation, the Nationalist/Country Party Opposition argued, was more progressive. Indirect taxation was inequitable because the rate was governed by the goods purchased and could not be subject to graduation: 'whether a man earns £4 or £40 a week, he pays the same rate' (Australia, Parliament, Senate and House of Representatives (Hansard) 1930b, p. 5286).

The Opposition pointed to the NSW unemployment relief tax as a model. This was a flat rate levy of 3d in the pound imposed on all but those earning less than £80 pa:[113]

> the tax applies practically to all wage earners, and it is expected to bring in £3,000,000, which, it is estimated, will provide for most of the unemployment in that State (Australia, Parliament, Senate and House of Representatives (Hansard) 1930b, p. 4629).

This, the Opposition argued, was 'a fair tax'. Unlike the sales tax, 'a tax on the poor man', it reflected 'ability to pay' (Australia, Parliament, Senate and House of Representatives (Hansard) 1930b, p. 5286). Opposition speakers also argued that the fairest form of indirect taxation was that on luxuries, such as the bulk of excises, because the taxpayer could quite easily do without them if he did not want to pay the tax. 'Conventional necessaries', such as tea, might also be dispensed with without causing serious injury to health, although such items were desirable to enable the people to conform to the standard of living in the country in which they lived. Next to a tax on luxuries, the Opposition considered a tax on such conventional necessaries to be least harmful to the country.

The Labor Government's response was that avoiding new Commonwealth taxation through cutting Budget spending on wages and unemployment relief was more unfair to workers than its sales tax proposal. Scullin argued that the new tax merely replaced lost customs revenues. The incidence of the new taxes had been spread as fairly and as widely as possible, in

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[112]This was reinforced by critical comment on the regressive distribution effects of the sales tax by Brigden, writing in the *Sydney News* on 14 July, and in the *Sydney Morning Herald* on 15 July (see Australia, Parliament, Senate and House of Representatives (Hansard) 1930b, p.4543).

[113]The NSW unemployment relief tax was one of the numerous special taxes that were introduced by State governments during the Depression to fund social services and public relief for the unemployed (Bland 1976 [1934]). By 1930, these very regressive flat rate or fixed taxes on weekly wages and low incomes raised more revenue than States' income taxes.

order that 'an undue burden may not fall on any one section of the community and there may be the least possible disturbance of industry' (Australia, Parliament, Senate and House of Representatives (Hansard) 1930a, p. 3902). Under Labor's taxation policy, all suffered a similar loss. By contrast, the Opposition's fiscal and wage policies would diminish the incomes solely of the wage earning class.

Scullin was also sharply critical of Opposition proposals to encroach onto States' field of taxation such as by extending federal income taxation to lower incomes. The Government had rejected this option because:

> existing State taxes preclude the Commonwealth from imposing heavy additional taxes in fields in which the States also operate (Australia, Parliament, Senate and House of Representatives (Hansard) 1930b, p. 4721–23).

According to Prime Minister and Treasurer Scullin, the sales tax was also better than leaving the States to deal with cuts in grants from the Commonwealth. Cutting grants to States was tantamount to taking money from the right-hand pocket and putting it in the left-hand pocket:

> We should be big enough to visualise Australia as one people. Surely the Commonwealth and the States are one. There is not the slightest doubt that if we withdrew £2,500,000 [for roads and unemployment relief] from the States, the State Treasurers would have to increase taxation by that amount, and some of the States are not in a position to increase taxation at all (Australia, Parliament, Senate and House of Representatives (Hansard) 1930b, p. 4723).

Under the Scullin Government's 1930 sales tax legislation, more sales were exempt than taxable (Australia, Office of the Commissioner of Taxation 1931, p. 14). The new tax exempted exports and goods made by primary producers. However, most exemptions were for items prominent in the budgets of basic wage households, including basic foods such as 'milk, butter, cheese, condensed milk, wheat, flour, sugar, bread and pastry, potatoes and market garden produce, orchard produce, poultry, other dairy produce, fish, grapes' (Australia, Office of the Commissioner of Taxation 1931, p. 14).[114] A long list of domestically manufactured goods also escaped sales tax on similar grounds (Australia, Parliament, Senate and House of Representatives (Hansard) 1930b, pp. 4933–5).

Granting exemptions for such basic wage items but not for inputs to primary production led to accusations the Labor Government was favouring labour-intensive manufacturing industry over primary producers (Australia, Parliament, Senate and House of Representatives (Hansard) 1930b, p. 4440). The Government was also accused of 'coddling the millionaires of Australia as they have never been coddled before', because sales tax would not tax large professional incomes or incomes from rent yet would hit the workers' and families' living costs (Australia, Parliament, Senate and House of Representatives (Hansard) 1930b, pp. 4542–3).

Labor member Chifley's speech on the sales tax bills makes clear that the extensive exemptions from the original sales tax were a deliberate policy to reduce its regressivity (Australia, Parliament, Senate and House of Representatives (Hansard) 1930b, pp. 5305–9). The Government's sales tax was equitable because:

> Under this tax practically all foodstuffs will be exempt. From 50 to 75 per cent of the earnings of the workers is spent on rent and foods. The average working man is paid not more than £250 a year, and it is safe to say that £175 or £200 out of this income is used in the purchase of foods and services that will be exempt from the tax. Those persons with incomes ranging from £750 to £1000

[114] It might be asked why the Government was concerned to exempt such items when the Commonwealth basic wage was indexed for price increases. It may have preferred to protect wage earners directly, as indexation of the basic wage occurred only after a lag of 5 months and State wage tribunals did not necessarily follow the Commonwealth Arbitration Court. Furthermore, even if basic wage earners were protected by indexation, many other wage earner families could still have been exposed to the regressive effects of sales tax unless compensated through higher wages.

> a year do not have nearly such large families as do the bulk of the workers, and a good deal of their earnings are disbursed in the purchase of goods that will be subject to the tax.

Chifley argued the poorer section of the community would not be substantially affected by the tax:

> As the commodities that are necessary to preserve life are exempt, those who have a comparatively low income, and cannot afford to purchase luxuries, will largely escape. The man who buys an £800 motor car will pay more on that one transaction than the average worker will pay in nine or ten years.

Acknowledging that sales taxes tended to be regressive, Chifley cited authorities on 'the almost universal practice' of exempting, or taxing at special low rates, the foodstuffs and other items that constitute the major portion of the expenditures of the poorer classes, but a smaller fraction of the expenditures of the richer classes:

> If the renting of dwellings, as a service, is untaxed, and foods are entirely exempted, the entire distributive character of a general turnover tax is changed. The poorer classes are practically entirely relieved of its burden.

Country Party representatives also expressed their approval of exemptions for those commodities that were viewed as 'absolutely necessary to the producer's and the working man's family' (Australia, Parliament, Senate and House of Representatives (Hansard) 1930b, p. 4443) including basic foods. They joined rural Labor parliamentarians in seeking further exemptions for other foods.[115] It is likely parliamentarians were motivated by the producer interests in their constituencies, and the interests of relatively low income consumer households.

Contemporary economic opinion argued that the relatively few exemptions for items in the working man's budget compared to the Canadian model made the Australian sales tax more objectionable on distributional grounds (Burton 1930, p. 246).

Although exempting items such as hay and straw, fertilisers and other products used in primary production, the Government resisted most industry calls for further exemptions. Revenue considerations overrode all but the most pressing cases for further exemption. Exempting half the potential base had already necessitated a rate of 2.5 per cent rather than 1.25 per cent. However, Scullin promised to give priority in future Budgets to widening exemptions if revenue permitted:

> The government hopes that in the course of time the rates may be reduced and the exemptions increased. That has been the experience of other countries, particularly Canada (Australia, Parliament, Senate and House of Representatives (Hansard) 1930b, p. 4935).

In the event, the sales tax raised less than anticipated. In the 1931–32 Budget, it was increased from 2.5 per cent to 6.0 per cent. Controversy erupted over the change:

> While some wholesalers and manufacturers had been content to submit to the failure to recoup the 2.5 per cent tax paid by them, they felt it was impossible to adopt the same attitude towards a 6 per cent tax (Australia, Office of the Commissioner of Taxation 1931, p. 14).[116]

The increased sales tax rate was accompanied by an extension of the exemption list in late 1932. This mainly aimed at extending exemptions 'in aid of primary production', but also

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[115] For example, see Australia, Parliament, Senate and House of Representatives (Hansard) 1930b, p. 5287, 5291–300.

[116] It is not clear why industry felt the incidence of the tax was borne by producers. Certainly the presumption during the 1930 Parliamentary debates was that the tax would fall on consumers. The issue was somewhat muddied by technical legal issues which created some confusion about whether the tax could be passed on by wholesalers; this was remedied by amending legislation the following year. However, it would appear that the depressed conditions experienced in some industries at that time made it difficult for producers or importers to pass on the tax, and this affected some industries more than others. See also Burton (1930).

responding to concerns at equity or administrative difficulties of taxing basic household goods (Australia, Office of the Commissioner of Taxation 1933, p. 15).

As fiscal conditions improved from 1933 sales taxation was eased. In 1933, the rate of tax was reduced to 5 per cent (Australia, Office of the Commissioner of Taxation 1934, p. 19). The Government gave highest priority to increasing exemptions rather than reducing the general rate, with the objective of lowering production costs for domestic industry. Although numerous additional exemptions were introduced during 1933 and 1934, under the *Financial Relief Acts* of 1933–35, the general rate was not lowered again until 1935, to 4 per cent (Australia, Office of the Commissioner of Taxation 1939, 1940). By 1935, the sales tax raised £9.3 million annually. Receipts remained around that level for the rest of the decade.

Sales tax policy during World War II

Revenue or resource allocation? Sales tax policy in 1940

In the first full-scale war Budget announced on 21 November 1940, the Fadden (UAP/Country Party) Government introduced a tax package including:

- higher sales taxation;
- a lower personal income tax threshold of £150 per annum; and,
- excess company profits taxation.

Although income tax measures produced more revenue, rates had already been increased substantially.[117] While the Government saw income tax as the preferred and most effective method of collecting from each individual a contribution to the cost of the war, radical changes were needed to make it a major instrument of war taxation.[118] Higher sales tax was to bring £3.4 million of the £31 million sought in extra revenue for 1940–41, along with increases in duties on luxury items such as alcohol and tobacco yielding £4.2 million.

On Treasury's interpretation,

> Multiple rates [of sales taxation] were first introduced in 1940 to encourage resources to flow to 'essential' war related activities. Goods were classed according to the standards of the time. Subsequent classifications and reclassifications have also reflected the values that prevailed at the time of classification. Many of these judgements no longer appear appropriate given the rapid changes in technology and consumption patterns (Australia, Treasury 1998, p. 26).

Treasury continues:

> Overall revenue needs were high and there was a high priority placed on channelling resources into war-related activities. It is also important to note that differential rates were established not to tax 'luxuries' more heavily but to channel resources into more 'essential' areas in time of war (Australia, Treasury 1998, p. 26).

The war-time evolution of taxation and fiscal policy in Australia was generally shaped by ideas and policy in the United Kingdom (Watts 1987), where the thinking and advocacy of Keynes was highly influential. Avoiding inflation required sharp reductions in consumer spending, to be effected in part by heavily taxing lower and middle income earners. One concern about such a policy was the effect on incentives to work for low to moderate wage earners (Land 1975; Sayers 1956).

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[117]Commonwealth income tax rates had already been increased 50 per cent in Spender's Financial Statement of May 1940, following rises of 15 per cent and 10 per cent in the 1938 and 1939 Budgets. This imposed heavily on middle income earners because of the need to accommodate varying State income taxes on higher incomes.

[118]Income taxation of wage and salary earners, to be achieved through the lowering of the income tax threshold, was strongly resisted by Labor unless there was commensurate sacrifice by the wealthy. State income taxes were a factor standing in the way of the Government meeting Labor's demands (see Chapter 5).

However, the Australian sales tax changes of 1940 were not aimed at channelling economic resources to war needs, as suggested by Treasury. They were motivated simply by traditional public finance concerns of revenue and tax equity. Fadden, as Treasurer from October 1940, was at this stage unreceptive to the Keynesian framework for tax and financial policy (Coombs 1981, pp. 10–11). He emphasised tax policy to 'raise money' for financing defence expenditures rather than to conserve and direct economic resources for the war effort (Walker and Beecroft 1941, pp. 2–3).

The Government's view of indirect taxation was simply that:

> taxes upon the necessaries of life are to be avoided because they fall heavily upon the family and because they add, directly or indirectly, to costs of production. Taxes upon luxuries are free from these objections (Australia, Treasury, *Budget Speech and Papers*, 1940, pp. 10–14).

Its stated policy was to use customs and excise taxes (rather than sales tax) to reduce and divert consumption and discourage spending on luxuries and those goods likely to be in short supply (Australia, Treasury, *Budget Speech and Papers*, 1940, p. 97).

Treasury's interpretation appears to confuse this application of the traditional 'sumptuary' approach to indirect (customs and excise) taxation with introduction of multiple sales tax rates, motivated by broader tax policy objectives emphasising revenue and tax fairness.

Continuity of principle in sales tax policy

When revenue needs increased from around 1938 with defence preparations for World War II, the Government increased the rate, rather than winding back exemptions, to generate revenue. The rate of tax was increased to 5.0 per cent in 1938, 6.0 per cent in 1939, and 8.33 per cent in May 1940 (Australia, Office of the Commissioner of Taxation 1939, 1940). The differential sales tax rates introduced in 1940 permitted raising of additional sales tax revenues without infringing accepted principles for equitable sales taxation.

The Government was at the time very vulnerable to Opposition criticism of the increase in sales taxation (Australia, Parliament, Senate and House of Representatives (Hansard) 1940, pp. 790–1, 935).[119]

> There were still many persons who can well afford to pay a higher rate of income tax, and additional revenue should be obtained from those persons rather than from married men with families, the lower wage earners, and the invalid and old-age pensioners by means of this unfair indirect tax (Australia, Parliament, Senate and House of Representatives (Hansard) 1940, p. 938).

The Government's proposals were also criticised for being particularly inequitable for families:

> This form of taxation falls with particular severity on the lower sections of the community, and the larger a man's family, the more he has to pay' (Australia, Parliament, Senate and House of Representatives (Hansard) 1940, p. 800).

Labor leader Curtin reached agreement with Prime Minister Menzies to criticise but not oppose the measures (Sawer 1963).[120] Despite this, a number of his Labor colleagues directly repudiated the compromise. They bitterly challenged the equity of extending indirect taxation at a time when the Government was proposing direct taxation for the first time on ordinary wage earners. The Government was accused of trying to lift the burden of direct taxation from the

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[119] All was not well in the government ranks. After tensions between the UAP and the Country Party had come to a head in late 1939, Menzies had formed a UAP government with the 'discriminating support' of the Country Party. Spender became Acting Treasurer in November 1939, and Treasurer in March 1940. Following an election in September 1940, Menzies headed a minority UAP Government kept in office by two Independents. The following month Fadden, who had been Assistant Treasurer since March 1940, replaced Spender as Treasurer. During 1941, Menzies stood aside as Prime Minister for Fadden in the interests of political harmony.

[120] Menzies had, among other things, agreed to lower the income tax threshold to £200 rather than £150 p.a.

shoulders of its supporters with the view to spreading it over the community as a whole. The Labor left were especially critical of the taxation of drugs and medicines while veterinary products used by primary producers remained exempt:

> the woman who has done her duty in rearing children has to pay sales tax on the medicine bought for her kiddies when they become ill, whereas another woman who has failed to do her duty, and prefers to nurse a poodle-pup, can get all of the medicine that she requires for her pet dog and not pay any sales tax on it. ... Can the Minister justify the imposition of sales tax on the surgical footwear required by a child who has suffered from infantile paralysis, whilst medicines and requisites used in the treatment of racehorses, dogs, pigs and other animals are exempt from the tax? (Australia, Parliament, Senate and House of Representatives (Hansard) 1940, p. 780).

The Government was also accused of provoking strikes and industrial disputes by lowering the purchasing power of workers, in contradiction of its strong stance of opposition to inflation (Australia, Parliament, Senate and House of Representatives (Hansard) 1940).

Treasurer Fadden's response emphasised that the Government's priorities were to raise revenue, and to raise it quickly (Australia, Parliament, Senate and House of Representatives (Hansard) 1940). The proposed sales tax changes continued previous principles for sales taxation, namely preferential treatment for food, primary produce and certain primary industry inputs (Australia, Parliament, Senate and House of Representatives (Hansard) 1940). He revealed that the Government had been pressured to hold down the general rate of taxation by abolishing all exemptions. However, it did not adopt that approach (Australia, Parliament, Senate and House of Representatives (Hansard) 1940). Treasurer Fadden listed the well-defined criteria for exemptions from sales tax:

(1) the goods are basic foodstuffs;

(2) they are primary products;

(3) they are primary producers' machinery, or materials of production;

(4) they are goods used in industries which in peace time it is necessary and desirable to foster;

(5) they are goods used in activities relating to religious, philanthropic, benevolent, educational or medical and surgical activities.

Of the £565 million total of goods estimated to be consumed, no less than £314 million would remain exempt. Nearly two-thirds of the value of exemptions represented basic foodstuffs, fuel, light and power (Table 6.3).

Table 6.3
Exemptions from Sales Taxation, 1940

Item	*£ million*
Basic foodstuffs	131
Fuel, light and power	60
Primary products	25
Primary producers machinery, materials and aids	23
Goods sold to government departments	40
Beverages, tobacco &c., subject to heavy customs duties customs and excise	17
Sundry items	18
Total value of exemptions	314

Source: Australia, Parliament, Senate and House of Representatives (Hansard) 1940, p. 95.

Under the circumstances, the Treasurer argued, the proposed changes to sales tax did not materially depart from the major principles upon which exemption from sales tax had hitherto been granted. Differential rates had been avoided in the past, according to the Treasurer 'not because of any view that a varying burden could not be justified', but simply because of the higher compliance and administrative burden (Australia, Parliament, Senate and House of Representatives (Hansard) 1940, p. 109). The alternative to differential rates was a greater rise in the general rate.

To obtain the same £3.4 million of revenue from a single rate of sales tax, it would have been necessary to increase the existing rate from 8⅓ per cent to 13½ per cent. With the option of imposing differential rates of tax on non-essential goods, the Government felt it could not justify such an increase:

The loading of an additional 5 per cent on goods already heavily taxed would have had serious repercussions in many directions' (Australia, Parliament, Senate and House of Representatives (Hansard) 1940, p. 806). Total withdrawal of exemptions 'would so disturb the nation's economy as to cause harm greatly outweighing the advantages to be derived from ease of classification and the relatively lower rate. (Australia, Parliament, Senate and House of Representatives (Hansard) 1940, p. 95)

The Government therefore chose to raise £1.5 million by increasing the general sales tax rate, and the balance from selective increases and base broadening.[121] Taxing a limited selection of other previously exempted goods at half rates 'preserved the principle of preference' (Australia, Parliament, Senate and House of Representatives (Hansard) 1940, p. 107). While these items had 'undeniable' claims to exemption in times of peace, 'standards formulated in peace-time have to be adjusted to war-time necessities' (Australia, Parliament, Senate and House of Representatives (Hansard) 1940, p. 107). The items included in the 15 per cent category were not necessarily luxury goods but supplied 'less urgent needs' than those contained in the other schedules to the Act, or those upon which the general rate would fall (Australia, Parliament, Senate and House of Representatives (Hansard) 1940, p. 107).

The official rationale for the 1940 changes was summed up by the Tax Commissioner in his Twenty Third Report (Australia, Office of the Commissioner of Taxation 1942, p. 33):

- three different rates of taxation were introduced in lieu of the one flat rate formerly in force, 'because of the need of increased revenue for war purposes';
- the chief reason for the introduction of differential rates was 'the desire to avoid an unduly high general rate';
- the maximum rate of 15 per cent was applied only to goods 'which were considered to serve the less urgent or essential needs of the people, and which consequently might, in a time of national emergency, bear an impost greater than that imposed upon goods generally';
- certain goods formerly exempt from tax were now taxed at 5 per cent. Withdrawal of the previous exemption was to raise additional revenue but, as 'these goods were still considered to have a claim for preferential treatment', they were taxed at the rate of 5 per cent only, half the general rate of 10 per cent.

Sales tax and the taxation of low incomes; reconciling efficiency and equity concerns

By 1941, there were increasing concerns about inflation. Sales tax increases raised the prices of goods directly, and indirectly contributed to inflation by generating wage claims and general cost increases. To avoid fuelling price rises in the fully employed economy, the Government now avoided increases in indirect taxes. In October, the Menzies–Fadden Government fell and Curtin became Prime Minister, with Chifley as Treasurer.

[121]The increase in the sales tax rate to 15 per cent for less essential items would contribute £600,000 and the widening of the field to previously exempt goods would raise £1,300,000.

Chifley's Financial Statement of 29 October 1941 articulated clearly the Labor Party's view of the role of sales taxation (Australia, Parliament, Senate and House of Representatives (Hansard) 1941). Labor's view was that many on lower incomes could undoubtedly make a further contribution to war financing — in fact it was essential that they should do so. However, the Treasurer was unwilling to impose additional income taxation on middle and lower incomes, as income tax 'could not discriminate fully between individuals in accordance with their financial responsibilities' (Australia, Treasury, *Budget Speech and Papers,* 1941, p. 7). A heavy increase in tax on these incomes would frequently impose serious hardship. Hence, the 'tax contribution' from lower and middle income earners would be applied through taxation of non-essential consumption:

> as a means of reducing consumption, I think that for middle and lower incomes it is better to get the reduction by means of taxes on goods and services not really essential — which can be foregone without injury to health or efficiency (Australia, Treasury, *Budget Speech and Papers,* 1941, p. 7)

Chifley also foreshadowed that this policy of taxing lower incomes through selective taxation of consumption would be consolidated the following year. With further increases in sales tax — to 25 per cent from the old 20 per cent rate on non-essentials, and to 12.5 per cent from the old general rate of 10 per cent. At the same time, the 5 per cent tax on drugs and medicines introduced in 1940 would be abolished (Australia, Parliament, Senate and House of Representatives (Hansard) 1941).

Sales tax was now reaching its limits in wartime taxation policy because of its potential to fuel cost-of-living increases and wage claims in the booming war economy. Shortages, rationing and other restraints were also reducing consumption levels and the revenue base (Butlin and Schedvin 1977, p. 314). The only further sales tax changes of any substance were reductions in rates on rationed clothing and drapery from 12.5 per cent to 7.5 per cent in July 1943, and exemption of all building materials from September 1944. These measures were price stabilisation measures, offsetting clothing price increases that had already occurred and responding to serious rises in housing costs.

The sales tax was used to good effect as an anti-inflationary device in the 1950s and early 1960s (Groenewegen 1983a). An important precursor to this use of taxation for economic management purposes had been the introduction of the national child endowment scheme in 1941 (see Chapter 5).[122] However, increasing policy preoccupation with inflation was a factor in sales taxation falling into disuse as a stabilisation tool from the 1960s.

The main change in the sales tax since the 1950s was the increase in the general rate (Figure 6.1). The effective rate of taxation on all taxable sales was little changed between then and the 1980s and remained at around 15 per cent (Groenewegen 1983a, Appendix Table A2).

At times there have been up to seven different rates. More typically, there have been fewer.

Economic change and the 'outdated and irrelevant' sales tax

As observed earlier, the sales tax base was substantially reduced at the outset by the policy of exemptions. Table 6.1 summarises the declining trend in the ratio of the wholesale sales tax base to GDP over the period 1931 to 1996. In the first full year of introduction, the tax base covered 24 per cent of GDP. By 1945, the tax base had reduced even further to 15 per cent of GDP, compared to 14 per cent in the 1990s. This suggests that the 1930s and 1940s were the critical period in the evolution of the sales tax.

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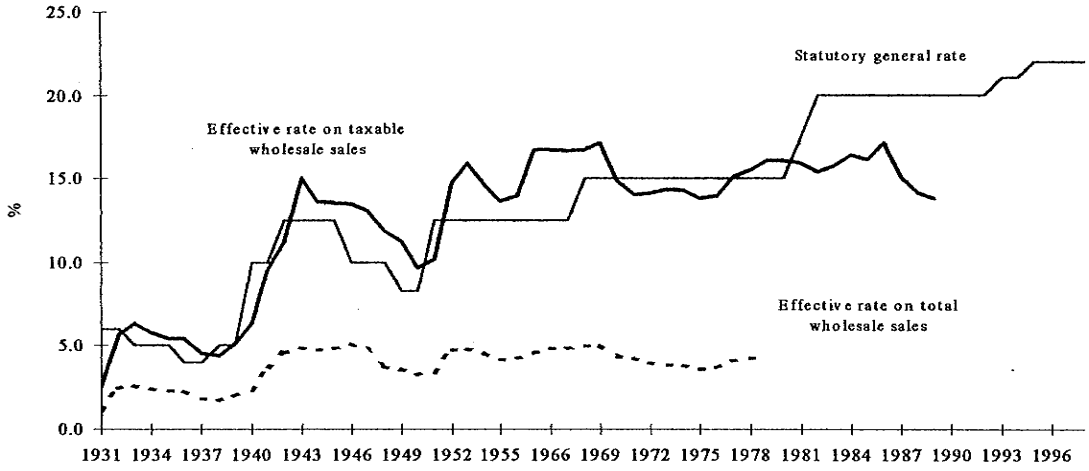
[122]This was part of a deal to forestall an increase in the basic wage (Chapter 5). Supplementing the purchasing power of families through child endowment permitted heavier taxation of ordinary wage earners, and protected families from counter-cyclical sales tax policy changes.

Figure 6.1
Statutory and Effective Rates of Sales Taxation, 1931 to 1998



Sources: Australia, Office of the Commissioner of Taxation, *Taxation Statistics*, various years; Groenewegen 1983a.

An important factor in the declining GDP share of the sales tax base was economic change. The declining relative importance of private consumer spending substantially reduced the potential base for consumption taxation. For example, while consumer spending represented around 75 per cent of GDP through the 1930s, this fell sharply to around 60 per cent from 1942 (Table 6.1). This corresponded to a rise in the private investment share of GDP from around 5 per cent before World War II to around 15 per cent in the post-war period. The public sector share of expenditure has also risen, from 15 per cent to around 20 per cent of GDP, since the 1930s.[123]

However, the change in economic structure over the period does not support the argument that economic changes since the 1930s warrant replacing the sales tax with a GST.[124] The observed decline in the sales taxable share of GDP due to a decreasing consumption share would have similarly affected a GST.

Another view of trends in the wholesale sales tax base is provided by the ratio of taxable sales to total sales (Figure 6.2). This ratio provides a better indication of the effects of legislative change on the sales tax base. Around half of taxable wholesale sales were exempted in the original legislation of 1930, and exemptions were extended in the following decade. The main decline in the taxable share of sales occurred in the period prior to 1951, the ratio remaining approximately stable at between 27 per cent and 21 per cent of private consumption spending from the mid to late 1950s

The significant episodes of legislative activity reducing the taxable field were in 1936–1940, and 1942–1944. In 1931, 44 per cent of sales were taxed. In the period 1936–1940, the taxable share of sales was reduced by 5 percentage points to 38 per cent, while during the 1942–43 period it was reduced by a further 4 percentage points. By 1943, taxable sales were already only 32 per cent of the total.

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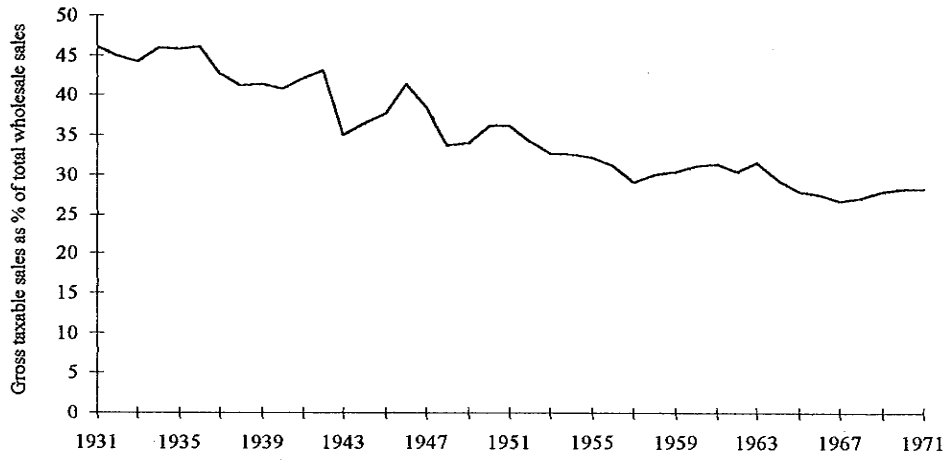
[123] As government activities are not taxed, the expansion of government consumption and investment has reduced the potential size of the tax base in relation to GDP.

[124] This argument constitutes an important part of the Howard Government's rationale for its GST policy (Australia, Parliament, House of Representatives (*Hansard*) 1998, p. 862).

Figure 6.2
Sales Tax Base, 1931 to 1971



Source: Australia, Office of the Commissioner of Taxation, *Taxation Statistics*, various years.

As noted earlier, these exemptions from sales tax in the 1930s and 1940s were not obviously and simply an *ad hoc* response to the pressure of special interests. Rather they mainly reflected a policy of exemptions based on principles of equity and social values and, to a lesser extent, concern to minimise the effect on economic activity and employment in key industries of a rise in the general rate.

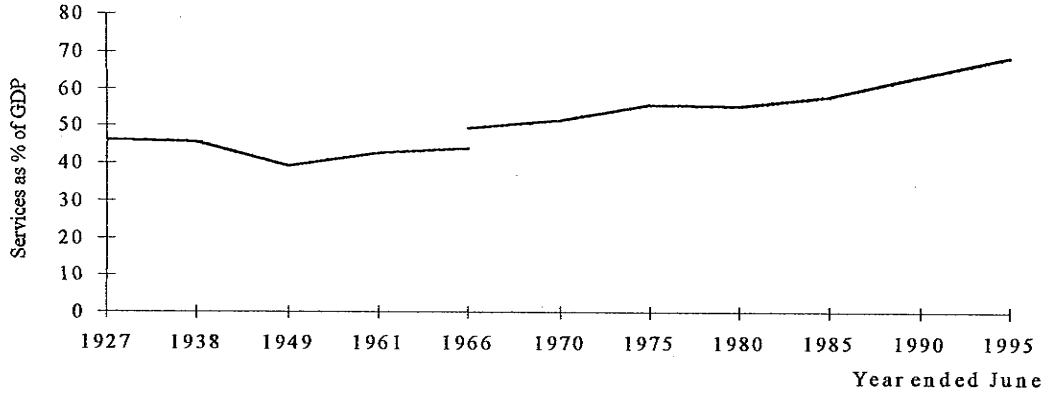
Another common argument for replacing the sales tax with a GST is the expansion of services in recent times. As is evident in Figure 6.3, services were an approximately stable share of GDP from around 1929 until at least the late 1960s (Dowie 1970). The services share of GDP did not increase significantly until the early 1980s, but increased by approximately 13 percentage points between 1980 and 1996.

Services are an increasing share of consumption as income rises so there is an equity dimension to this issue. As noted earlier, sales tax collections still increased over this period, to historical highs of 3 per cent of GDP and 5 per cent of private consumption spending in the late 1980s/early 1990s: this reflected rate increases in the early 1980s and base broadening activities in the second half of the 1980s.[125]

These changes appear to reflect a policy of offsetting declining import duty and excise revenues through increasing sales taxation (Australian Bureau of Statistics, *Taxation Revenue Australia* 1992, 1998). However, they are also a manifestation of the pressure on the Commonwealth to find new sources of revenues as international economic integration and domestic taxpayer resistance began to seriously erode the revenue prospects for the progressive income tax.

[125] Between 1980 and 1996, taxable sales rose from 11 to 14 per cent of GDP.

Figure 6.3
Services[a] as Share of GDP, 1927 to 1995[b]



Notes: [a] The series presented in Dowie (1970) is used for the years up to 1966. From 1966, the series is that derived from Foster and Stewart 1991 to 1985, and the ABS (*Australian National Accounts*, 1997) for 1990 and 1995.

[b] Services are defined as in Dowie (1970) to comprise wholesale and retail trade, transport, storage and communication; finance, property and business services, and other services.

Sources: Dowie 1977; Foster and Stewart 1991; ABS, *Taxation Revenue Australia, 1997.*

Conclusion

The Commonwealth Treasurer argued that the wholesale sales tax should be abolished because, supposedly, it had 'no logic or design'. This chapter has challenged that assertion, showing it to be historically wrong, and superficial. It also suggests that the historical interpretation by the Treasury (Australia, Treasury 1998), on which the Treasurer's arguments are based, misrepresents the origins and significance of sales tax exemptions and multiple rates. This is not to say that the WST was a good tax, or was better than an appropriately designed and broader based consumption tax such as the GST. However, this Chapter emphasizes that the case for the GST arises mainly from the revenue and equity benefits of its application to services, and to including value-added beyond the wholesale stage in the tax base, rather than from removing WST exemptions such as for food and other necessities.

Commonwealth tax policy during the Depression remains to be fully explored. However, this study shows that the Treasury interpretation of sales tax history in the 1930s and 1940s imposes a contemporary (and somewhat distorted) theoretical ideal for consumption taxation on the sales tax policymakers of the past. Such a conception of the perfect sales tax was explicitly considered and rejected at the time. This survey of the history and design of the WST suggest that such a model, which implies a comprehensive GST including on necessities such as food, housing and power, is only politically viable in Australia if social values have changed drastically since the 1930s.

This brief history emphasises that social protections and equity objectives have been deeply embedded in our tax system in ways that have not been understood or acknowledged. It shows that selective commodity taxation, achieved in part through certain exemptions from sales tax, has been a subtle strategy for reflecting social values about 'fair taxation' in Australia's tax system.

This is illustrated by the varying progressivity of sales tax on individual items (Kakwani 1983) which, in principle at least, 'suggests considerable potential for a discriminatory sales tax

with high rates on 'luxury' items' to 'minimize adverse distributional consequences' (Groenewegen 1983a, p. 347). This provides some explanation of the apparent paradox noted earlier, of Australia's heavy reliance on regressive indirect taxation earlier in the twentieth century despite the strength of the labour movement. It also gives a deeper understanding of the protective institutional pillars in the wage earners' welfare state (Castles 1985).

Specific findings are that:

- Tax fairness was a critical issue for Labor Prime Minister Scullin in designing the 1930 sales tax. Wide acceptance of certain basic equity principles for indirect taxation in Australia in 1930 resulted in the Commonwealth Parliament exempting half the potential sales tax base from the original 2½ per cent levy. The same equity principles underpinned the decision to introduce multiple rates in 1940. Exemptions from sales tax were mainly for food, utilities and fuel and other items considered 'necessities' for working-class households. By 1940, these accounted for around two-thirds of the value of exemptions.
- 'Fair' taxation encompassed more than just progressivity. It included other values, notably fairness to those supporting dependents, and to those facing higher than usual health or medical expenses due to ill-health or disability. Medicines were exempted for most of the period under study.
- It also incorporated non-taxation of socially valuable activities such as charities. Also implicit in the parliamentary debates was recognition of the importance of the fiscal incidence of taxation. That is, the fairness of the tax depended on what the money was used for.
- An appropriately modified WST (which exempted 'essentials') was the ALP's preferred new revenue source in 1930 for the following reasons:
    - WST replaced, rather than added to, revenues from customs and excise taxes, and approximately replicated their wide incidence. While indirect taxation was potentially regressive, customs and excise taxation in Australia has since Federation exempted the conventional necessaries of the working man like tea and kerosene.
    - WST was the Scullin Government's strategy to avoid the Commonwealth competing in a tax field that was increasingly occupied from the late 1920s by State governments — low and moderate wage incomes.
    - WST permitted the less well off population to largely escape the sales tax by avoiding consumption of 'non-necessities'. By contrast, an income or wage tax on the basic wage could not be avoided by living more frugally (although it could be avoided by not working), and was thus seen by the Curtin Labor Government as less equitable than the modified sales tax.
    - WST was less likely to discourage work effort during the high taxation of World War II, because the tax was less visible to workers than an income tax on their wages. Maintaining adequate work incentives was a concern of policy-advisers contemplating introducing substantial income taxes on the ordinary wage earner. This group was more likely than the salaried or well-paid middle and higher income taxpayers to reduce work effort in response to income taxation.
- Protecting the real living standards of ordinary wage earners from a decreasingly protective wage-fixing system was probably a factor in exempting basic wage items from sales tax in 1930. During the Depression, it was unlikely that workers could have been recouped the loss of purchasing power from sales taxation through wage indexation and the wage fixing tribunals. Sales tax exemptions for 'essential' items during and after World War II also avoided fuelling inflation in tight labour markets.
- Historically in Australia, the Commonwealth government has increased the yield of the sales tax by lifting the tax rate rather than by widening the base. Sales tax

reductions have generally taken the form of wider exemptions rather than lower rates.

- The narrow base of the WST did not result from erosion by 'rent-seeking' lobby groups in the post war period as assumed by many commentators. It mainly reflected the design principles implanted during the 1930s and early 1940s.
- As a share of GDP, the sales tax base changed little between 1945 and the 1990s. The 6 percentage point decline in the share of the sales tax base in GDP since 1931 is substantially explained by the 15 percentage point fall in the GDP share of private consumer spending over that period. This mainly reflected a rising private investment share of GDP compared to prewar levels, and is reflected in the sales tax base because most investment goods were not taxed, at least directly, by the sales tax.
- Economic change has affected the scope of the sales tax, but these changes in the importance of private consumption and the role of government would have similarly reduced the potential GST base.

A declining private consumption share rather than an increasing services share of GDP is the main factor in the historical decline of the sales tax base. However, from the early 1980s, expansion of services has contributed several percentage points to the declining WST share of GDP.

- Despite the effect of the growth of services, sales tax revenues reached historical peaks during the 1980s and 1990s, as revenues were increased by widening the base and raising the rate of sales taxation. Sales tax collections appear to have largely offset the declining share of import tariff revenues in taxation over the 1980s and 1990s.
- The taxable share of wholesale sales was already less than 50 per cent when the sales tax was introduced in 1931. It declined further to around 32 per cent by the early post-war period. Taxable sales remained around the same share of total wholesale sales for at least the next three decades for which official data is available.

The above examination of the history of the sales tax shows that social values were very important in designing the tax and were not overridden by administrative priorities favouring simplicity and comprehensive coverage. Efficiency and simplicity were not the only concerns of public policy. While it is true, as Treasury says, that 'what may be a luxury ... can evolve over time' (Australia, Treasury 1998, p. 29), this is not a new problem. Since the inception of the sales tax, for example, there have been fierce debates about what is a basic food and should, therefore, be exempt. Classifying goods as 'non-essential' requires judgements, which will produce different classifications in the 1990s than in the 1940s. However, this need not allow administrative concerns about distinguishing 'non-essentials' or 'luxuries' to override social values favouring preferential tax treatment of (what are identified as) 'essential' expenditures. Indeed, 'fair' taxation can often only be achieved through additional complexity. The economic costs of administration and business compliance costs may be less than the economic cost of ameliorating the undesired distributional effects of an 'unadulterated' GST through the tax-transfer system or other means.

'Rent seeking' has been used to make a case for a comprehensive GST.[126] However, the findings of this chapter, that equity concerns were fundamental to gaps in the sales tax base, puts the onus on those of the 'rent-seeking' school to provide empirical support for their alternative view. This paper has drawn on historical quotation from the designers of the sales tax to argue for a 'benevolent government' interpretation of tax design, at least in the early to middle part of this century. This contrasts with the rent-seeking model currently in vogue and apparent in the Commonwealth Treasury's interpretation of history. It is true that what went on behind the scenes could be less benign, and may be misrepresented by the public utterances of

[126] For example see Australia, Treasury 1998, p. 30.

the key players. However, the evidence presented in this study on the stated objectives of those who gave the sales tax its present form challenges adherents to the rent-seeking model to test their case against the historical facts. It also invites them to show how they would prevent the presumed latter-day counterparts of these rent-seeking groups from similarly corrupting a single-rate, comprehensive GST.

Also, the conceptions of equity implanted in the sales tax were complex. Replacing exemptions for food and essentials with nothing more than means-tested assistance to narrowly defined categories of social security and family assistance recipients risks losing sight of the more complex and richer set of distributional criteria and social values reflected in the Australian tax system.

This simplistic approach to the design of the tax system also raises the issue of the public's trust (or lack of trust) in governments. Sales tax exemptions for food and other essentials of wage earner households survived both Depression and war in Australia, despite the compelling revenue needs of those national crises. Scullin's Labor Government perhaps rightly anticipated that protecting low income earners through the structure of the sales tax was less vulnerable to the vagaries of future (conservative) governments' fiscal priorities or to erosion by inflation, than budgetary compensation. Likewise, it can be argued, exempting food from the GST provides a more durable and certain guarantee that it is not a Trojan horse for major unheralded distributional shifts over the coming decades.[127] This is especially so given the historical experience of governments raising the rate of the WST over its long life, and in the light of experience in New Zealand with a GST (Smith 1998c). It is also worth noting that sales tax policy had a subtle but significant interaction with Australian wage-fixing institutions through the exemption of basic wage items.

The relative stability of the sales tax structure since the 1940s also reinforces the point that the taxation system has quasi-constitutional elements to it (Head 1983a). The observed stability in the basic structure of the revenue system is easily explained and justified: major reform risks opening up previously settled controversies over income distribution. This has important implications: there is little to be gained from a reformed and more efficient tax system unless it can be expected to apply without substantial variation over a considerable period.

> Long term stability in the tax structure is ... of great importance in discouraging socially wasteful rent-seeking activities of lobby groups and vested interests seeking to change the tax system between major structural reforms. There is accordingly much to be said for the view that major tax reform exercises should be few and far between (Head and Krever 1997, p. xiv).

This suggests that from a political viewpoint, a GST that provides appropriate exemptions from the outset may be more robust against 'rent seekers' than one that is inconsistent with social values.

This argument for tax stability also highlights the transitional costs of major changes to basic tax rules and structures. Some win and some lose — some of these distributional consequences will be judged obnoxious by public opinion, and there will be continued pressure for transitional relief or offsetting compensatory measures to ensure the new tax system is broadly consistent with prevailing notions of equity. If the revenue or efficiency costs of transition or compensation measures are too great, the tax reform journey will not have been worth it.

Regarding such compensation to low income earners, this Chapter has shown that sales tax exemptions helped ensure that wage earners contributed to public revenues at a minimal cost in terms of work disincentives. Imposing the more visible income tax on low and moderate wage earners was seen as a risk to work effort. This reinforces the point that exempting

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[127] Musgrave (1987) points out that in the United States during the 1980s, the 'tax reform' process allowed legislatures to bypass important questions about the desired distributional effects of taxation. Tax reform should not simply legitimise the effect of tax loopholes and inflation in reducing the progressivity of taxation; rather, he suggested, there should be an explicit legislative review of this central issue.

necessities from consumption taxation may be a more economically efficient way of achieving vertical tax equity than direct compensation through the income tax or social security system.[128] That is, the Howard Government's compensation package approach to ameliorating the regressive effects of a GST may be more distorting than using exemptions to the same ends because the marginal deadweight losses from exempting necessities from GST may be less than the effect of exposing a greater population to potential poverty traps and high effective marginal tax rates through a targetted compensation package.[129] High effective marginal tax rates arising from pervasive income testing and higher (usually income) taxation to finance such social equity measures have significant economic efficiency costs.

The relevant issue is whether these efficiency costs exceed those of the alternative of using multiple rates of indirect tax or exemptions to achieve the desired social distributional outcomes. The high effective marginal tax rates, work disincentives and poverty traps arising from the present interaction of income support payments with the income tax system was already an important public policy issue by the early 1990s. Increasing the level and coverage of such payments to 'compensate' for GST brings many more people into the net, suggesting significant economic efficiency costs. The net economic efficiency gains from reform are in such circumstances finely balanced and uncertain.

The history behind the WST suggests that the comparative invisibility of indirect taxation and the potential for discriminatory rates on non-essential items, provides a greater degree of policy freedom in meeting conflicting policy criteria of equity and efficiency compared to the present approach which places the entire burden of meeting distributional objectives onto the progressive income tax and means tested social security system.

Although it is said that 'large scale and disruptive reform should reliably promise large benefits' (Aaron 1996, p. 2), this chapter suggests that even the Howard Government's modified GST package may well leave Australians with a tax/transfer system which less reliably or less completely meets their distributional concerns than a GST with appropriate exemption of necessities.

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[128] Even if the wider and richer range of distributional goals of the WST identified above can be translated fully into direct means tested compensation payments, which is unlikely. For example, income alone is likely to provide little information to target transfer payments to those supporting children, or those with high pharmaceutical or health expenses. Appropriately specified exemptions can be an additional instrument for achieving social equity goals, which are not limited to progressivity or 'vertical equity'.

[129] The original package relied heavily on a substantial program of means-tested social security and related payments for its overall fairness.

Chapter 7
Redistribution and Federal Finance*

Introduction

When the Australian colonies began negotiations on federation in 1891, the majority of their revenues came from customs and excise, which they planned passing over to the new Commonwealth. Progressive land and income taxes were a novelty, and government expenditures were minimal. Social security was non-existent. Over the coming decades, the role of government changed dramatically, especially in its redistributive aspects. Progressive income taxation became the dominant source of tax revenues. National age and invalid pensions and later, child endowment, widows' pensions and unemployment benefits were established and public health and education expanded. Accompanying the expansion of the Government's redistributive role were dramatic changes in the relationship between the Commonwealth and the States. No longer was the Commonwealth a mere agent of the States. By the end of the twentieth century, the Commonwealth was the dominant financial partner in the Australian federal system, collecting all income taxation and most indirect taxation.

This chapter explores the evolution of Commonwealth–State financial arrangements over the past century, focussing on how economic and social change interacted with the Constitution's financial provisions after Federation to shape federal fiscal arrangements and the redistributional role of government during the century since Federation.

The aim of the chapter is to identify the causes and consequences of Australia's unique federal fiscal institutions and arrangements, in particular in regard to the likely implications for the redistributional role of taxation.

The first section, 'Federating in the dark', examines how the colonies' diverse fiscal situations and local tax and tariff politics prevented immediate resolution of the financial problems of federating the tariff, and how framers of the financial clauses of the Constitution dealt with this problem. The second section, on the negotiations leading to the 1909 agreement for per capita payments, documents how the continued diversity in the States' economic circumstances and the pressures for national age pensions set the direction of Commonwealth–State financial relations. The third section traces how the growing incongruence between economic forces, social values and Australia's federal financial framework shaped the evolution of Commonwealth–State financial relations and special financial assistance for the smaller States through the 1920s and 1930s. Like uniform taxation, the Commonwealth Grants Commission (CGC) and special grants had significant long-term implications for the redistributional role of taxation in Australia. The fourth section draws connections between the States' diverse fiscal capacities and the entrenchment of income tax centralisation after World War II and relates the shift to full fiscal equalisation to the Commonwealth's superior tax powers and economic prosperity.

'Federating in the dark'

Negotiations on financial arrangements for federation began in 1891 at the Australasian Convention in Sydney. Protecting the States' autonomy within the federation was fundamental to designing the federation agreement (Norris 1970; 1975; La Nauze 1972). As E. Barton told the Sydney session of the Convention: 'we cannot do away with the solvency of the several States. If we do that those States die, and we have no longer a federation but a legislative union' (Australasian Federal Convention 1897, p. 203).

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* This chapter is an edited version of that published in 2001 as 'From The Federation Debates to 1970', in *Financing the Federation*, J. Hancock and J. Smith (eds), South Australian Centre for Economic Studies, Adelaide, pp. 5–43.

Despite potential risks to States' autonomy, it was agreed that the Commonwealth must have unlimited powers of taxation. Victorian federalist and protectionist[130] A. Deakin was persuasive in the view that 'it was impossible to cast the duty of defence on the government of the commonwealth without giving them unlimited taxing power' (National Australasian Convention 1891, p. 675). In the case of a blockade, customs revenues would be minimal:

> One of the foremost of its duties, that in fact which created this Convention, was to provide for the common defence of Australasia, and it may be necessary to devote not only the last ship, but the last shilling to that object (National Australasian Convention 1891, p. 675).

His argument was supported by several free trade advocates. South Australian delegate T. Playford pointed out that the extent of the Commonwealth's taxing powers might determine whether free traders would support federation:

> If you take away the general power, and draw the line at customs and excise duties, then those who believe in a free-trade policy will have no hope whatever of being able to give effect to that policy. ... If you limit the power of the commonwealth in the way suggested, those who hold free-trade views will never be able to give effect to them (National Australasian Convention 1891 p. 672).

Although the Convention was warned that removing colonies' taxing powers without taking over their debts would result inevitably in the bankruptcy of several colonies, Deakin responded that Commonwealth tax powers would not hinder States' taxation. While there was a certain point at which the taxable resources of the community would cease, 'that is a point at which we are never likely to arrive' (National Australasian Convention 1891, p. 675). He argued that concurrent tax powers did not give the federal tax-gatherer precedence. Furthermore, the States would soon need direct taxes to replace tariff revenues and would thus gain the advantage of precedence in time.

Another strand of this debate was the federationists' fear that the threat of higher State taxes would defeat the federation goal. Tasmanian representative W. Burgess urged the Convention to require commensurate relief of States' financial responsibilities before handing over State tax powers.

> Taxation through customs is the sheet-anchor of all our colonial finance; and if we hand over all rights in connection with customs and excise, it will be a matter of extreme difficulty for some of the colonies (National Australasian Convention 1891, p. 678).

If the Commonwealth was to resort to direct taxation only in times of national crisis, safeguarding the solvency of the federated States depended either on ensuring that a sufficiently large federal revenue surplus was available for distribution to the States or, alternatively, on providing sufficiently for the financial relief to the States' budgets by transferring existing spending responsibilities to the federal government. Thus a solution that was fair to all required a 'sufficient' distribution to the States, as well as a 'fair' distribution of the revenue surplus among them. At the same time, a common view was that the Constitution should not be too prescriptive.

The main solution to these intertwined problems was to transfer the States' debts to the federal government (Gilbert 1973). Conveniently, the interest payable on the States' debts at this time roughly matched the expected federal surplus. As one observer later commented, the smaller the surplus, the less bitter would be the struggle over its distribution (Black 1895). Imposing on the new Commonwealth government the responsibility for servicing colonial debts out of its ample revenues was also likely to improve the States' borrowing terms and relieve their debt service burden.

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[130] At the turn of the century, the two major political parties were Protectionist and Free Trade. Protectionists favoured the use of tariffs, which tend to protect domestic manufacturers, whereas Free Traders favoured low or no tariffs, and this was the major dividing issue in parliamentary politics.

Debt consolidation was embraced enthusiastically by many delegates as a practical and economical solution to the federal financial problem. It would have the benefit of requiring 'the strictest scrutiny of every particular of public expenditure', imbuing in the Commonwealth government 'habits of close economy' (Deakin in National Australasian Convention 1891, p. 839). Campaigners against federation would be denied the bogey of a large federal surplus. Tasmanian Treasurer B.S. Bird argued that the hand-over of revenues should be matched with commensurate liabilities: 'it is most dangerous to leave in the hands of the commonwealth such a large surplus as there will be unless these debts are handed over to it' (National Australasian Convention 1891, p. 846). A South Australian amendment to make the Commonwealth liable for a fixed per capita amount of each State's existing debt was nevertheless opposed fiercely by New South Wales.

Debt consolidation was particularly appealing for the smaller States as they would make large interest savings from a centralised debt conversion. There was less advantage in debt consolidation for the larger States and for Western Australia.[131] While supporting such a scheme as a longer-term solution, New South Wales Premier G. Dibbs argued a compulsory transfer of State debts required transferring the corresponding State assets and the associated revenues:

> Our liabilities at present are secured on our assets; and if the commonwealth takes over the liabilities, they want something more than the revenue derived from customs duties to cover the liabilities ... property will have to be taxed considerably to make up the deficiency (National Australasian Convention 1891, p. 843).

Thus, Dibbs argued, the proposal also raised the threat of Commonwealth meddling in State rail construction and pricing policies and implied Commonwealth control over States' future borrowing and land development.

Fear of expanded direct taxation meant the debt transfer proposal was objectionable to New South Wales Protectionists. Sir John Quick and Robert Garran noted that it was also unpalatable to New South Wales for a reason which was only hinted at, but which they saw as the deciding factor:

> To saddle the Commonwealth with the interest on the public debts would practically have meant imposing on the Federal Parliament the duty of raising a large amount through the Customs, and would have placed the Free Trade party at a disadvantage in federal politics. It was seen that the amendment was on dangerous ground, and it was accordingly negatived without division (Quick and Garran 1976 [1901], pp. 140–1).

With the intense New South Wales reaction threatening progress on the broader issue of federation, delegates were persuaded that it was 'going too far' at this stage to impose a debt take-over arrangement, and they backed away from the South Australian proposal to compel a take-over. The 1891 Commonwealth Bill thus simply provided for a Commonwealth take-over of States' debts, as a matter for parliaments.

> The Parliament of the Commonwealth may, with the consent of the Parliaments of all the States, make laws for taking over and consolidating the whole or any part of the public debt of any State or States, but so that a State shall be liable to indemnify the Commonwealth in respect of the amount of a debt taken over, and that the amount of interest payable in respect of a debt shall be deducted and retained from time to time from the share of the Surplus Revenue of the Commonwealth which would otherwise be payable to the State (National Australasian Convention 1891, p. 960).

With the debt transfer on hold as a solution to the problems of federal finance, attention then focussed on how the federal revenue surplus should be distributed. As Quick and Garran described the problem:

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[131] Western Australia was disadvantaged by a scheme for a per capita take-over of debt because, although sparsely populated, it was incurring large development costs. New South Wales could already borrow relatively cheaply.

> Should revenue be credited to the several States in proportion to their populations, or in proportion to their contributions? Should expenditure be charged against the several States in proportion to their populations, or on the basis of services rendered? So far as revenue was concerned, the population basis of adjustment showed that the consumption of dutiable articles varied greatly in the different colonies, and it was anticipated that even under a uniform tariff considerable differences might continue. The contributions basis seemed fairer, but less federal: and it was open to the objection that with inter-colonial freedom of trade it would be difficult to ascertain accurately what share of dutiable articles was consumed in each State. Here at the outset, was the whole financial difficulty which was afterwards to cause so much trouble (Quick and Garran 1976 [1901], p. 134).

The difficulty reaching consensus on the principle for distributing surplus revenue reflected the different ways the competing proposals affected the diverse State budgets. It also arose from uncertainty about the eventual fiscal policy of the Commonwealth parliament, and the implications for competing taxation philosophies.[132] The matter was further complicated by debate on how the question of how the expenses of the Commonwealth government should be shared among the States.[133] Central to a conflict between the finance committee's recommendation for a per capita distribution and the constitutional committee's drafting based on the 'contributory' principle was the need to accommodate future direct taxation by the Commonwealth. As Sir Samuel Griffith put it:

> We were bound to deal with the possibility that they should raise revenue from other sources than customs and the only way in which we could see it was fair to return direct taxation was in proportion to the amount raised (National Australasian Convention 1891, p. 807).

Around Federation, all the colonies relied heavily on customs and excise taxes, with this source averaging three-quarters of colonial revenues. However, the tariff policies and fiscal structures of each of the colonies were distinctly different (see Table 7.1). Direct taxes such as income taxes were becoming more common (Smith 1993b).

Differences in colonial tariff policies were linked with differing political attachments to protection or free trade. Free trade New South Wales had relied heavily on land for revenues but was now contemplating its replacement with direct taxation; Victoria was proudly protectionist.[134] Varying degrees of protectionism also influenced revenue yields. Such differences reflected the varying stages of development of each colony at that time, the diverse levels of economic wealth and fiscal resources, and differences in consumption patterns (Mathews and Jay 1972). Western Australia, for instance, was almost entirely dependent on customs and excise duties as it faced significant practical difficulties in imposing income taxes on its dispersed and migratory population.

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[132]One issue was the level and structure of the federal tariff. The other was the extent and incidence of Commonwealth direct taxation. While there was some argument that the incidence of a uniform federal tariff would be uneven between the States, it was generally accepted that the incidence could be assumed to be roughly equal across the Commonwealth. With regard to direct taxation, however, equal incidence could not be assumed. For example, a gold tax would bear more heavily on Western Australia than other States. A tax on pastoral rents would be collected mainly in Queensland. While Free Traders were concerned to provide the powers of direct taxation to the Commonwealth so as to avoid revenue pressures for a protectionist tariff, others were concerned that a Commonwealth Parliament dominated by Free Traders might reduce the tariff and rely on expanding direct taxation, including income or land taxes.

[133]The general view was that the colonies should contribute to the expenses of the new government in proportion to population. However, there were concerns that, in conjunction with a per capita basis for distributing surplus revenues, this might be excessively generous to South Australia. There was also a view that the same principle must apply to both the distribution of revenues and the charging of expenses.

[134]The evolution of tariff policy in the Australian colonies during the nineteenth century is documented in Patterson (1968).

Table 7.1
Australian Taxation 1896–97

	New South Wales		*Victoria*		*Queensland*		*South Australia*		*Western Australia*		*Tasmania*		*All Colonies*	
	$m	*%*	*$m*	*%*	*$m*	*%*	*$m*	*%*	*$m*	*%*	*$m*	*%*	*$m*	*%*
Customs & excise duties	3.0	63	4.0	77	2.5	86	1.3	65	2.2	96	0.7	78	13.8	76
Income tax	0.6	13	0.4	8	0.1	3	0.2	10	na	na	0.1	11	1.3	7
Probate & stamp duties	0.7	15	0.6	12	0.2	7	0.3	15	0.1	4	0.0[a]	0	1.9	10
Land taxes & rates	0.3	6	0.2	4	na	0	0.2	10	na	na	0.1	11	0.7	4
Other taxes	0.2	4	0.0[a]	0	0.1	3	0.0[a]	0	0.0[a]	0	0.0[a]	0	0.5	3
Total[b]	4.8	100	5.2	100	3.0	100	2	100	2.4	100	0.9	100	18.1	100

Notes: [a] Less than $50,000.
[b] Figures may not add to totals due to rounding.
na = not applicable

Source: Mathews and Jay 1972, Table 5.

The principle of per capita equality — a constitutional keystone in North America — was contentious as a practical basis for Australian fiscal union because it threatened increasing New South Wales taxation to finance revenue transfers to other States and there were large differences in the per capita consumption of dutiable items between colonies. At the close of the debate, federalists from both larger and smaller States chided the 'pettifogging, parochial spirit of selfishness' which would embody in the constitution 'whether Queensland drinks a little more whiskey than South Australia, or whether the populations of some of the larger and more settled states cloth themselves in costlier raiment' (National Australasian Convention 1891, p. 825).

After lively but inconclusive debate, and against a backdrop of conflicting desires regarding the future tariff and taxation policies of the Commonwealth, the 1891 National Australasian Convention eventually resolved the distributional issue through an uneasy compromise. It determined that, until the federal tariff was in place, the surplus revenue should be returned in proportion to the amount of revenue collected in each State, with Commonwealth expenditures charged to the several States in proportion to their population. The 1891 Bill left the Commonwealth parliament to determine a 'fair' distribution of the federal surplus after the uniform tariff, albeit with the collections basis continuing 'until the parliament otherwise prescribes' (National Australasian Convention 1891, pp. 959–60).

The Bill was 'put by' by colonial parliaments until a new impetus arose from the 1891–93 financial crisis and the popular movement for federation. By 1897, the desired principles for federal finance were much clearer. The task of the framers of the Constitution, as summarised by R.R. Garran (1897), was to allocate taxing powers and expenditure responsibilities and provide for suitable intergovernmental financial arrangements. These arrangements must be 'co-ordinate', in the sense of minimising the dealings between Commonwealth and State governments to the narrowest and simplest possible basis, 'elastic' enough to cope with future uncertainties, and yet 'final' enough to avoid pressures for tinkering for special advantage (Garran 1897, p. 161). It was of overriding importance for agreement on federal union that the arrangements be fair to all of the federating States, not only at the date of the union, but in view of their probable growth and contingencies.

Garran argued (Garran 1896, 1897) that the best solution to the federal financial problem would be for States to hand over responsibility for their debts to the Commonwealth government at federation. The alternative, of handing over a large surplus revenue to the Commonwealth, was open to the grave objection that the federal government would have control of a revenue far greater than needed for its own expenditures and thus being tempted to gain cheap popularity either by 'embarking on a policy of extravagant expenditure', or 'by an equally reckless remission of federal taxation' (Garran 1897, p. 164). Garran warned that the effect on State finance would be demoralising:

> A great part of each State's revenue would come from a source wholly beyond the control of its government, and liable perhaps to fluctuations for which that government was nowise responsible. The blame of a state deficit could thus easily be shifted onto other shoulders; the Treasurer's financial responsibilities would be lessened, and the chief guarantee of economical administration be removed (Garran 1897, p. 164).

Not only did debt consolidation provide for a more satisfactory separation of central from colonial finances than any other method, it also promised savings to the national fisc. Garran noted that such an arrangement for Commonwealth government take-over of the States' debts might be a regular feature of federal finances, as a large federal surplus was likely to reappear at a future date. Providing for the Commonwealth to take over further liabilities from the States would obviate the need for undue direct taxation by State governments and minimise risks to State government finances and autonomy.

The issue of consolidating the public debt of the colonies had become more pressing after the financial crisis of the 1890s (Garran 1896; Black 1895). Reducing the interest burden

of the colonies' debt through consolidation was the only financial benefit of federation that figured in public debate (Gilbert 1973). The promise of significant economies was one of the ways those favouring federation might convince a sceptical public that federation did not mean higher taxation (Norris 1975). The advice by a respected London banker cited in 1897 by John Walker, a Convention delegate and finance expert, was that consolidating the debt could save the colonies perhaps £1,500,000 per annum, the approximate additional cost of the new central government (Walker 1897).

Debt consolidation returned to the forefront of debate at the 1897–98 Convention (Australasian Federal Convention 1897, 1998; National Australasian Convention 1897). Victorian Treasurer George Turner proposed the Commonwealth take over existing State debts, paying interest from the surplus revenue and debiting or crediting States with the balances. Because of New South Wales opposition, the Convention agreed merely to a clause (later s. 105 of the Constitution) enabling the Commonwealth to take over the States' debts after federation.[135] It was considered that such a solution would be more acceptable when economic convergence had brought per capita debt levels more closely in line. Convention delegates were thus persuaded to turn their attention to alternative means of distributing the surplus (Gilbert 1973). The financial problem was now becoming increasingly difficult as rejecting the debt take-over plan made a large federal surplus inevitable (Garran 1897; Gilbert 1973).

At the 1891 Convention, the 'contributory' principle had appeared more practicable in the short term than a per capita reimbursement of federal tariff revenues. However, by 1897 it was evident that the immediate loss of revenues to some States would be excessive, due partly to the great variation among the States in the share of revenue from tariffs on internal trade.[136] With the expected change in the pattern of trade after tariffs were abolished, some States would be deprived of revenues, while the two States with the major ports of Sydney and Melbourne would benefit. The 'contributions' distributional scheme was also criticised as being inconsistent with the 'federal' principle. Therefore the Adelaide Convention agreed to adjust the basis for attributing revenues to a 'derivations' basis, which would take account of changes in intercolonial trade.[137]

Responding to criticism of the resulting complexity of the Adelaide Bill, R.R. Garran explained the thinking behind it: the aim was to get 'as nearly as possible, an equal *per capita* distribution of the benefits and burdens of federation' (Australian Economic Association 1897a, p. 38). The difficulty was that the per capita level of customs and excise revenues raised in the several colonies differed greatly. However, it was assumed that:

> the ultimate result of a uniform tariff — after say five years — would be to make this inequality disappear; that the effect of intercolonial free trade, aided by a Federal tariff specially designed to distribute taxation fairly throughout the Commonwealth, would be that the per capita contributions of the various States would be about equal (Australian Economic Association 1897a, p. 38).

The fairest plan for distributing the federal surplus, therefore, would be 'to credit each State with a *per capita* share of revenue, and debit it with a *per capita* share of expenditure', but not for the first few years after the establishment of a uniform tariff, 'because the equalising

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[135]Key delegates to the Convention were later told, through New South Wales Premier Reid, that such provisions for consolidation of the public debt threatened the financial interests of British investors and that they would, therefore, be unacceptable to the Imperial Government (La Nauze 1972). In opposing the Braddon clause, Reid is said to have relied heavily upon the advice of Sir Timothy Coghlan (1855–1926), New South Wales government statistician from 1886 to 1905. Coghlan contributed substantially to the public debate on the financial aspects of federation, insisting on safeguards for New South Wales.

[136]Less than one sixth of customs revenue in New South Wales came from tariffs on interstate trade, but Queensland relied on intercolonial duties for around one-fifth of its customs revenues and Tasmania relied on them for around one-half.

[137]The 'derivations' basis was to operate for five years after the introduction of the uniform tariff. 'Bookkeeping' permitted revenues to be attributed to where revenues were derived or the goods consumed, rather than to the State at which border they were collected. While it would be administratively difficult, it would allow revenues on interstate trade, a half of total customs collections for some States such as Tasmania, to be returned to those States.

tendency of that tariff would take some time to work out its full effect' (Australian Economic Association 1897a, p. 36). The Convention, therefore, determined to postpone the complete adoption of the per capita basis till five years after the imposition of the uniform tariff. During those years of transition, 'bookkeeping' would allow revenues to be returned to the States in accord with the revenues that each contributed, while expenditures would be attributed on the more federal per capita principle.

Complex 'bookkeeping' provisions in the Adelaide arrangement made for inconvenience, but Garran judged it 'fair' and preferable to the 'forlorn hope to which Sir Samuel Griffith and others had been driven — the expedient of leaving the whole question to the Commonwealth Parliament to decide'. That alternative, Garran warned, 'asked all the colonies to federate in the dark' (Australian Economic Association 1897b, p. 60).

From late 1897, attention moved to providing for some 'guarantee' to the States that they would receive sufficient surplus revenues to protect their solvency. Eventually, the 'guarantee' found its form in the so-called 'Braddon clause' (s. 87 of the Constitution) as well as in the requirement for any surplus of Commonwealth revenue to be returned to the States (s. 93 and 94). The Braddon clause, so named after Tasmanian Premier Sir Edward Braddon,[138] required that the Commonwealth restrict its spending to no more than 25 per cent of the customs and excise revenues; at least 75 per cent of the net surplus must be distributed to the States.[139] Flexibility — added by s. 94, s. 95, s. 87, and s. 105 — was also viewed as an important feature of the Constitution's financial provisions because it addressed the smaller States' need for financial security. As it was impossible to foresee the future and with secession not possible there had to be some remedial mechanism for States with a grievance (Wise 1913).

Although the 1891 Commonwealth Bill had specified the sharing of Commonwealth direct taxation as well as customs and excise revenues, by 1898 the focus was entirely on ensuring adequate access by the States to the latter. Virtually no delegates contemplated the Commonwealth expanding its direct taxation to meet its revenue needs.[140] Concurrent powers to levy income and similar taxes were given to the Commonwealth only because limiting its access to finance in a national emergency was considered 'foolish' and 'unfederal'. The framers of the Constitution's financial clauses expected that the States, rather than the Commonwealth, would expand income and land taxation after Federation as their incomes and wealth — and taxable capacity — expanded. All States except Western Australia and Queensland had resorted to such taxes by 1897 but it was agreed that a large immediate expansion of State income taxes to replace customs was not yet possible or even desirable as a solution to the federal financial problem.

However, the Braddon clause in its original form was objectionable to New South Wales because its citizens were said to face higher taxes in the form of either a protective tariff or increased income and land taxes (La Nauze 1972). As a result of strong New South Wales opposition to the clause, led by Reid, the Premiers' Conference in 1899 eventually agreed to limit its effect to ten years after Federation, 'and thereafter until the Commonwealth Parliament otherwise decides' (La Nauze 1972, p. 242).

However, the issue nearly broke up the Conference as the smaller States were concerned that this temporary provision did not adequately protect their financial situation and would force them into even higher taxation (May 1971). In the end, the Premiers also agreed

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[138] This clause originated with an earlier proposal by the South Australian F. W. Holder, but was initiated late in the Melbourne sitting of the 1897–98 Convention by Braddon.

[139] By this time the 'commercial principle' proposed at the Bathurst convention had been accepted as the basis for dealing with federal spending: new functions to be performed by the Commonwealth, including defence spending, would be attributed on a population basis, while federal expenditures due to transferred functions would be attributed to the State which benefited from those expenditures. At that stage around £1,200,000 was the anticipated cost of transferred functions such as posts and telegraphs, while around £300,000 was the additional costs of federation. Negotiations now concentrated on the 'net surplus' and net losses to States.

[140] By this time, a decision of the US Supreme Court ruling that the federal income tax was unconstitutional because of its uneven incidence in the various states had influenced thinking in Australia about Commonwealth direct tax powers. See La Nauze 1972 and Quick and Garran 1976 [1901].

there should be a further protection for the financial viability of States: the Commonwealth was given the power to make grants to any State 'on such terms and conditions as it saw fit' for the first ten years after Federation, and thereafter as Parliament should decide (La Nauze 1972, p. 242). This would become s. 96 of the federal Constitution.[141]

This provision was an acceptable compromise to New South Wales mainly because the needs of the financially weakest State could now be addressed directly through a grant to that State. The smaller States, being wary of special provisions, also accepted these generalised arrangements as at least better than the alternatives (May 1971).[142] Quick and Garran said of the s. 96 power:

> It is for use as a safety valve not as an open vent ... and it does not contemplate financial difficulties, any more than a safety valve contemplates explosions (Quick and Garran 1976 [1901], p. 871).

The financial clauses were thus a compromise that enabled the implementation of a commonly held set of principles: to protect all States' finances sufficiently so that they could join the federal union and to allow sufficient flexibility to provide relief for a State that might otherwise find it financially impossible to remain within the union.

From 1897 there emerged a consensus that it was untimely for a permanent settlement of the financial issue because of the unknowns of federation itself and because the level, structure and impact of the Commonwealth tariff remained major uncertainties affecting State financial security (Gilbert 1973).[143] As Sir Samuel Griffith put it, the problem of distributing the surplus was 'at the present time insoluble, by reason of the want of the necessary data' (quoted in La Nauze 1972, p. 168). In mathematical terms — and Griffith had first class honours in mathematics — there were more unknowns than equations.

By delaying the debate on a permanent scheme of federal finance, delegates anticipated that the current difficulties would be more easily solved. A convenient assumption was adopted: that State economies would expand and their fiscal and economic capacities converge after Federation under a uniform tariff. An equal per capita basis for distributing the surplus would then be both 'equitable' and sufficient for the needs of the smaller States and more acceptable to New South Wales.[144] The contributions basis for returning the net surplus revenue would then equate to the more federal per capita principle for reimbursement, while the implicit redistribution of revenues from the financially stronger to the financially weaker States would be within politically acceptable bounds. Agreement on federating State borrowing and debt would also be easier as debt policies and capital spending needs of the States became more similar.

However, informed observers acknowledged there was no objective basis for expecting natural economic and fiscal convergence (Gilbert 1973).

'Trusting convergence' — the federal financial problem to 1920

In the first decade after Federation, continued divergence in economic and fiscal capacity prevented any agreement between the States on a solution to the problem of the federal surplus. Moreover, there was now a new party at the negotiating table — the Commonwealth. By the end of the decade the Commonwealth's rising expenditures on age pensions began to affect the

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[141] By contrast, with an unlimited Braddon clause the Commonwealth might have been forced to raise tariff revenue to finance payments to all States at a level necessary only for the weakest, a situation characterised by New South Wales free traders and anti-federalists as requiring the Commonwealth to raise four times more revenue than it needed.

[142] All agreed with Western Australian leader Sir John Forrest that his State was a special case, and WA was later permitted (s. 95) to maintain its own tariff for five years after fiscal union (La Nauze 1972).

[143] This had been the view of New South Wales since 1891, and from 1897 other States, notably Queensland and, more reluctantly, South Australia, came to share that view (Gilbert 1973).

[144] No scheme that showed New South Wales as a loser was acceptable. Assuming convergence was, therefore convenient, as it got the principle of per capita distribution past New South Wales (Giblin 1980a [1926]).

'surplus' revenues available to the States, while the introduction of its progressive land tax encroached on potential State tax fields.

The State Premiers began meeting regularly soon after federation (Bernie 1947) and, at the Conference of Premiers in April 1903, turned their attention to Commonwealth–State financial matters (New South Wales, Legislative Assembly 1903). As Victorian Premier Irvine said at that time:

> Even with the protection of the Braddon clause, several of the States have already been obliged to have recourse to heavy direct taxation. If that protection be allowed to lapse, the immediate result will be a steady depletion of the surplus customs revenue payable to the States, bringing with it an increasing necessity to impose further and more drastic direct taxation (New South Wales 1903, p. 97).

Anticipating that rising Commonwealth expenditures would reduce the revenues available to States, Victoria put forward a detailed scheme for transferring State debts to the Commonwealth. However, New South Wales Premier Sir John See, suspicious of effectively subsidising other States and sceptical that his State could gain the financial benefit of borrowing on finer terms, viewed such action as premature.

The report of discussions held the following year shows that the Commonwealth Treasurer, G. Turner, responded enthusiastically to debt take-over proposals as a means of providing financial security for the States and achieving the public debt interest savings sought from Federation (Victoria, Parliament 1904a, 1904b). However, in practice this entailed either introducing Commonwealth direct taxes or the Commonwealth having the power to access State railway revenues. In addition, transfer of only pre-Federation debt was insufficient for the needs of heavily indebted South Australia, Queensland and Tasmania. Transferring all debts including those incurred since Federation meant the interest burden would exceed the revenue due to States under s. 87 of the Constitution and required the offer of further indemnity to the London financial market if the Commonwealth was to convert these debts on good terms.[145] Despite some reservations, substantial agreement along the lines Turner suggested had been reached by the end of the 1904 Conference (Tasmania [Parliament], 1982a, b).

This fragile consensus unravelled in 1905 after a change of government at the Commonwealth level injected new players into the Premiers' Conference (Groenewegen 1982). The States tried to force Commonwealth action by emphasising the effect of public opinion on the 'disastrous financial embarrassment' the States would face if the Braddon clause were not extended (Tasmania [Parliament], 1982a, p. 39). Commonwealth Treasurer Turner responded that one of the main reasons for Federation had been to bring all public debt under Commonwealth control. He warned that the Commonwealth was impatient to escape the complexity of the Braddon clause with its requirement for monthly surplus revenue payments and, with Labor parliamentarians pressuring strongly for national age pensions, substantial new expenses were expected by the end of the decade.

A Commonwealth proposal regarding national aged pensions was also considered in some detail at the 1905 conference. New South Wales had introduced a pension scheme immediately after Federation and Victoria and Queensland had followed suit shortly after. However, Prime Minister Reid argued that the existing arrangements were unfair as, for example, the many itinerant workers often could not meet the eligibility requirements of any particular State. While a national scheme would be fairer, its expanded eligibility inevitably made it more costly. Turner anticipated that the Commonwealth would need a new source of revenues to extend the Braddon clause if it introduced age pensions.

Various schemes for financing the aged pension had been considered since 1901, including a Commonwealth land tax (Kewley 1973). The Commonwealth now proposed to the

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[145] While the Commonwealth Government could introduce direct taxes to meet the revenue gap, Turner noted there was general agreement that this source of revenues should be left to the States. He also considered it unwise to have both the Commonwealth and States taxing the same base.

States that it earmark revenues for this purpose from a special duty on tea and kerosene — outside the Braddon clause. To meet the full costs, the Commonwealth also proposed reducing the surplus customs and excise revenue payments to the States on a per capita basis. However, the States were generally hostile; while some would be relieved of existing or imminent age pension costs, others viewed national pensions as an unnecessary and premature extravagance.[146]

While the States' interests were converging on making the Braddon clause the permanent basis of federal finance, the Commonwealth's opposition to this was hardening. Further financial proposals, based on annual per capita payments as a part of debt transfer schemes, had been rejected by the States between 1905 and 1907 (Prest and Mathews 1980).[147] Under strong political pressure, the Deakin Government had committed itself to introducing an age pension; in 1908, it passed the *Surplus Revenue Act*, charging any surplus customs and excise revenue above the Braddon clause's 75 per cent minimum to trust funds rather than returning it to the States. The 1908 Commonwealth tariff supposedly increased this surplus revenue to around two-thirds the estimated cost of age pensions. Labor supported the legislation conditional on the Commonwealth old age pension scheme having first charge on the revenues. The States now received only the minimum grants guaranteed to them by the Constitution under the Braddon clause (s. 87), and the Braddon clause would expire in 1910.

By 1909, Commonwealth–State financial negotiations were primarily concerned with arrangements for a fixed Commonwealth payment distributed to States on a per capita basis, with special arrangements for Tasmania and Western Australia. As its defense and age pension expenditures meant it needed to finance a budget deficit, the Commonwealth would soon be competing with the States in the loans market. This, and the prospect of a Labor government winning the forthcoming elections, caused the Premiers to agree to proposals by Prime Minister Deakin and Commonwealth Treasurer Forrest at a secret conference in August 1909.

The 1909 agreement for fixed per capita payments to States replaced the Braddon clause's revenue sharing arrangements. This arrangement involved a substantial fall in revenues to the States, as it reflected both the loss due to Deakin's *Surplus Revenue Act* of 1908 and adjustments for the balance of the Commonwealth's costs for national old age pensions (Prest and Mathews 1980). Although a referendum in 1910 failed to embed the Premiers' agreement in the Constitution, it was enacted by the Fisher Labor Government as the *Surplus Revenue Act* 1910. Under this Act, which operated for ten years, revenue payments were distributed to the States at 25/- per head of population.

The Act included an arrangement for temporary special grants to Western Australia for ten years from 1910–11 as compensation for that State's large per capita contribution to customs revenue; the cost was shared between the Commonwealth and other States. Meanwhile, Tasmania successfully claimed compensation under the book-keeping arrangements. A Royal Commission confirmed the leakage of customs revenues from Tasmania and recommended payment of £1.8 million in equal installments over ten years. The payment was not viewed as charity but as a payment due to the State under the general transitional financial provisions of the Constitution; nonetheless, it was an acknowledgement that equal per capita grants at the levels set by the 1910 arrangement were still insufficient for some States' budgetary needs.

The per capita payments established under the *Surplus Revenue Act 1910* were severely eroded by inflation arising from World War I, while the introduction of a Commonwealth land tax in 1910 and of Commonwealth income tax in 1915 created acute problems of double taxation. The smaller States particularly resented these developments. Federation had forced especially heavy direct tax increases on South Australia and Tasmania. For example, the relative

[146]For example, the two smaller States, Tasmania and South Australia, argued that their taxation was already too high to contemplate pensions in the near future and were adamant a national pension scheme had to be financed by new Commonwealth direct taxation.

[147]The financially weaker States considered the proposed fixed payment too low, while New South Wales and Queensland remained sensitive about being sole judges of their loan raising.

severity of taxation in Tasmania rose from 0.97 at Federation, to 2.03 by 1910.[148] Likewise, the relative tax burden in South Australia increased from 1.18 to 1.44, and in Western Australia from 0.39 to 0.86. By contrast, in New South Wales relative tax severity fell from 1.26 to 0.75, reflecting its substantial easing of taxation between 1901 and 1909. From the viewpoint of the poorer States, the Commonwealth received public favour for its expanded social programs — funded from customs revenues formerly due to the States — while State parliamentarians faced strong public resentment because of the increase in their politically visible land and income taxes (May 1971). Meanwhile, the populations of the smaller States were draining to New South Wales and Victoria, reducing both their potential revenue base and their aggregate payments from the Commonwealth under the *Surplus Revenue Act 1910*.

Fiscal crisis of the States, 1920–1933

New negotiations on federal finance were necessitated by the imminent expiry of the per capita arrangements in 1920. At the 1919 Premiers' Conference the Commonwealth Government sought to reduce per capita payments, and offered to substantially withdraw from income taxation if the States agreed to terminate the 1910 agreement.[149] Recognising the uneven impacts of such a reform, the Commonwealth Government also offered special provisions for Tasmania, Western Australia and Queensland if direct taxes were reassigned, but this was not sufficient reassurance.

The Commonwealth making room in the direct tax field was of dubious financial benefit to the poorer States, as they had relatively low taxable capacity. Replacing per capita grants in the smaller States' budgets would have required high income taxes compared with those in more affluent States. More generally, such developments as the Commonwealth Government's special purpose grants for road building instituted from 1923, gave the less populous and rural States a further stake in arrangements under which the Commonwealth Government had a strong revenue raising role and redistributed such revenues to their benefit.

Estimates of taxable capacity and tax severity showed very clearly how unevenly the burden of taxation was distributed among similarly placed taxpayers in different States during the first two decades after Federation (Copland 1980a [1924]). This underlined the great difficulties of arranging a general scheme for the delimitation of spheres of taxation between the Commonwealth and the States or promoting uniformity in State taxation. Economist D. Copland concluded that:

> any proposal [for reassigning taxation fields], while offering relief to some States, will create hardships for others and the pressing financial needs of most States are at present an insurmountable obstacle to uniformity (Copland 1980a [1924], p. 393).

Academic and official opinion increasingly recognised the economic and financial disadvantage of the smaller States, and the diverse nature of their difficulties. Professor L.F. Giblin, the Tasmanian Statistician, used Commonwealth income tax data to show that the belief in the convergence of taxable capacity was unfounded (Giblin 1924). The steeply progressive Commonwealth income tax of 1915 raised revenue disproportionately from wealthier States because of the higher average incomes of their citizens — it raised only half as much revenue per capita in Tasmania as it did in the wealthier States. The smaller States thus benefited from a substantial redistribution as a result of a progressive centralised taxation system and a grant allocation system with an equal per capita character. In a 1926 review, Giblin also observed:

> So long as the federal tax is uniform and uniformly administered in all States, it cannot go wrong. The State which is flourishing at the time (or more precisely in the previous year) will pay more than the average, and the State which has

[148] As measured by an index of its direct taxes proportional to industrial production and relative to its share of the national aggregate of such production (see May 1971). This approximates the method later used by Giblin (1924) and the Commonwealth Grants Commission to assess 'tax effort'.

[149] The course of these negotiations is summarised in Smith 1993b (pp. 47–49).

had a bad year will pay less. The adjustment is automatic[150] (Giblin 1980a [1926]), p. 57).

Nevertheless, from 1923 the Commonwealth Nationalist/Country Party Government, under the influence of Treasurer Earle Page, adopted a policy of vacating the direct tax fields in favour of the States and ending their dependence on Commonwealth grants. Page and his colleagues believed that the grant arrangements caused duplication and irresponsibility (Sawer 1956) and that Commonwealth direct taxation should be reduced to pre-war levels. However, because of its heavy commitments for war debt and war-related social services such as for veterans (Jones 1980), and the need to budget for special assistance to Tasmania and Western Australia, reducing Commonwealth taxation meant reducing payments to States.

The May 1926 Premiers' Conference was unable to obtain the necessary unanimous agreement of the States on reassigning taxes between the Commonwealth and States. The interests of the smaller States had increasingly come to lie in a system that centralised income taxation. The dynamics created by divergent taxable capacities and the redistributive fiscal activities of the Commonwealth Government meant that there was no agreed view among the States as to the best (or even a jointly acceptable) direction of change. The Bruce–Page Government, nevertheless, remained committed to more 'coordinate' fiscal arrangements. In early 1927, it passed legislation replacing per capita payments with a fixed grant at the 1927 aggregate payment level. This forced the States to negotiate on the Commonwealth's proposal to take over States' debts and contribute to their debt servicing, and which culminated in the Financial Agreement of 1927.

In the short term, the States were better off under the new arrangements. The Commonwealth grants were more certain than the per capita payments, as s. 105 of the Constitution was amended to remove Commonwealth Parliament discretion over the payments. The agreement also meant the Commonwealth took over part of States' debt servicing responsibilities, which was especially beneficial to the smaller States (Gilbert 1973).

However, while the Agreement reduced the Commonwealth's role in funding the States, it did little to address their unequal fiscal capacities. Because of its own spending commitments, the Commonwealth was unable to accept all of the States' debt servicing commitments. By 1928, economist Professor R. Mills would observe that while 'the States find it increasingly more difficult to meet their political responsibilities from the fields of taxation which they now share with the Commonwealth, ... the Commonwealth finds it necessary to explore new fields of expenditure in order to dispose of a superabundant revenue' (Mills 1980 [1928], p. 73).

Anti-federal sentiment had increased markedly by the mid 1920s. Much attention focussed on the economic and associated fiscal 'disabilities' imposed by Federation. The Commonwealth wage arbitration system and industry protection policies were perceived as threatening the economies and budgets of the smaller and predominantly primary producer States. In 1929 the Commonwealth increased the tariff and lowered its income tax threshold to boost revenues, taking it into a part of the income tax base that it had vacated to the States since 1923.[151] This provoked particular anger in the smaller, primary producing States.

Special assistance to Western Australia from 1925–26 had emerged from a 1924 Tariff Board Report on the disadvantages to that State's Budget from Commonwealth protectionism. Also Tasmania had for some time been seeking redress for the financial disabilities of federation, associated mainly with its high indebtedness from the unprofitable State railway operations. The State was also losing population to the mainland. Reflecting the work of Professor L.F. Giblin, Tasmania's submission to a Commonwealth Government inquiry into its request argued that by joining the Federation, a small, resource-poor State experienced

[150] It is interesting to note that modern economic theories have identified this redistributive effect; for example, Sala-i-Martin and Sachs (1992) identified that a progressive tax transfer system contributes to output-risk sharing within a federation.

[151] The increasingly overlapping spheres of Commonwealth and State direct taxes led to the appointment of the Fergusson Royal Commission on 'double taxation' in 1932 (see Chapter 4).

difficulties beyond those imposed directly by Commonwealth policy (May 1971). As Giblin explained, the State found it more difficult to avoid raising standards of public services and had less 'liberty to cut its coat according to its cloth' (Giblin 1980a [1926], p. 53).

The 1927 Financial Agreement allowed for South Australia to seek special grants, which it did in 1928. The Commonwealth set up a Royal Commission to assess its claim, and South Australia submitted that it needed assistance 'to enable it to maintain the standard of progress of the wealthier States' (May 1971, p. 19) and noted an implied promise that the weaker States would not be allowed to suffer on account of joining the Federation. Adopting the approach suggested by Tasmania in previous enquiries, the Royal Commission based its recommendation for grants on the State's budget deficits after adjusting for tax capacity and level of taxation, and other items, taking need as the justification for assistance.

With the arrival of the Depression in 1929, Western Australia and Tasmania made frequent claims for additional assistance. As Greenwood commented regarding the secession movement in Western Australia:

> The economic ills of the State were responsible for transforming secession from a goal favoured by a few extremists into a movement expressive of universal dissatisfaction with existing conditions (Greenwood 1946, p. 180).

Looking to tensions in other federal countries in 1934 Professor J.B. Brigden observed that 'federation everywhere might become a casualty of the Depression' (1980 [1934], p. 217).

Between 1925 and 1932, there were no fewer than seven separate official inquiries and three Royal Commissions into the effects of Federation on the finances of Tasmania, Western Australia and South Australia. Recognising underlying economic development factors as the root cause of their financial problems, conditions attached to 'disabilities' grants aimed to encourage convergence in the States' economic capacity (May 1971). Special grants were also directed in some cases at eliminating the inducements for population movements between States that arose from differences in taxable capacity (Prest 1974).

By late 1929, the arbitrariness and uncertainty of the special grants process had become an election issue because of the Bruce–Page Government's policy of attaching conditions to special grants (May 1971). The offer of a grant to South Australia provoked enormous controversy because it was conditional on transferring part of the State's railway system to Commonwealth control. The conditions attached to previous Tasmanian grants had been bitterly resented in that State. And in the same year, the Commonwealth offered assistance to Western Australia if that State transferred its north-west portion of territory to the Commonwealth. The political uproar over the Commonwealth's use of conditions emphasised the need to regularise assistance and to determine such grants on a better coordinated, more principled and objective basis.

During the election campaign in 1929 the Opposition Leader, J.H. Scullin, promised to implement special grants to Western Australia and Tasmania without conditions. Shortly after his election to government, the conditions were removed. In early 1930 the Scullin Government established a review conducted by the Commonwealth Parliamentary Joint Committee of Public Accounts (the Joint Committee). It reported in August 1930. When controversy re-emerged over the South Australian grant, the Government asked the Joint Committee to investigate that grant; the terms of reference were later amended to include assessment of a request by Western Australia. This Joint Committee review represented the first attempt to co-ordinate the claims for grants by South Australia, Western Australia and Tasmania (Prest and Mathews 1980).

Before it finished its work on Western Australia, the Joint Committee was abandoned but its 1930 report on Tasmania and 1931 report on South Australia pulled together a number of strands of thinking on the special grants issue. It adopted the suggestion made by Giblin (1980b [1930]) to look at a State's public accounts and calculate the grant needed to balance the budget where the State: was taxing with considerably greater severity than the Australian average; was not attempting social provision on a more generous scale than average; had below average costs of administration; and had shown moderation and caution in loan expenditure.

The Joint Committee also called for the establishment of a permanent independent body to determine grants on a consistent and principled basis. In 1932 the Commonwealth established the Commonwealth Grants Commission for this purpose: this represented the main institutional response to the political instability and conflict engendered by State financial difficulties during the Depression. It was also the first formal acknowledgment that the economic and fiscal capacities in the States were not converging. Redistribution of revenues from richer to poorer States was now institutionally recognised as a necessary and permanent feature of the Federation.

Searching for the underlying cause of the States' financial distress, the 1935 Report of the CGC highlighted that financial inequality between States resided in what it described as 'a conflict between political and economic forces' (CGC 1935, p. 40). It observed that before Federation, colonial tariffs had checked the economic tendency for concentration of manufacturing in the south-east of Australia, but this barrier had been abolished at Federation. Noting that self-government in the colonies had arisen from the need for 'some effective principle of decentralisation', the CGC concluded that the centralisation trend

> has been that best fitted for Australia as a whole, and is in accord with the universal modern trend of economic integration which favours the large unit as against the small. But it tends to concentrate population and power, both political and economic, in the eastern centres (p. 41).

That is, an economic tendency for increasing centralisation of power conflicted with the direction of change in political institutions, towards greater decentralisation of power.

The problem faced by the CGC was to find a 'principle' that could be applied with consistency to the circumstances of the different States. Its first recommendations for grants were driven to a considerable extent by the need to accommodate the interests of the smaller States at a time when Western Australia was petitioning the British Parliament to be allowed to secede from the Commonwealth. Reflecting such political realities, the Commission needed to adopt principles and methodologies that generated a level of grants at least matching the generosity of those under previous arrangements. To prevent political conflict with the larger States, it was also necessary for the Commonwealth to find the correct balance of federal principle/generosity and conditionality/effort. The difficulties of measuring 'disabilities' and the differences between States in the nature of their claims for special assistance also underscored the need for the Commission to develop an approach which was flexible, seemed objective and was at the same time more practical than attempting to place a money value on the net disabilities from federation. These characteristics were found in the principle of 'fiscal need', described by Head (1967, p. 473) as 'an ingenious reconciliation of the diverse arguments in a principle of financial equality'.

The principle of fiscal need, explained in the CGC's 1935 report, was that 'the Governments of States ... are in a different position from the people of a State. Governments cannot change their occupation or move to other States where conditions are better' (CGC 1935, p. 36). In fact, 'the movement of their people to other States in accordance with economic conditions worsened their problems, because the overhead burden of interest may become so heavy as to outweigh any possible economies in current expenditure' (CGC 1935, p. 36). Under the terms of the Financial Agreement the Commonwealth was responsible for the States' solvency. It was therefore 'a fundamental obligation for the Commonwealth (and indeed for other States) to make it possible for a State government in distress to function at some standard (CGC 1935, p. 36). The only ground for this assistance was 'the inability of the State to carry on without it' (CGC 1935, p. 36).

The basis the CGC adopted for ascertaining the level of assistance, therefore, was to bring claimant States up to a minimum standard, somewhat below that of the non-claimant States, rather than to their average level. In recognition of the federal principle of the grants, and no doubt reflecting public outrage at the conditionality of some previous payments, all grants were unconditional.

The principle of fiscal need that emerged in the Depression was a frugal expression of the 'federal' principle which was to be refined over subsequent decades. Fiscal equalisation, which would bring claimant States to a level of fiscal capacity equal to that of non-claimant States, remained some years away, awaiting increased economic prosperity, buoyant Commonwealth revenues and the renewal of federal political tensions over grant allocations.

Uniform taxation and the problems of federal surplus revenue revisited

With uniform taxation in operation from 1942, the States were initially reimbursed for their lost income tax revenues according to the distribution of collections in 1939–41. This paralleled the arrangements for distributing tariff revenues just after Federation. Like the Constitution's financial provisions for customs collections, these arrangements also acknowledged the diverse impact on State budgets of the uniform taxation arrangements — any State that felt it received insufficient grants could apply for supplementary assistance.

In 1943, the Curtin Labor Government established the National Welfare Fund using revenues from higher income taxation and its 1941 payroll tax.[152] It substantially increased taxation rates especially on low-income earners to provide for a national system of social security. As was also the case with age pensions and the Financial Agreement of 1909, the reimbursement of revenues to the States was adjusted for estimated cost-savings to the States from the Commonwealth taking over responsibility for the widows' pension (Butlin and Schedvin 1977).

Expanded social services at the national level were thus funded, as under the *Surplus Revenue Act* 1910, at the expense of payments to the States. For example, Commonwealth tax revenues, enlarged mainly by increased income taxation (see Chapter 3), rose from 15 per cent to 25 per cent of GDP between 1941 and 1985 (Figure 7.1). Over the same period however, untied grants to the States rose by less than 5 percentage points (see Figure 8.8 in Chapter 8). While, to some extent, the balance of the Commonwealth's additional revenues was accounted for by tied grants and Commonwealth underwriting of States' borrowing through the Loan Council, the smaller rise in untied grants is nevertheless suggestive of the extent to which the Commonwealth's gained a 'surplus' revenue from the unification of income taxation.

When the Commonwealth continued the uniform income tax arrangements after the war, there was vigorous opposition from some States. However, Prime Minister J.B. Chifley questioned whether restoring their income tax powers would benefit the three claimant States:

> Long before the introduction of uniform income tax, when the three claimant States had complete taxing power, they were not able to finance themselves. I have said before, and I repeat now, that the three less populous States must be assisted by the larger and more affluent States and the Commonwealth, if we are to have a national outlook on the development of Australia (quoted in Stargardt 1952, p. 229).

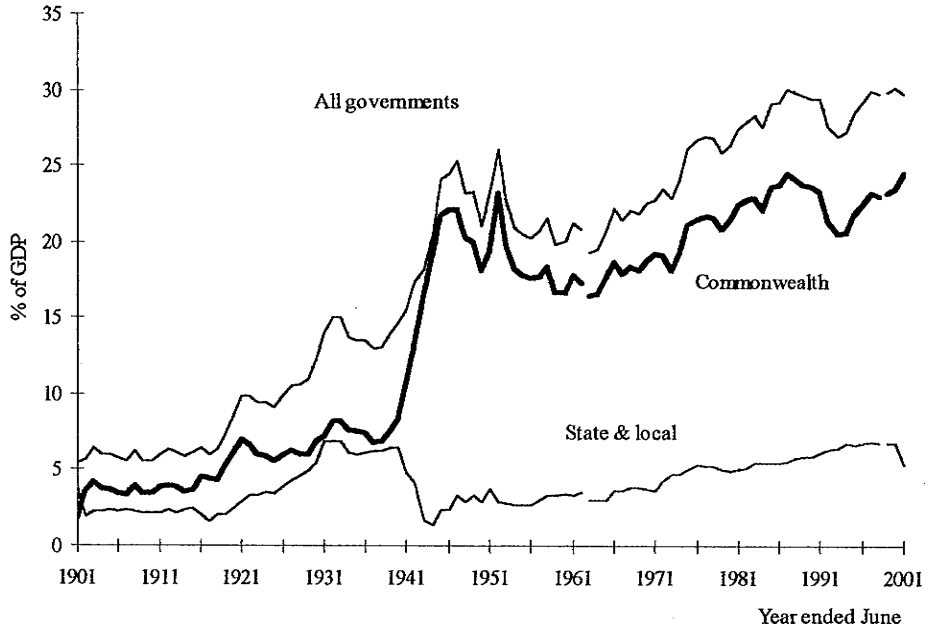
As Chifley's argument recognised, collection of progressive taxes by the Commonwealth and distribution of the proceeds to the States on an equal per capita basis was tantamount to a redistribution from the richer States to the poorer States. Indirectly, so too was the payment of Commonwealth means tested social security benefits to individuals. Unlike New South Wales and Victoria, who remained deeply dissatisfied, the smaller States had little financial interest in overturning this arrangement, and their opposition was decisive. Hence the High Court ruling in favour of the Commonwealth's action was not the only obstacle keeping States out of the income tax field.

This was most evident in the early 1950s when the Menzies Government sought to return some income taxing power to the States (Australia, Commonwealth and State Treasury Officers 1953). At that time it was the smaller States that opposed it because of their lesser capacity to raise revenues from income taxation compared to the more affluent States and to the

[152] See Chapter 5 regarding the background to Commonwealth payroll taxation.

Commonwealth (Binns and Bellis 1980 [1956]). This was explicitly recognised in the tax sharing arrangements adopted later under the Fraser Government's policy of 'New Federalism' during the 1970s.[153]

Figure 7.1
Taxation as a Proportion of GDP Since Federation



Source: Hancock 2001.

In the meantime, war-related improvements in economic conditions and acknowledgement meant that the CGC's concepts of 'tax effort' and the 'penalty for claimancy', which had formerly reduced the amount of special grants,[154] were becoming increasingly meaningless (Brown 1952).[155] War-related factors, and the Commonwealth's ample income tax revenues over the next several decades, underpinned a gradual shift away from the minimalist principle of 'fiscal need' towards fiscal 'equalisation' as a basis for allocating grants to States.

By 1945, the Commission's 'penalty for claimancy' and the adjustment for additional tax effort — the most obvious formal differences between fiscal need and fiscal equalization — had been abandoned (Head 1967).[156] After World War II the basis for distributing tax reimbursement grants also gradually evolved from a 'contributions' basis to an adjusted per capita basis.[157]

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[153]Although these arrangements were structurally flawed because they gave the States no incentive or genuine opportunity to implement their own income taxes (see Mathews and Grewal 1997, pp. 266–71).

[154]See Head (1967) for a discussion of the basis for these adjustments.

[155]Wartime restrictions on State expenditures combined with the uniform tax arrangements made it less meaningful to assume a State could exercise financial autonomy and responsibility in its taxation and expenditure policies.

[156] In its early reports the CGC had emphasised that there was not a 'scientific' basis for penalties, and it was for the Commonwealth Parliament to judge what level of 'penalty for claimancy' should be imposed and to what standard the claimant States should be raised.

[157]Under the adjusted per capita model, phased in over the ten years to 1957–58, the measure of State population was adjusted for its demographic structure. This method adjusted grants for the higher costs of providing services in sparsely populated States and reflected a convergence with the principle of assessing capacity and need applied by the CGC since the 1930s for claimant States.

Pressures for expanding the role of the post-war public sector and the relatively slow growth of tax reimbursement grants meant that the States' revenues had were increasingly out of balance with their functional responsibilities. Applications for special grants by both Victoria and Queensland in 1957 provoked in a general review of Commonwealth–State finances. As a result of the review, 'tax reimbursement' grants were replaced from 1959 with financial assistance grants (FAGs).

However, the Commonwealth was also aiming to reduce the number of claimant States to two and to reduce the quantum of funds flowing to the States as special assistance. So that South Australia would withdraw from claimancy, its 1958–59 special grants were built into the FAGs base, making them much more redistributive than the tax reimbursement grants (Head 1967; Lane 1977).

The post-1959 distribution was not based on any clear principles but rather reflected an arbitrary combination of factors.[158] As Prest commented (1980 [1959]), p. 482), 'if such a differential *per capita* is to be used, there is a strong case for basing the differentials ... on some objective formula'. From 1959 there was increasing arbitrariness in the relativities of general revenue grants and in the distinction between claimant States and non-claimant States. By the late 1960s, this created major tensions between the Commonwealth and the States (even politically aligned States) over grant allocations. Having shown itself willing and able to be politically accommodating with grants the Commonwealth government now found an expectation that it would continue to be so.[159]

Commonwealth generosity was aided by its ample tax revenues, which had reached 20 per cent of GDP in 1968–69 compared to around 8 per cent in 1938–39 (Smith 1993b). As Mathews and Jay commented (1972, p 299), 'there seems little doubt that even allowing for increased Commonwealth grants, State and local authorities have been under greater financial pressure than the Commonwealth'. The increase in State and local governments' own revenues from 3.4 per cent to 6.2 per cent of gross national expenditure over the period 1949–50, to 5.4 per cent by 1969–70, was 'clear evidence that they have felt the need of a bigger increase in their share of community funds than was provided from Commonwealth grants' (Mathews and Jay 1972, p. 299).

Thus, from 1942 federal financial arrangements were adapted to the unification of income taxation and to improved economic conditions by the Commonwealth increasing the redistributive element of its grants to States. While post-war expansion of tax and social services reinforced the redistributive element of the progressive tax-transfer system the Commonwealth took advantage of its superior taxing powers to control the level and direction of State and local government expenditures. As Mathews and Grewal concluded, by the mid 1970s 'the concentration of taxing power in the hands of the Commonwealth encouraged a tendency to liberal spending on its own services and heavily constrained spending on State services' (1997, p. 267).

While most commentators focus on the damaging effect of vertical financial imbalance on fiscal responsibility of governments or on locational efficiency,[160] it is argued in Chapter 8 below that this imbalance in favour of Commonwealth services and against State spending represents a more significant economic effect of Australia's unbalanced federal fiscal

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[158]These included adjusted per capita allocations, the CGC criteria of fiscal need and the political factors that had been embedded in the 1958–59 grants base. For example, the additional tax reimbursement grants that the smaller States (South Australia, Tasmania and Western Australia) had received during the war had been incorporated in an *ad hoc* way into the tax reimbursement grants base from 1947; supplementary grants were also made on an *ad hoc* political basis by the Commonwealth Government rather than through the CGC between 1947 and 1958. South Australia, Tasmania and Western Australia had also continued to receive special grants through the CGC based on 'fiscal need'.

[159]The move to full horizontal equalisation in 1985 was intended to avoid this arbitrariness and potential for political conflict, in the same way that the CGC had been an institutional mechanism to coordinate the distribution of Commonwealth grants during the less prosperous years of the Depression (Hancock 2001). Predictably, new tensions arose over fiscal equalisation when the States' share of the national fiscal cake shrank.

[160]See Hancock and Smith (2001, pp. 70–91) for a discussion of this debate in the Australian context.

arrangements than effects on fiscal responsibility or location decisions, through the adverse impact on States' investments in economic and human capital.

Conclusion

If delegates to the Australian Constitutional Convention had studied modern theories of federal finance, which assign the redistribution function to the central government for several very good reasons, the financial clauses of the Constitution would have been rather different. As it was, the Constitution gave few redistributive functions to the central government. The changing fiscal relationship between the Commonwealth and the States from Federation has been examined here from the perspective of how it responded to the redistribution problem.

While some view fiscal equalisation as an outgrowth of protectionism, this chapter has shown that its origins are deeper and more complex. By mapping the connections between different aspects of Commonwealth–State financial relations, it has questioned the common view that the centralisation of taxation (and the associated expansion of social security) over this century reflects either simply a Commonwealth grab for power or a 'cop-out' by 'taxation-shy' State governments. It is suggested instead that the changing financial relations between governments were moulded by broad social and economic forces, particularly by the different taxable capacities of States and by their citizens' shared values of national unity and equality as reflected in their expectations of uniform standards of social services.

The financial clauses of the Constitution provided the institutional framework within which the respective roles of Australian governments, and Commonwealth–State financial arrangements, evolved during the past century. This chapter has demonstrated how the diversity of the taxable capacities and fiscal situations of the States and the fiscal politics of the late nineteenth century shaped this constitutional framework. It has also shown that this economic and fiscal diversity worked as a centralising force after Federation because the financially vulnerable States benefited from the Commonwealth's fiscal expansion. This was partly through the Commonwealth's grants to the States, and partly through its uniform and means-tested social security system and progressive income taxation.

A conclusion of Chapters 4 and 5 was that the constitutional assignment of taxation powers became increasingly at odds with centralising social and economic pressures and with the continued differences in the States' fiscal capacities during the twentieth century. Here it is argued that the establishment of the CGC was another institutional response to the growing inconsistency between the States' fiscal capacities and ideas of the rights of all Australian citizens to comparable standards of social services, a response triggered by the fiscal crisis of the Depression. Just as the process of fiscal centralisation was assisted by accelerating economic integration, tax competition and demands for social services originating in the Depression years, the genesis of horizontal equalisation is found in the economic and fiscal distress of that time. That is, both uniform taxation and horizontal equalisation were responses to the problem of redistribution and social protection in a federal system in a period of economic vulnerability and fiscal crisis.

Mathews has concluded that Australia's system of horizontal equalisation is a practical manifestation of Australians' dominating concern for equity:

> It has been one of the most important unifying influences in bringing together people scattered over vast geographical areas ... it has been one of the principle means of achieving equity for all Australians ... [and is] a major factor in achieving political stability across the different regions ... and of protecting the less populous States against New South Wales and Victoria ... it has protected New South Wales and Victoria against inequalities associated with back-room deals and arbitrary Commonwealth action (1994b, p. 14).

As was evident to the framers of the Constitution, the problem of the federal revenue surplus (or 'vertical fiscal imbalance') and its distribution ('horizontal balance') are inseparable. Present challenges to it arise 'not from any inherent defects of horizontal equalisation, but from

pressures which are being placed on it by the continuing failure to restore vertical fiscal balance' (Mathews 1993, p. 123): Ironically, States argue about the shares of the diminishing funds that the Commonwealth arbitrarily makes available' rather than about their collective access to sufficient revenues (Mathews 1993, p. 122).

Hence, while Federation did achieve the greater harmony sought in areas where more unified markets made national laws and policies more necessary, the framers of the Constitution would judge themselves unsuccessful in their goal of protecting the fiscal powers and autonomy of State Parliaments. The implication of this failure has been that State governments have been unable to respond effectively to political demands for a more redistributive role for government both during the 1920s and after World War II. While the States benefitted greatly from the expansion of government spending and Commonwealth grants during the early 1970s, because of their inferior taxing powers and fiscal dependence on Commonwealth they have borne the brunt of fiscal retrenchment since the mid 1980s.

It remains to be seen whether the much-vaunted reforms associated with 'the new tax system' will alter the fundamental imbalance in Australia's public finance system. However, past history suggests the centralisation of the consumption tax base through introduction of the goods and services tax in June 2000 will, in the longer term, simply exacerbate previous tendencies. For example when, in the late 1960s, and again in the late 1990s, the High Court ruled invalid the taxes that were resourcing State governments, Commonwealth–State financial arrangements were reshaped along similar lines to earlier revenue-centralising arrangements. While the States were initially reimbursed according to what they contributed, 'reimbursement' evolved into 'financial assistance' and, in the process, the degree of 'vertical financial imbalance' increased (Collins 2000).

As it has in the past, this imbalance in the revenue resources of the Commonwealth compared to the States is likely to have implications for both the level and character of fiscal redistribution in Australia in the future. Before 1942, Australia's federal financial arrangements constrained the States' capacity to respond to demands for improved public facilities and social services, while after World War II a similar result followed from their subordination through the Commonwealth's superior taxation powers, an issue explored further in Chapter 8.

Chapter 8
Infrastructure Funding and Commonwealth–State Finances*

Introduction

The public sector in Australia owns around 90 per cent of economic infrastructure and most 'social' infrastructure (Economic Planning Advisory Council (EPAC) 1988). During the post-war period until the 1970s, this public investment was effectively substantially financed from Commonwealth taxation. Research showing strong links between public investment and the private sector's economic performance, and a sharp fall off in public investment from the mid 1980s triggered debate during the 1990s on the significance of trends in public investment in Australia.

Although public investment is an input into production both in the market economy and in the non-market, household economy, most commentators have focussed narrowly on the implications of public infrastructure for market production, and ignore the economic significance of non-market household production of goods and services and of human capital.

While a sharp decline in Australian governments investments in human capital has been identified from the mid 1980s, this issue has attracted little attention from economic researchers since that time. Furthermore, although the level of public investment spending, and how it is financed, has important implications for the distributional impact of government taxing and spending decisions, this has been largely ignored in the public infrastructure debate.

As illustrated in Chapter 7, a bias in the allocation of Australian taxation revenues in favor of the Commonwealth and away from State and local governments has arisen from flawed federal financial arrangements. The decline in the Australian capital spending between the 1960s and early 1980s has been attributed to the growth of Commonwealth income taxation as a subsidy source during the post-war period.

While much has been written about Australian public investment, there is only a limited literature on its relation to the institutions of federal finance, or on its implications for redistribution and income inequality. Nor has research embodied a perspective relating public investment policies to the efficiency of human capital production and households' economic output.

This chapter considers Australian public infrastructure financing and spending in the post-war period including from such non-market, human capital and equity perspectives, and the implications of post-war trends for the redistributional role of taxation. Firstly it outlines the wider background to these issues, drawing connections between Australian economic development, public investment and Commonwealth–State financial arrangements. Then it reviews and discusses trends in public physical investment since the 1960s. Some economic and equity implications of declining public investment are then drawn.

While most critics of the economic efficiency of Australian fiscal federalism focus on how horizontal equalization distorts the location of labour and capital, and how the 'vertical fiscal imbalance' (VFI) reduces accountability and responsibility of government spending, it is argued here that of far greater consequence for Australia's economic performance are the averse effects of the VFI on levels and patterns of investment spending.

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* This chapter is based on a study originally published in 1994 as 'Infrastructure Funding in Australia', *Research Papers*, no. 14, Parliamentary Library, Canberra.

Public infrastructure investment and the Australian economy

In common parlance, the term 'infrastructure' means transport, communications, and energy networks, notably urban and regional infrastructure such as roads, bridges, ports, railways, public bus and tram systems, post and telecommunications networks, gas and electricity, and water supply, drainage and sewerage systems.

The social infrastructure of a country can also be defined more widely to include publicly owned education and health facilities. The Organisation for Economic Cooperation and Development (OECD) and others include communal assets — such as recreation and leisure facilities, open space such as national and local parks, playgrounds and setbacks or verges — in urban areas as important elements of public infrastructure. Law and order facilities such as prisons also count as social infrastructure in such broader definitions. The public capital stock may also be viewed as extending to human capital investments and knowledge-acquisition financed by the public sector (OECD 1993; EPAC 1993).

The public sector, mainly State and local governments and their business enterprises, has traditionally played an important role in providing both economic and social infrastructure in Australia (Butlin 1959). However, a shift in the post war period up to the early 1980s was associated with the fiscal and policy making preeminence of the Commonwealth government due to uniform income taxation.

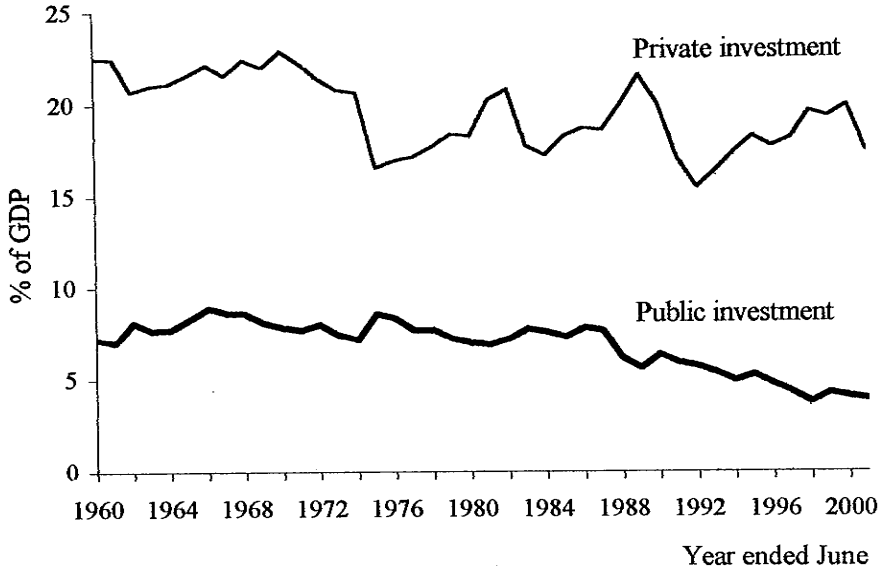
> Centralised authority, exercised for the first time in Australian history, has led since the early 1950s to a gradual retreat from public capital formation ... The withdrawal in terms of the public withdrawal of infrastructure and its services had tended, through Federal constraint, to be concentrated on State activities. Those specific areas in which Federal interest is strong have maintained and increased their presence (Butlin et. al., 1982, p. 48).

Butlin *et al.* (1982) linked their finding to the growth of Commonwealth income taxation as a potential subsidy source, which 'weakened the ability of public undertakings to resist private pressures or public inclinations to engage in cross-subsidisation' in favour of particular competing private interests (Butlin *et. al.*, 1982, p. 341). Associated with this, they identified an increasing priority of 'foreign private interests, not domestic Australian interests' in Australian public spending and regulatory decisions (Butlin *et. al.*, 1982, p. 47).

As evident in Figure 8.1, the declining share of public capital formation identified by Butlin *et al.* accelerated in the 1980s, and continued into the 1990s. Research showing the strong links between public investment and the private sector's economic performance reopened debate over whether such declining public investment should be a matter of concern (for example see Cox and Forsyth 1988; Dowrick 1994a). The long term reduction evident in private, non-dwelling investment since the 1960s (Figure 8.2) reinforces the importance of the issue of public investment to Australia's overall growth performance. A related issue has been the appropriate extent of privatisation of public infrastructure and its funding (for example, see EPAC Task Force on Private Sector Involvement in Public Infrastructure 1995; Quiggin 1996; Neutze 1997).

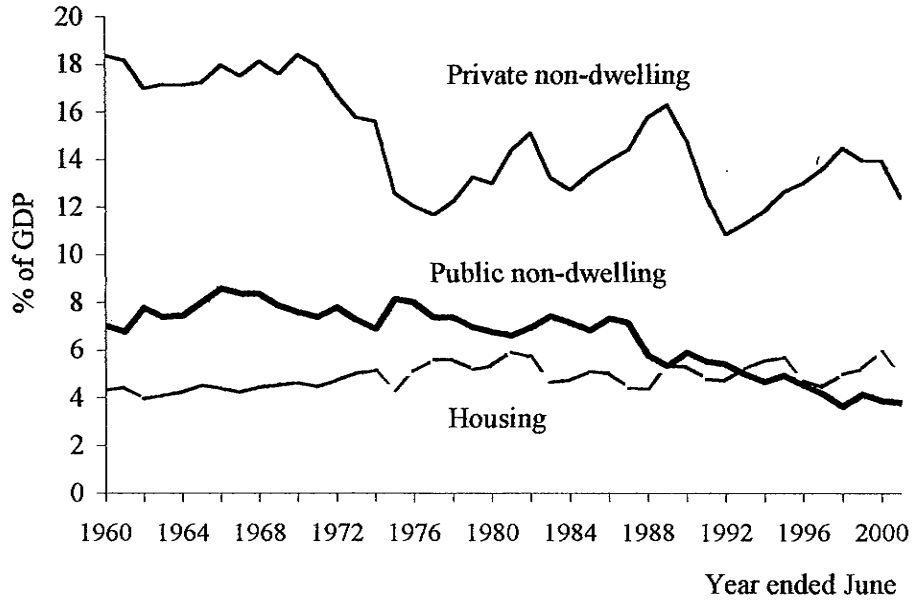
Declining public investment also raises important questions about the role of public investment in human capital, its relation to the productivity of the non-market household sector, and its redistributional consequences. For example, research at the International Monetary Fund has found that as economic development proceeds, the distribution of human capital replaces tangible wealth as the main determinant of income, and income inequality (Tanzi 1998a). In fact, 'the role that the government lays in creating human capital may be the most important impact that the government can have on income distribution' (Tanzi 1998a, p. 3).

Figure 8.1
Public and Private Investment
as percentage of Gross Domestic Product,
1959–60 to 2000–01



Source: ABS, *Australian National Accounts*, 2000.

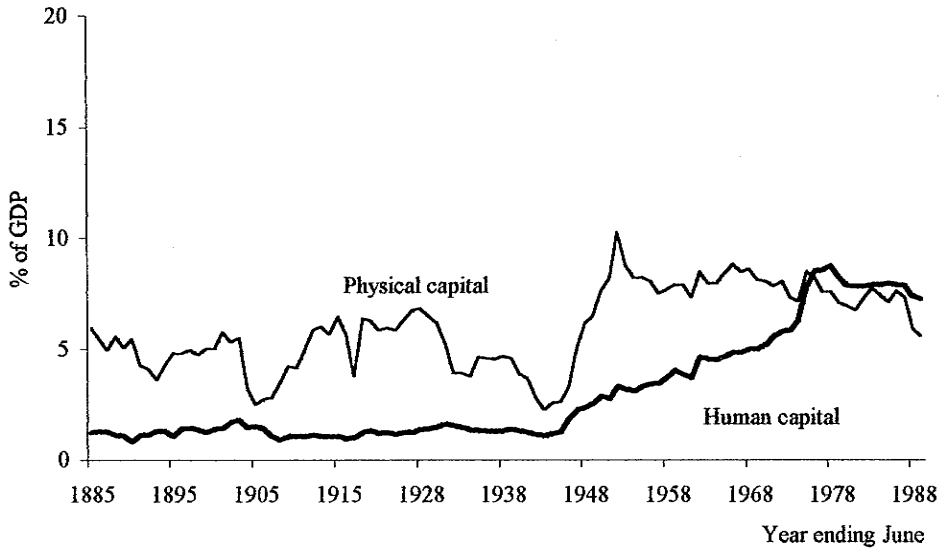
Figure 8.2
Public and Private Non–Dwelling Investment
as percentage of Gross Domestic Product,
1959–60 to 2000–01



Source: ABS, *Australian National Accounts*, 2000

In keeping with this finding, a historical study of human capital in Australia during the twentieth century found that the public sector was responsible for most (market) investments in human capital, mainly through education, but also through health and immigration (Pope 1989). However, that study showed that strong expansion of public human capital investment after 1945 was sharply checked from the mid 1970s (see Figure 8.3). This appears to be largely due to cuts in Commonwealth health funding as part of a policy of encouraging private health insurance between 1975 and 1982 after the Fraser Government terminated Medibank (Butler 1998). (The implications of this are considered further in chapter 11).

Figure 8.3
Public Human and Physical Capital Formation as a percentage of Gross Domestic Product



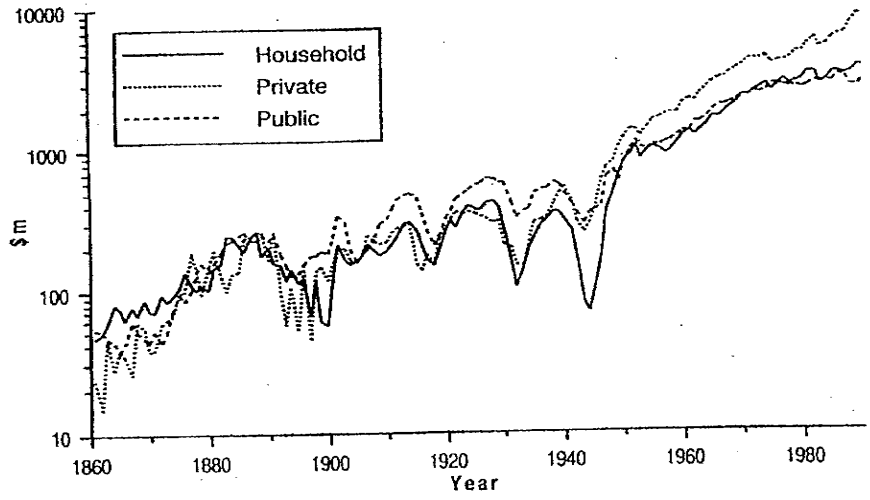
Source: Pope 1989.

'Economic' production includes the household economy as well as the market economy (Kuznets 1941). According to the Australian Bureau of Statistics (ABS) (1990), the level of unpaid household production is comparable with market output. The historical evidence (Snooks 1984) suggests public capital investment has moved closely with that in the household/unpaid economy in the long run (see Figure 8.4)There is also a close relation between public capital formation and productivity trends in both the private market and household economies, evident from comparing trends in Figures 8.4 and 8.5. Notably, through the period of declining public physical investment from the mid 1960s, the productivity of the household economy appears to have dramatically lagged growth in the market sector. Public investment in infrastructure therefore may be significant for productivity and output in the non-market economy as well as the market economy.

Public infrastructure funding: trends and causal factors

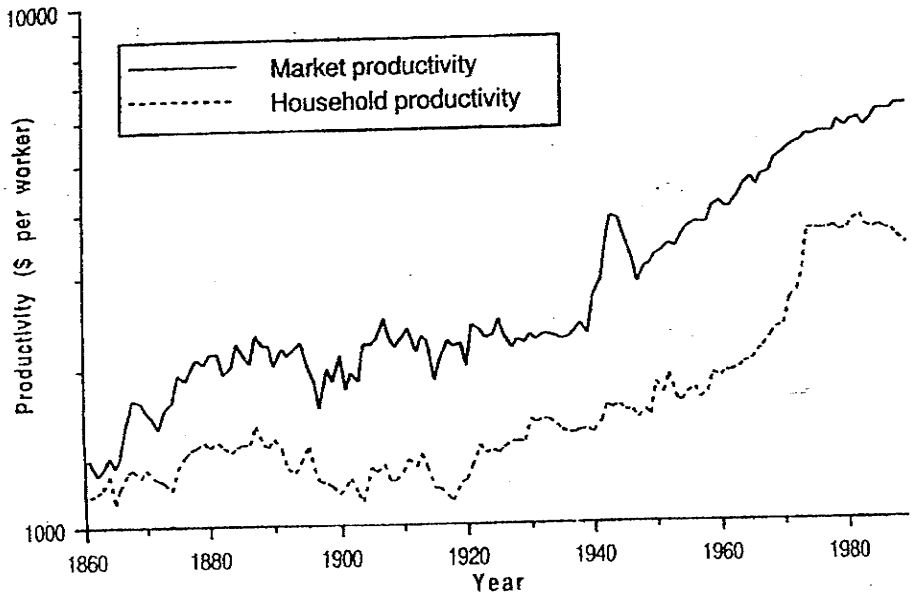
Since the early 1960s, public investment in Australia has been lagging behind the growth of the national economy. With the sharp decline in public investment since 1985, public capital formation fell below 5 per cent of gross domestic product (GDP) from the early 1990s, compared to more than 8 per cent in the 1960s (Figure 8.3 above).

Figure 8.4
Total Capital Formation by Sector,
1861 to 1990, 1966–67 Prices



Source: Snooks 1994.

Figure 8.5
Household and Market Labour Productivity
1861 to 1990



Source: Snooks 1994.

Infrastructure spending in Australia has traditionally been financed by public borrowing, and amortized through various combinations of State, local and Commonwealth taxation and charges on users of public services, in proportions reflecting the relative importance of distributional or social goals and externalities in total project costs. Social infrastructure, where distributional objectives and concerns about social externalities are most dominant, is typically funded mainly through taxation, while physical infrastructure, such as roads, water and sewerage services, has usually been amortised mainly from direct charges for access or use with debt service costs funded from taxation to account for benefits to future generations.[162]

Traditional methods of funding public infrastructure investments have come under pressure during the last two decades due to:

- high real interest rates and costs of investment;
- attempts to make public infrastructure providers more efficient in supplying services;
- the higher costs of reducing the adverse effects of development on the natural environment.
- perceived political pressures to reduce taxes;
- policies of limiting public borrowing;

Since the 1950s, when the Commonwealth began using its surplus income tax revenues to underwrite State and local government borrowing through the Loan Council, Australian governments have financed a substantial portion of investment spending out of taxation revenues (May 1974; Saunders 1990). This source of funding diminished as the Commonwealth moved into deficit from the early 1970s (FitzGerald 1993).

Much of the responsibility for infrastructure investment lies with Australian State and local governments and their enterprises. While Commonwealth investment spending has remained roughly unchanged at 1.5 per cent of GDP, public investment spending by State and local governments has declined steadily since the early 1960s. There was a more marked fall since the mid 1980s.

Public enterprise investment is a key element in the declining trend of public capital formation since World War II (Butlin *et al.* 1982) and in the acceleration of this decline since the 1980s (Figure 8.6). As a result, State and local governments now account for only half of public capital formation in Australia, compared to nearly two–thirds in the 1960s (Figure 8.7).

Since uniform income taxation in 1942, State and local governments have come to rely heavily on Commonwealth grants. Under pressure to fund their public services from their own resources, State and local governments slightly increased their share of national taxation during the 1980s. Despite this, and the introduction of the Goods and Services Tax (GST), State and local governments remain heavily dependent on Commonwealth grants (Collins 2000) and on numerous *ad hoc*, narrowly based, low yielding or unstable taxes like stamp duties, gambling taxes and land taxes (see Chapters 10 and 12).

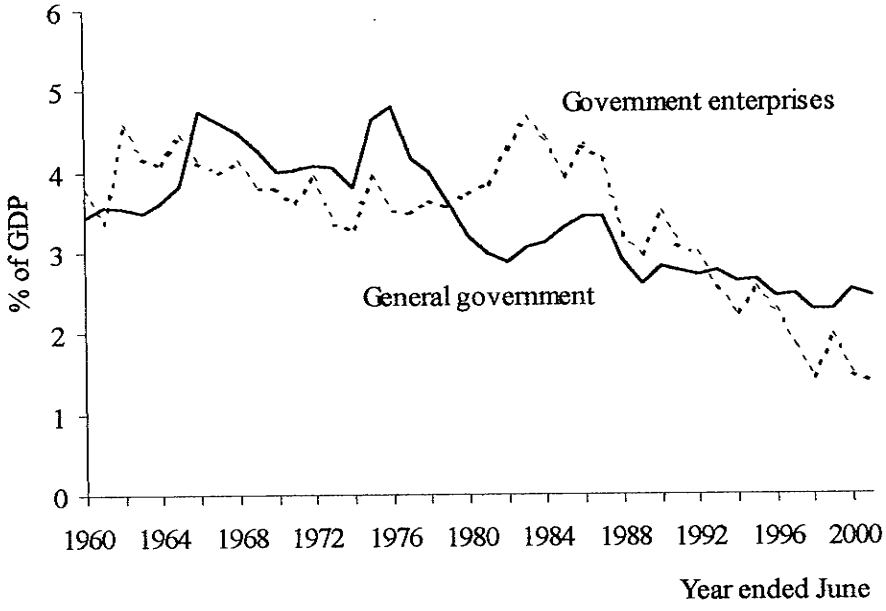
This lack of revenue autonomy has had significant implications for State and local government infrastructure financing and investment spending (Walsh 1992). While personal and corporate income tax revenues rose from 5 to 15 per cent of GDP between 1939 and the late 1990s (Smith 1993a; Foster and Stewart 1991; ABS, *Taxation Revenues Australia*, 1998), untied grants to States rose by only around 4 percentage points over the same period (Figure 8.8).[163] A declining trend in Commonwealth payments to States and local government is mirrored in public investment *per capita,* which peaked in the early 1990s after slow but steady

[162]Examples are public utility loans amortised out of current revenues, property taxes or rates levied by State or local governments, fuel taxes, developer charges, connection fees and user charges for water services, telephones or electricity.

[163]The Commonwealth's tied grants rose considerably more than untied grants, but still not as much as its taxation revenues. It is difficult to attribute the effects of specific purpose grants, which have varying degrees of conditionality attached, and may be for both capital and current purposes (Mathews and Grewal 1997).

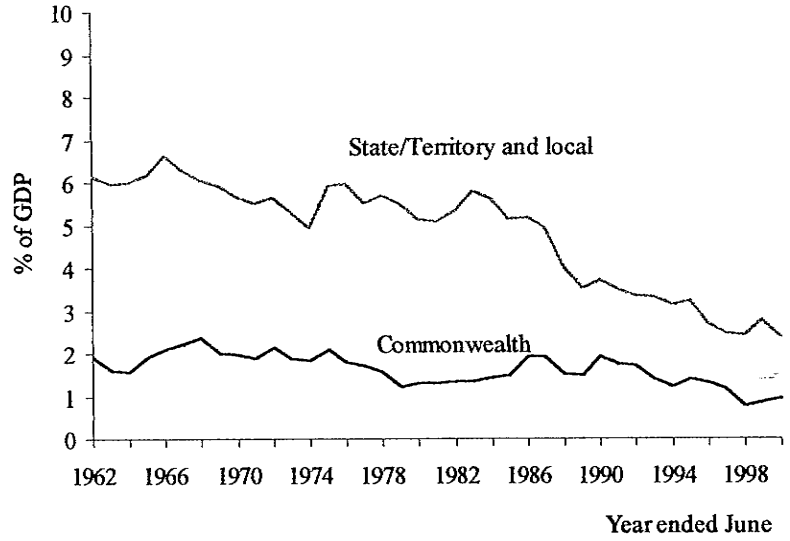
growth since the 1960s (Figure 8.9). This indicates that the level of resources provided to State and local governments from the 1980s did not keep up with the rapid growth of population.

Figure 8.6
Investment by General Government and Governmental Enterprise as percentage of Gross Domestic Product, 1959–60 to 2000–01



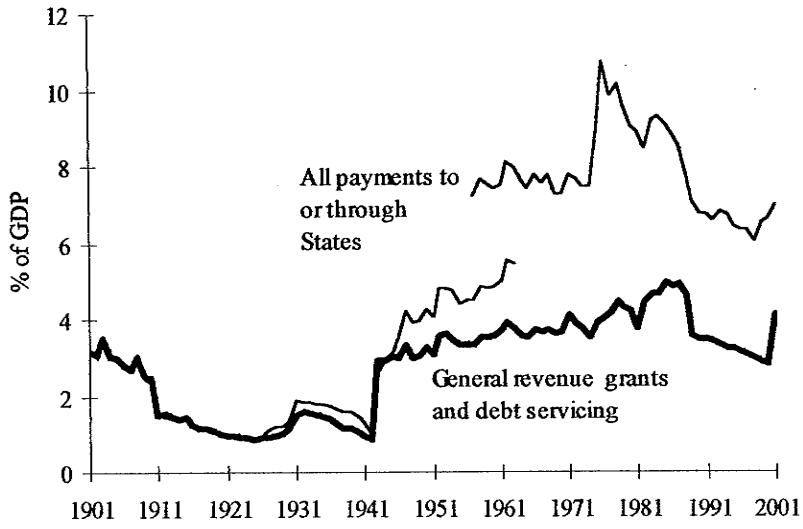
Source: ABS, *Australian National Accounts*, 2000

Figure 8.7
Public Investment by Level of Government as a Percentage of Gross Domestic Product, 1961–62 to 1999–00



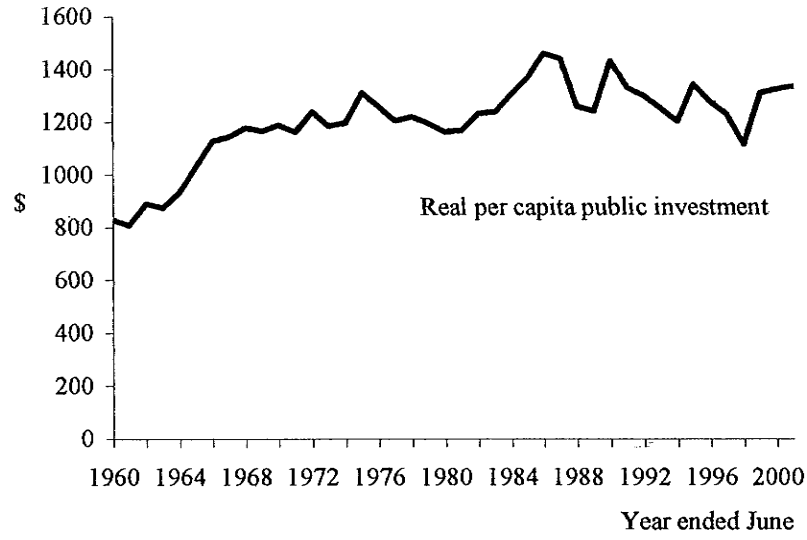
Sources: ABS, *Australian National Accounts*, 2000; 2002.

Figure 8.8
Commonwealth Payments to State and Local Governments as a Proportion of Gross Domestic Product, 1900–01 to 2000–01



Source: Hancock 2001.

Figure 8.9
Real Gross Public Fixed Capital Expenditure Per Capita, 1959–60 to 2000–01

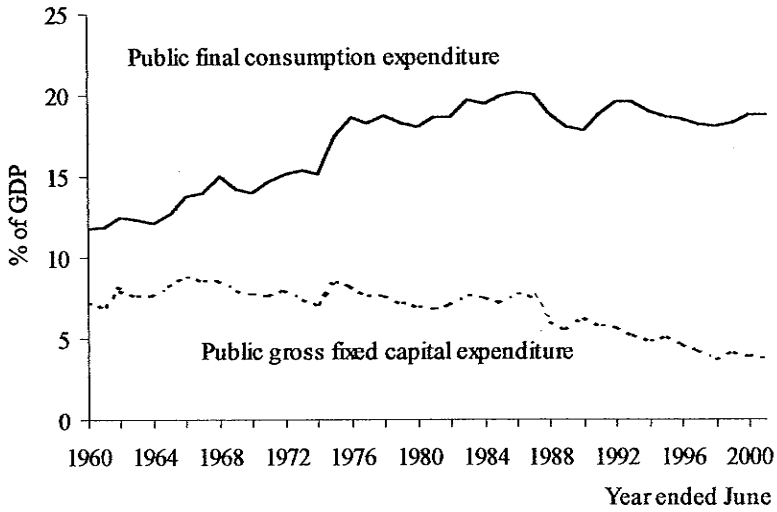


Source: ABS, *Australian National Accounts*, 2000.

Notwithstanding heavy pressures on the Commonwealth budget from unemployment, Commonwealth taxation was reduced from the mid 1980s, falling from 25[164] per cent of GDP to around 20 per cent in 1991–92 (see Figure 7.2 in Chapter 7). A reduced Commonwealth Budget deficit since the mid 1980s was achieved in substantial part through lower grants to other levels of government. The Commonwealth also controlled State and local borrowings through its dominance of taxation revenues and the States' dependence on grants. With strong financial market pressures to reduce public debt, aggregate public sector borrowing was severely curtailed through the Loan Council from 1986-87 (Grewal 1999).

With the emphasis of wages policy being on maintaining the value of the 'social wage', Commonwealth government consumption spending was relatively protected at this time. It has been suggested that to protect 'social wage' items including social security, the Commonwealth created pressures for those managing Australia's public infrastructure assets to run them down, with an effect of the Prices and Incomes Accord being reduced net worth of the Australian public sector (Kearney 1994). However, as is evident in Figure 8.10, public consumption has been rising steadily since at least the early 1960s, showing that more fundamental economic or institutional factors are also at work (see Chapter 7).

Figure 8.10
Total Public Capital and Consumption Spending as a Percentage of Gross Domestic Product, 1959–60 to 2000–2001



Source: ABS, *Australian National Accounts*, 2000

Thus the overall picture is that centralized income tax powers, shrinking Commonwealth transfers to State and local governments and restraints on public sector borrowing led to reduced public investment, particularly State and local governments, and this trend was associated with a rising share of consumption in public spending. That is, fiscal contraction from 1985 was achieved through cuts to State and local government investment spending (Alesina, Gruen and Jones 1990, 1991), alongside rising Commonwealth expenditures on social security.

[164]Excluding compulsory superannuation contributions, which being paid to private funds, are excluded from OECD definitions of taxation.

Economic issues and implications

Public and private investment spending

Public funding of infrastructure investments declined markedly from the mid 1980s. The Langmore Committee first raised concerns about such trends in 1987 (Australia, Parliament, House of Representatives Select Committee on Transport, Communications and Infrastructure, 1987). However, there has been debate over whether this is a matter for concern.

The context for the policy of fiscal constraint since 1985 has been the desire to reduce Australia's current account deficit and the associated reliance on overseas savings by increasing public sector savings. However, shifting responsibility for infrastructure funding from the public to the private sector does not remove the nation's investment funding problem. A private investment strains aggregate demand and the balance of payments as much as a public sector project does.

Neither does sale of public assets to the private sector fix the funding shortfall. Unless private infrastructure financing taps new sources of funding, or provides the infrastructure with less capital or at lower overall cost, it does not increase the funds available for infrastructure spending: it may wastefully distort the allocation of available funds. Nor does it achieve the macro-economic objectives of reducing Australia's current account deficit and net borrowing overseas.

While more competitive markets in infrastructure can bring substantial benefits, there are limits to, and pitfalls from, increasing private involvement in public infrastructure provision. The evidence from overseas is that full private funding of infrastructure with no government underwriting of risk or hidden equity is rare. The public interest, such as in high standards of accountability and transparency, or regulatory integrity, may be compromised if private investment is pursued for its own sake. As the OECD noted in its 1991 study of urban infrastructure financing (p. 78);

> The pursuit of public objectives remains paramount; but it cannot always be reconciled with the objectives of private providers. There is a clear need for procedures to ensure that public interest considerations are not swamped in the attempt to make involvement attractive to private interests.

The ensuing policy debate highlighted the need to increase the efficiency and productivity of public infrastructure rather than its level, and emphasised the role of appropriate public sector pricing policies in generating adequate funding for public infrastructure spending. In response to the sharp decline in public infrastructure spending from the 1980s, EPAC and other researchers emphasized that too much public infrastructure investment could be as economically costly as too little (Cox and Forsyth 1988; EPAC 1988; Smith 1992). These studies argued there was no evidence of general under investment in public infrastructure, although they identified some particular areas of under-investment.[165] Declining trends in public enterprise investment spending was partly explained by privatisation of public enterprises over the period. Another argument was that the decline in public investments reflected to an unmeasured structural shift from tangible to intangible assets, such as health and education (Depta *et al.* 1994).

The official rhetoric of the 1990s thus focused on improving the management and operational efficiency of public infrastructure and enterprises, rather than on the general adequacy of public capital formation, its relation to changing demands and needs, and the allocation between public and private sector. Such emphasis on 'productive efficiency' underpinned attempts to impose greater competitive pressures on public enterprises through 'national competition policy' (FitzGerald 1994).

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[165] EPAC (1988) found under-investment in urban arterial roads, some rural roads, some airports, ports and local roads. Cox and Forsyth (1988) found evidence of excessive investment in irrigation and electricity generation, but under-investment in rail freight, and urban arterial roads. Smith (1992) concluded that the decline in public infrastructure spending since the mid-1980s to previous over investment, for example in electricity generation in the early 1980s.

Decisions to cut public investment to maintain current consumption spending may be the democratic expression of a disregard for future generations. However, even if the current generation were indifferent to the interests of the future, it may be argued that intergenerational equity places an obligation on governments to redress private myopia with a more farsighted and unselfish view.

Furthermore, there are reasons to believe political, institutional and fiscal incentives — rather than better public decision-making, a search for efficiency, or unmeasured intangible investments in human capital — were the driving factor behind the declining public investment trends of the 1980s and 1990s.

- While State and local governments' funding for public infrastructure was constrained by Commonwealth fiscal policies and Loan Council restrictions, the Commonwealth was providing costly (see Chapter 13) and unnecessary tax subsidies to private financing of public infrastructure (EPAC Task Force on Private Sector Involvement in Public Infrastructure 1995).
- The macroeconomic policy emphasis of Commonwealth fiscal policy and taxation policy since 1985 emphasized the value of private project financing, while high real interest rates exacerbated a narrow and short term focus for public investment decisions.
- One-sided budget policies emphasized the debt side of the public balance sheet rather than the asset side, or overall net wealth of the public sector.
- Labels — whether a project was 'public' or 'private', 'on' or 'off' budget — resulted in 'private sector financing being encouraged simply to get around Loan Council ceilings, and created the potential for a less than optimum use of resources and higher financing costs' (Australian Loan Council 1994, p. 2).[166]
- Budget and related processes provided the public very minimal or poor information on public asset holdings and infrastructure repair, maintenance and investment with which to make collective decisions about investment levels or priorities.[167]
- Complex financing arrangements such as Build Own Operate Transfer (BOOT) schemes concealed the extent of the effective privatization of government activities and of the unwarranted profit accruing to private partners through such 'financial engineering' (Walker and Walker 2000, p. 189)
- Increased public spending on unmeasured intangible investments in health and education may simply reflect the need to replace decreasing household investments in human capital, due to a shifting of household productive activity from the home to the market.
- It is usually politically less damaging to cut government investment rather than government consumption as the costs of deferring or reducing public investment are either less apparent or have less immediate impact on the public than cuts in current services or transfers.

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[166]Loan Council arrangements have centred on the macro-economic effects of public sector borrowing, with controls aimed at restricting aggregate borrowing rather than to ensure the availability of capital for public or private projects with the highest returns (Australian Loan Council 1993; Grewal 1999). Such restrictions have implications for the split between public and private investment as capital funding for projects in the public sector is 'rationed', while financial deregulation means private investments are not constrained in this way. Arrangements in place since the mid 1990s maintain a bias towards private involvement; fiscal imperatives were still expected to continue to limit infrastructure spending, and the Loan Council's reliance on Government Finance Statistics (GFS) conventions meant that the full cost of all public projects were counted as 'public' regardless of the public share in the project (Australian Loan Council 1994). See also Walker and Walker (2001).

[167]The Industry Commission Report on Taxation and Financial Policy Impacts on Urban Settlement Patterns (Industry Commission 1993) noted the very poor information available on public infrastructure assets, with there being in some cases no information at all, let alone properly costed or valued inventories. In general, public sector accounts have not provided a clear and comprehensive picture of the breakdown between public capital and current spending, or between capital and current receipts (Australia, Parliament, House of Representatives Select Committee on Transport 1987; Kearney 1994; Walsh 1992).

Private involvement in infrastructure can, in principle, bring some of the benefits of competition to the public sector. However, in practice, competition is rarely a reality when it comes to infrastructure provision, which is often characterised by increasing returns to scale, and network externalities associated with tendencies to monopoly. Private provision does not deal adequately with the various 'public good' aspects of infrastructure. Also, complex longer term and non-profit goals can be a valid consideration in the case of public infrastructure provision.

Private involvement in financing can sometimes result in more efficient phasing and financing of projects, or better risk management of infrastructure projects (Quiggin 1996). However, different forms of infrastructure financing have different implications. Recent experience has highlighted difficulties in such relationships between governments and private suppliers because of information problems and difficulties in appropriately allocating various kinds of risk (Neutze 1997, 1999). These need to be examined carefully case-by-case to ensure each party earns recompense commensurate with their true contribution of capital and bearing of risk. The appropriate risk premium for governments is likely to be considerably less than for private finance. Issues of public conflicts of interest may also have to be considered and properly dealt with (Quiggin 1996).

Viewed in this light, some of the privately financed public infrastructure investments over the 1980s and 1990s were clearly uneconomic, representing merely complex ways of shifting, channelling or spreading over time the public contribution to the cost of providing the infrastructure.

While altering the financing arrangements for a project so that its budget cost is more evenly spread over time, or hidden from public view altogether, may have satisfied misguided market perceptions about public borrowing and financial deficits, the financial and economic cost of fiscal 'window dressing' is potentially very high. In the Australian Capital Territory (ACT), which has a public leasehold system of land tenure, Loan Council restrictions were cited as a reason for introducing private land development from the late 1980s, despite research showing that the financial returns to public investment in ACT land development were extremely high (Barrassa, Neutze and Strong 1994). Many of the BOOT schemes that have been properly evaluated show that far from getting 'something for nothing', the public paid dearly for infrastructure financed in this way (Walker and Walker 2000).

Similarly, where the availability of outside funding has distorted public investment priorities by moving funds away from high priority public infrastructure projects to those attracting outside (that is, private or Commonwealth) funding, public investment funds may have been dissipated on less productive investments. For example, an uneconomic location and phasing of urban development was determined essentially by the availability of private financing for the Rouse Hill development (Nedeljkovic 1991). Likewise, tied Commonwealth grants for Better Cities' projects resulted in ACT public funding being redirected into refurbishing existing infrastructure with a low economic return, and away from high-return infrastructure investments in greenfields locations (Barrassa, Neutze and Strong 1994; also see Chapter 9).

While the public sector, like the private sector, undoubtedly has made some poor investments, it is likely that the deteriorating public investment performance from the mid 1980s has reduced the productive as well as unproductive public capital stock. Walker and Walker (2000) reviewed the public accountability and transparency of the privatization of public assets and their financing that has occurred in Australia during the 1980s and 1990s, while Quiggin (1996) has examined infrastructure financing and privatization as part of a broader critique of 'microeconomic reform' over the same period. These studies form part of accumulating evidence that important equity and public interest issues associated with privatization and increased private involvement in infrastructure financing were not adequately dealt with during these years.

By the mid 1990s, respected observers were suggesting that the focus on increasing public sector efficiency had run its course, with national productivity benefits from adding to

public infrastructure at least equalling gains from further progress in improving the efficiency of existing infrastructure through micro economic reform (FitzGerald 1994). In its Medium Term Review, EPAC (1993, p. 67) acknowledged the importance of efficiency but commented that

> the combination of growing internationalisation of economic activities, the drive for improved international competitiveness, urban growth and environmental concerns will ensure that demands on transport, energy, water supplies, waste disposal, telecommunications and so on will increase in the years ahead. Our social capital will also need to be maintained and advanced, with investment in areas such as health education and corrective services likely to be required.

Public infrastructure was argued to be critical to reducing business costs and determining the location of investment because high living standards from high quality public health, education or other 'soft' urban infrastructure attract population and valued skilled employees (McKinsey and Co. 1994).

Such concerns that public investment efficiency gains had reached their limits were given added force by growing evidence that private sector growth depends on complementary public investments. Overseas research (Aschauer 1989a; Aschauer 1989b, 1990; Lynde and Richmond 1993; Munnell 1990a, 1990b; Munnell 1992; Erenberg 1993), later applied to Australia (Otto and Voss 1994a, b), suggested that public infrastructure investment, notably in transport, communications and water services, produces high economic returns, making a very important contribution to the productivity of private investment and to growth of output, and employment.[168] Previous research on the returns to public investment had drawn on detailed studies of investment projects, rather than on aggregate econometric studies. Cost-benefit analysis of individual projects is notoriously deficient in accounting for the dynamic interactions and spillovers that characterise public infrastructure investments. These benefits are more likely to be captured in the aggregate analyses in the more recent studies (Dowrick 1994a, b).

Such research also challenged the conventional thinking that reducing public sector demands on capital markets allowed lower real interest rates and reduced current account deficits because excessive public borrowing 'squeezed out' more productive private investment. Rather than 'crowding out' private investment through the effects of higher interest rates on private investment demand, research on the 'supply-side' effects of public investment showed public investment was a necessary complement to private investment. A 'crowding in' effect of public investment on medium and long term private investment and output may substantially outweigh any short term 'crowding out' effects on investment and economic growth (Aschauer 1989b).

While the earlier American research was criticised because it produced implausible magnitudes in its results, a wide range of international research confirmed that public investment had important positive spin-offs for private investment and output levels (Dowrick 1994a, b). For example, studies comparing different regions in the United States found a $1000 investment in public capital produced a $400 increase in private investment and a 0.2 per cent boost to employment growth (Munnell 1990a). Other studies (for example Lynde and Richmond 1993) also confirmed high returns to public investment, leading to the conclusion that, on average, a 1 per cent increase in public capital investment induced a 0.15 to 0.3 per cent rise in private sector output (Dowrick 1994a).

Prospective economic rates of return on a range of public infrastructure investments were found to be higher than on private investments in the early 1990s. On average investment returns to public sector investments were higher than on private investments by a ratio of 1.25 (Otto and Voss 1994b, Figure 1). Allen Consulting's study of land transport infrastructure in Australia (1993) found evidence that new infrastructure spending had not catered adequately for

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[168]It is worth noting that the output benefits of public investment projects increase the Commonwealth government's income tax revenues rather than State or local government revenues, which are less related to the growth of national income. This means reduced incentives for State or local governments to fund highly economic projects even if they are self-financing overall.

additional demand, with utilisation of road stock rising dramatically and road capacity falling far behind indicators of demand. FitzGerald (1994) noted returns from new investment in public infrastructure were estimated at 16 to 50 per cent.[169] Based on these estimated returns from road investments, Allen Consulting (1993) suggested an annual economic benefit of $940 million for every one-off infrastructure investment of $1 billion, arising from reduced business costs. This estimate excludes economic benefits to households.

Evidently high commercial rates of return for some public infrastructure investments suggest that public infrastructure has been substantially under-funded even from a purely financial point of view, as public infrastructure investments are usually characterised by significant 'externalities' or spin-offs to the community at large which make the social rate of return substantially higher than the commercial return.[170]

A growing literature argues the lack of economic justification for policies that have reduced public investment levels, and increased public asset sales in the decades of the 1980s and 1990s (for example see New South Wales, Auditor General 1994; Quiggin 1996; Neutze 1997, 1999; Walker and Walker 2000; Harris, 2000).

The non-market economy

Although existing research draws the link between public infrastructure and *measured* or *marketed* private output — the private business sector — an important side-effect of the run-down in public urban infrastructure, such as roads, schools or other public facilities, may be on productivity in the household, or unpaid, economy.

As shown earlier (Figures 8.3 and 8.4), there is a close link between public capital formation and household's economic production. Poor public infrastructure provision will be reflected in particular strains and reduced productivity for families attempting to combine work in the market with that in the unpaid household sector, due to less convenient and more congested access to public and commercial facilities and jobs. What may be seen as improved economic efficiency and cost-saving for the public sector provider may be reduced infrastructure services and higher financial and economic costs for users — representing cost-shifting rather than cost-saving. For example, estimates of the $4 billion economic cost of urban road congestion in Sydney and Melbourne imply economic costs of a comparable magnitude for households (Allen Consulting 1993). (Further evidence on this issue is found in Chapter 9, which identifies the cost-shifting interest of public enterprises as a factor in public investment decisions imposing economic costs on households).

With the size of the unpaid household economy equal to around half that of marketed economic output (ABS 1990), infrastructure inadequacy is also likely to have important implications for the economic efficiency, production potential and standards of living of households in Australian cities.

In addition, public infrastructure services are important consumption items for households. Living standards in Australian cities, where most of the population is concentrated, depend directly on the consumption of public urban services such as roads, water supply, sewerage, schools, parks and medical facilities. These infrastructure services are usually provided by State or local governments. As infrastructure provision failed to keep up with the growth of population over this period (Figure 8.5), living standards of households were likely to have been affected.

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[169]Fitzgerald estimated that, with so much economic activity concentrated in urban areas, the decline in road funding dramatically increased capacity utilisation with costs of congestion reaching around $4 billion a year.

[170]The effects of public capital shortages in driving up rates of return on public infrastructure may explain private interest in some parts of infrastructure provision, despite the inability of private investors to capture the wider spillovers from such public infrastructure (Neutze 1994b).

Distributional consequences

Most social and economic infrastructure as well as health care and education service provision in Australia is the responsibility of State and local governments. The allocation of taxation between Commonwealth, and State and local governments is thus a critical issue in public human capital as well as physical investment trends. Commonwealth income taxation is a more progressive way of financing public investments than expanded State and local taxes. Because State and local government revenue sources cannot easily be expanded to include more progressive and broadly based taxation instruments, governments have been forced to move further in the direction of user charges, with adverse equity consequences, and with reduced certainty that public infrastructure investment has been sufficient to meet private and social needs. The policy of encouraging State and local governments to replace Commonwealth grants (financed by income tax) through higher State taxation or greater resort to user charges has therefore effectively implied a significant change in the distributional role of the Australian public sector.

How infrastructure is funded has significant equity implications not only for various regions and parts of cities but also for generations, for income groups, and for the public and private sectors. 'Rationing' of public infrastructure funding is likely to impact most adversely on the economic production potential or consumption standards of those with the least capacity to protect their interests — low income households and future generations. As the costs and benefits of nearby public infrastructure are built into the value of assets such as businesses and houses, there are complex locational, social and intergenerational equity issues associated with the rundown in public infrastructure and the move towards the non-provision of or cost-recovery pricing policies for public infrastructure such as schools, roads or open space. Hence, when the public sector fails to maintain, replenish and expand the public capital stock needed to provide capacity for a growing population, some groups of taxpayers, home owners, businesses, regions or generations may end up effectively paying twice for the benefits of public infrastructure, or paying charges for services or assets which are not provided, while others pay little or nothing.[171] These complex equity factors have been substantially neglected in the national infrastructure policy debate.

The conventional view is that public infrastructure pricing should be not be used for pursuing equity goals. Rather, it has been argued that it is better to achieve social or redistributional objectives directly through budget subsidies, because this is likely to target subsidies more effectively and progressively at the least economic cost (for example, Cox and Forsyth 1988). Using the price system to achieve equity can also raise administration costs.

However, this wrongly assumes that such a direct subsidy will in fact be provided and that it is progressively financed by income taxes, or that such redistribution is effectively costless in economic terms.[172] The point is that financing the costs of meeting social goals through different mechanisms must be compared in each case; income distribution through progressive pricing policies and income redistribution through the tax-transfer system being alternatives. That is,

> redistribution through pricing should be pursued up to the point where the marginal cost, in terms of efficiency losses, is equal to the marginal efficiency cost of pursuing redistribution through the tax-welfare system (Quiggin 1996, p. 120–1).

Ultimately, all infrastructure is funded by the private sector, either through contributing resources through taxation to governments or through payment by consumers or users to

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[171] Neutze (1994) points out that the largest private investment in public urban infrastructure has been funded by buyers of homes and developed properties, who have then transferred ownership to the public sector for the operation, maintenance, and eventual replacement of these assets.

[172] State or local government taxation on gambling (see Chapter 10), for example, is regressive and may not be a more progressive financing source than cross subsidies achieved through public utility pricing. State taxes may also be more distorting than user charges at least in the case of physical infrastructure (Neutze 1987). Income taxation also has efficiency costs, which in Australia are likely to be around 20 cents in the dollar (Quiggin 1996).

infrastructure providers. Whether responsibility for infrastructure funding should lie with private sector or the public sector depends partly on whether a competitive market exists, or can be created, for the infrastructure, and whether it is feasible to recoup funding costs through user charges. Different infrastructure financing methods have different distributional implications. Whether infrastructure can be made privately profitable depends on whether user charges can be levied which make the project fully self-financing at a given interest cost –that is on the extent of social and economic externalities and other public good characteristics.

Different pricing structures will be appropriate for different types of infrastructure. User charges have undeniable efficiency benefits in some cases, especially for investments where most benefits can be privately appropriated. For some items of urban infrastructure where distributional concerns are less compelling, user charging has been common and may sometimes be appropriately extended (Neutze 1987). In some such cases, social equity goals are minimal, spill-over effects or externalities are few, and capital markets are developed enough to deal with the risks and the financing task associated with such large scale, long-term projects.

However, a pricing policy which supports full self-funding can present very real problems for some forms of infrastructure because of the difficulties in excluding non-payers, the external or spillover effects, or because the nature of the investment produces large economies of scale tending to natural monopoly. For such infrastructure it may not be politically or technically feasible, or economically efficient, to recoup all capital costs through user charges.[173] Especially where there are 'spill-over' effects, price signals do not give a good guide to the level of infrastructure provision that is socially optimal. Left to private providers infrastructure is likely to be undersupplied. A key issue, especially for social infrastructure, is whether the distributional goals or the wider social effects of an investment are substantial. Private funding means the public sector loses control over how funding costs and the benefits of access to infrastructure, are distributed, and in some cases this may have undesirable equity consequences.[174] The scope for increasing private involvement in the funding of most public infrastructure is thus limited by the difficulty, cost and sometimes the social undesirability of attributing and charging for the general benefit flowing from such investments (Neutze 1994), and many investments in infrastructure, such as for schools, open space, medical facilities or roads, must be funded substantially from taxation revenues.

Conclusions

This chapter concludes that especially over the period 1985 to 1995, Commonwealth fiscal constraint fell on worthwhile public investments while public consumption spending and private investment was more cushioned from such pressures, or even publicly subsidised. Poor public accounting systems, decision making processes and institutional arrangements helped produced this result.

It is argued here that federal financial imbalance has had adverse effects on the level and pattern of investment spending and on the disincentives from taxation and social security. It has done this by reducing States spending on public infrastructure investments and human capital investments such as universal public health, primary and secondary education services, which reduces the potential economic productivity gains and long term income equalizing effects of government spending.

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[173]For example, charging for social infrastructure such as schools. In such cases, the efficiency effects of imposing on those who initiate development the relative infrastructure costs at a particular site have unacceptable equity implications. In some cases the efficiency benefits of charging for off-site physical infrastructure, such as headworks and trunk mains and arterial roads, may not be substantial.

[174]For example, the ability of private infrastructure providers to recoup physical urban infrastructure costs from house buyers is constrained by the important social goal of promoting home ownership. Developer charges and up-front costs are passed forward into house prices, so that market constraints on borrowing by individuals unnecessarily limit home ownership if funding the infrastructure by public sector borrowing — amortised over time out of taxation, rates and user charges — is a feasible alternative.

Although there is virtually no economic research on the impact of this on the unpaid household economy, the decline in public investment might also have been mirrored in a decline in the level and efficiency of household production of goods and services. The economic costs of congestion, for example, are likely to be high for households as well as for businesses (see Chapter 9). Effects on the household economy would also include on the expending of resources on reproduction and maintenance of human capital through unpaid childcare, health care and education service — areas of human capital investment in which public sector involvement has become increasingly common (Depta *et. al.*, 1994).

As Pope commented in his review of human capital investment trends, if the aim of public policy has been to reduce the burden on measured economic growth of a high dependency ratio, then it makes sense to encourage female labour force participation. Recognising however, that 'part of the increase in measured output will displace unmeasured domestic production (i.e. unpaid house duties)' (Pope 1989, pp. 9–10), it is argued that

> The human capital development of pre-school children may be retarded as a consequence. However, the answer depends on the quality of alternative care. ... The question then raised is who, parents or society, should meet the cost of this investment?' (1989, pp. 9–10).

At the same time, it is suggested, the same flaw in Commonwealth–State fiscal relationships has biased public spending towards substantial public subsidy of private infrastructure financing and provision through Commonwealth income tax concessions (see Chapters 11 and 13).

The implication is that Australian institutions of federal finance have increased the economic efficiency cost of redistribution in Australia and reduced public sector net assets, by reducing economic and social returns from public spending.

Meeting pressing infrastructure needs in Australian cities and regions requires urgent reforms of Commonwealth–State taxation and financial arrangements, proper use of public sector balance sheet accounting, infrastructure financing and asset management processes. It also requires a sophisticated understanding of the relative strengths of private and public sector entities in the infrastructure field, rather than an ideological or self-interested insistence on the relative inferiority of public sector activity. A public debt aversion continues to underpin Australian governments embrace of BOOT-type private financing schemes despite the often higher economic cost compared to public borrowing (Gray 2002).

The squeeze on public investment funds since the 1980s has also manifested in greater private involvement in the public infrastructure provision and financing. An understanding of the limitations of private sector involvement in infrastructure funding highlights the more general question of whether the fiscal policies of the past two decades have been a false economy, preventing the public sector from raising the resources for the adequate provision of infrastructure, while also raising the nation's costs of financing infrastructure through inappropriate and hidden public subsidies for private sector involvement.

Public borrowing for social infrastructure investments is an entirely appropriate principle of public finance. Public borrowing to finance communal investments with a high social return is neither wasteful nor necessarily inflationary. It may also be equitable, as public investments usually benefit more than one generation, and can appropriately be paid for over time rather than 'up front' or over a short period of time.

Along with the evidence on the large budget cost of tax expenditures in Chapters 11 and 13, and the social and other costs of the 'gambling tax addiction' of State governments in Chapter 10, trends in public investment in the post-war period highlight patterns of fiscal behaviour which are remarkably reminiscent of the 'reckless remission of taxation', and the 'demoralization' of the State Treasurers that R.R Garran forecast in 1897 would result if constititutional arrangements for federal finance were unsatisfactory.

It remains to be seen whether 'the new tax system' results in any long term expansion of State and local government revenues, as the GST arrangements do not fundamentally alter the

imbalance in tax powers of Commonwealth and State/local governments (Collins 2000), and presentation of the GST as a State tax is incorrect (Australia, Auditor-General 2002).

However, as argued in Chapter 11, the largest single asset of the public sector is the net present value of its taxing power. In the long run, perceived inequities in taxation, infrastructure and public service provision, and poor quality public services contribute to less political support for taxation. This fundamentally erodes the effectiveness of public revenue systems and thus the net worth of the public sector. These themes are developed further in chapters 9 to 12.

Chapter 9
Is Urban Consolidation Economical? The ACT's North Watson Case*

Background

The Australian Capital Territory (ACT), like the States, has come under strong fiscal pressures in recent years. With the move to self-government in 1989, economies are also being sought to accommodate the reduction in grants from the Commonwealth Government. The squeeze on State finances means that education, health and local infrastructure spending to accommodate population growth is under severe pressure.

In 1992, the ACT Government announced a policy of 50/50 urban renewal/greenfields development. Several changes to land use policies in the Territory Plan have since been approved by the ACT Legislative Assembly to permit 'urban renewal' developments. Most are on the urban fringe rather than true urban redevelopment or infill. These developments merely tack mini-suburbs onto existing towns by converting land from existing uses, such as commercial forestry, community services, pastoral uses or commercial tourism, to residential. No social infrastructure, including schools is provided for these suburbs. The Government argues that population change in North Canberra since the 1960s and in other established areas leaves ample capacity in existing public and private infrastructure.[175] An important consideration in the ACT Government's policy has been the potential savings in public infrastructure costs.

Urban consolidation thus appears to offer government the attraction of delaying the costly provision of social infrastructure such as schools and the major physical infrastructure including water, drainage and major roads that would be needed for greenfields developments.

Under these circumstances, the ACT Labor Government was naturally keen to participate in the Commonwealth's Building Better Cities (BBC) program, and a proposal was put together in time to be included in the 1992–93 Budget. The Commonwealth and ACT Governments announced the agreement for a $13 million BBC grant to the ACT just before the March 1993 federal election.

The political context for this planning policy change is clearly the national urban consolidation agenda, driven by the fiscal priorities and policies of the Commonwealth Government (Alexander 1994). Yet there remains controversy over the broader economic merits of urban consolidation with Troy (1992, p. 38) for example, summing up the debate with this comment:

> A point rarely covered in estimates of economies to be gained from consolidation: so called savings in public capital — even if we agreed were fair estimates — are calculated as savings in cost and represented as benefits; but the costs in terms of loss of amenity, reduced freedom of choice, increased accident rates, increased inequity or lowering of standards are never offset against them.

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* An earlier version of chapter 9 was awarded the Australian National University's Peter Harrison Memoral Prize in the field of town planning, for the best tertiary student essay or project in Australia on the subject of the community basis of the planning and development of Canberra. It was published as M. Dunstone and J.P. Smith, 'Is urban consolidation economical? The ACT's North Watson case', *Urban Policy and Research*, 12: 222–38, 1994.

[175] The past pattern of development in Canberra means that new suburbs are settled in a short period of time by young families. The population of North Canberra, which was largely built in the 1950s and 1960s has declined from around 53,000 to around 40,000 now, with most of the decline due to fewer children as the population ages and the demographic mix becomes more like that in other Australian cities.

The purpose of this study is to sound a note of caution, using an ACT project as a case study, against justifying investment in urban consolidation projects by its supposed 'economic' benefits without thorough economic evaluation. Drawing on a conventional cost-benefit approach, the economic and financial arguments put forward to support an ACT urban infill project are analysed. As the project is funded under the Commonwealth government's BBC program, the implications of that program for ACT planning and development is also investigated.

The first section outlines the debate on the project, drawing on material available through the various public inquiry processes, while the second section evaluates the ACT Government's consultant's report on the economics of the project and its impact on public finances. There is also comment on the distributional implications using a planning balance sheet approach. Finally some broader implications of the chapter's findings are considered, putting the North Watson development in the context of the ACT 'Better Cities' program, Commonwealth fiscal stringency since the mid 1980s and changes in Canberra planning and development since self-government in 1989.

The North Watson 'Better Cities' project

One of the largest ACT urban consolidation projects is North Watson, a major element of the federal BBC strategy for Canberra. This 'infill' project accounted for some $50 million of a total $75 million public and private spending (Commonwealth of Australia and the Australian Capital Territory 1992).

North Watson is an area of about 120 hectares on the northern edge of central Canberra, adjacent to the Mt Majura Nature Reserve and the main north/south highway into the ACT. The intended land use under the 1993 Territory Plan and under previous plans was commercial tourism, recreation and leisure facilities and municipal services. About 30 to 40 hectares of the site are developed under this land use plan, the rest is still used for grazing. To the south of the site is the suburb of Watson, built in the mid 1960s.

In March 1994, as part of the ACT Government's 50/50 urban renewal policy, it passed legislation to vary the land use for North Watson, allowing the redevelopment or construction of up to 1300 residential dwellings on the site. Approximately one half was to be standard density lots, the rest were to be higher density townhouse, cottage lots or converted tourist units.[176]

Policy advice on North Watson economics

The North Watson project presents as a very interesting case study. The local community, through the Watson Community Association (WCA), opposed the Territory Plan variation for North Watson. The reasoning and figures underpinning the Government's proposal were challenged at every stage of the process. Public hearings by the local legislature's planning committee on the proposal were the longest ever held by the committee. There are considerable data and information available as a result of the consultation process pursued in the ACT, the BBC documentation, and the Industry Commission Inquiry on Urban Settlement Patterns.

The Government's preliminary assessment of the North Watson site (ACT, Planning Authority 1992) emphasised the economic and financial benefits of the development, referring to previous government studies, to public savings from using existing social infrastructure and to private economic benefits from reduced travel times. The assessment included no site specific analysis of this: its assertion of financial and economic benefits relied on the ACT Government's 1992 hypothetical comparison of greenfields development versus more consolidation in established areas (ACT [Government Service] 1992).

In February 1993, under pressure from the community, the ACT Legislative Assembly's Planning Development and Infrastructure (PDI) Committee recommended that the

[176]In the event only the latter component of the development on private leased land has proceeded, the former element of the project having been abandoned on environmental grounds.

minority ACT Government provide an independent economic assessment of the North Watson project. The Government commissioned Access Economics to undertake such an assessment (Access Economics 1994). It was on the basis of that study the Assembly approved the project in early March 1994.

The ACT Government's 1992 submission to the Industry Commission (ACT [Government Service] 1992) hypothesised a 50 per cent urban consolidation policy to accommodate future population growth. It noted the potential for wider economic benefits of consolidation (citing Neilson Associates' Melbourne study (1987) on travel savings) but focussed on the benefits of reduced government infrastructure spending. It estimated that increasing urban consolidation to meet 50 per cent of new housing demand in the ACT could defer over $58 million in capital spending at greenfield sites over a five-year period. It found major savings in roads and community facilities.

This hypothetical analysis was updated by the Economic Priorities Advisory Committee of the ACT (EPACT) (1992), which endorsed the strategy of saving on infrastructure costs by an ambitious urban consolidation policy. Using somewhat different time-frames and population scenarios, EPACT estimated that a 50/50 consolidation/greenfields development strategy would save $85 million by deferring $110 million of infrastructure spending for thirteen years. It emphasised however, that

> case by case evaluation of proposed urban renewal sites will be necessary, in order to keep urban renewal costs as low as possible and to realise its potential benefits. (EPACT 1992, p. 2)

Around the same time, the ACT Government prepared a proposal for Better Cities funding (ACT [Chief Minister's Department/Department of Environment, Land and Planning] 1992) showing no significant difference in infrastructure cost streams for the Gungahlin/greenfields[177] option compared to the North Watson scenario, using a discount rate of 4 per cent. The absence of public sector savings was largely because the latter development brought forward the need for refurbishment and augmentation of sewer and stormwater systems to accommodate increased dwelling densities. The ACT Government's Better Cities proposal therefore argued that broader economic benefits (namely private travel savings rather than public sector financial savings) warranted federal support for the North Watson urban consolidation project (ACT [Chief Minister's Department/Department of Environment, Land and Planning] 1992).

Community criticisms of North Watson economics

In the light of these unconvincing 'hypotheticals', the WCA (1993b) challenged the Government to provide a site specific analysis of the economic and public financial impact of the development. The community association argued that the development should be considered in a cost-benefit framework, incorporating third party and private costs and the economic cost (that is, the alternative use value) of the land. It also argued that a greater net reduction of public assets associated with the North Watson redevelopment should be counted as a public sector cost.

The approach mirrored that of the Industry Commission (1993), which criticised as unsound the cost-savings approaches to urban planning used by the ACT Government, recommending instead a cost-benefit approach to assessing net community benefit.

The WCA contested the Government's claim of economic benefits from reduced travel times and argued that any public sector infrastructure savings would largely be offset or exceeded by the value of land subsidies to private developers or leaseholders at North Watson. This was because land gains (betterment) under the existing land administration legislation

[177] Gungahlin is the current 'greenfields' development area for Canberra, being the fifth town built in Canberra.

would substantially accrue to existing lessees rather than to the public land-owner (Watson Community Association 1993a, 1993d).[178]

In questioning the Government's assertions of public infrastructure savings from 'infill' development, the WCA drew on the findings of the Industry Commission that,

> where there are capacity constraints in some services, additional costs of replacing or augmenting infrastructure need to be weighed against the savings from greater utilisation of other infrastructure — the whole range of infrastructure services needs to taken into account (Industry Commission 1993, p. 3).

The WCA also highlighted the warning of the House of Representatives Standing Committee for Long Term Strategies, which commented in its 1992 report that,

> for the savings considered possible from an urban consolidation program to be achieved, it is essential the redevelopment and urban infill are directed to locations where spare capacity exists. If they are not, the cost to the community could be greater than if urban fringe expansion continued because the cost of augmenting services in the inner suburbs is higher than building them afresh on the fringe. [Spare capacity] cannot be assumed to coincide with middle and inner suburbs with falling populations (Australia, House of Representatives Standing Committee for Long Term Strategies, 1992, p. 121).

The WCA argued that the economic superiority of the Government's North Watson proposal had not been demonstrated as there had been no systematic comparison of this particular site with other possible sites. The comparative economic merits of the site could not be substantiated: alternative sites might yield higher benefits.

The ACT Government responded in September 1993 — several months after the Minister endorsed the project — estimating infrastructure savings of $12 million (ACT, Department of Environment, Land and Planning 1993). Public spending for 1300 dwelling lots at North Watson would be $16 million compared to $28 million for the equivalent Gungahlin/greenfields development. Estimated savings in social infrastructure accounted for all but $2 million of the total estimated savings to the public sector.

The Government did not address the community association's criticism regarding private economic costs or land costs, and its estimates of infrastructure costs did not attribute to North Watson any timing costs associated with the sewer augmentation needed in North Canberra. It emphasised increased 'housing choice' and the improved viability of local services, rather than 'travel benefits', as the private economic benefits of the development.

In its September submission to the ACT Assembly's Planning, Development and Infrastructure (PDI) Committee, the WCA (1993c) again challenged the methodology used by the administration in calculating public infrastructure savings, arguing that the correct basis for comparison was a net present value analysis of the alternative cost streams rather than merely the difference in the capital cost of each alternative. This methodology was argued to allow appropriately for timing of outlays and for the fact, that in a growing city, the savings were from delaying, not avoiding, spending on greenfields infrastructure (see also EPACT 1992, p. 24).

The WCA also challenged the Government on the issues of housing demand, traffic costs, land costs, viability of services, betterment and Commonwealth Government Better Cities funds, and other social, environmental, economic and public financial impacts that the Government's response had failed to address.

Against this background of controversy and debate the Government commissioned Access Economics to do a nine-day study. The full terms of reference were not released. However, Access Economics saw its brief as carrying out a comparative study of the economic costs and benefits, including social, third-party cost and benefits for North Watson and

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[178]Moreover, the estimate of infrastructure savings by EPACT was shown to be overstated by approximately 100 per cent because that study had erroneously applied a nominal interest rate to constant price estimates of capital spending.

greenfields housing development (Access Economics 1994, p. 7), arguing that 'few of the wider private and third party costs can be reliably quantified', but that they would be neutral between the two options so the large savings in public infrastructure costs meant the project 'also comes out ahead on the cost-benefit analysis' (Access Economics 1994, p. 1).

Access Economics concluded that the development of North Watson for housing would result in net financial cost savings of between $6 and $8.6 million (or $4000 to $6000 per lot), with a benefit to the ACT public sector from securing Better Cities funds from the Commonwealth Government for North Watson.[179]

While wisely noting that there were issues it could not resolve fully in the short time available, especially in the cost-benefit analysis, Access Economics felt able to state that 'we have been able to address the major issues adequately and that further investigation is unlikely to alter the conclusions of this report' (Access Economics 1994, p. 3). This statement appeared to be directed at reassuring the ACT Assembly that detailed public scrutiny or debate of the Access Report was unnecessary before approving the project. The Assembly voted for the development within forty-eight hours of the Access Economics report being tabled, in spite of the serious shortcomings identified at the time (Neutze 1994a).

The next section sets out a critique of the Access Economics study, while the section following that discusses the project in the context of the 'Better Cities' program, ACT planning and development since self-government, and Commonwealth–State relations.

Critique of the Access Economics assessment

The Access Economics study failed to address several major issues adequately. If these failings were redressed and quantified, the conclusions regarding the net economic benefit, as well as the financial costs to the ACT and the public sector, would be shown to be false. Although the study purports to assess comprehensively the economic merits of North Watson, it is essentially a financial cost-saving analysis, focussing on a limited set of public sector and resource costs.

The key flaws of the study are:

1. The consultant's report overestimates *infrastructure cost savings* from consolidation at North Watson compared with greenfields development at Gungahlin. These public sector infrastructure savings are considered by the report to be the net economic benefit for the consolidation development. All other economic and financial impacts are argued to balance out. The consultant also failed to account for the cost of the public land subsidy at North Watson.
2. No assessment is made of other development options that may provide a greater economic benefit, for example the development of a lower number of residential units that would not trigger infrastructure augmentation, or a lower cost means of stimulating commercial development of the area.
3. The consultant ignores the additional land costs of consolidation although the urban consolidation option will have higher economic opportunity costs because it displaces higher value uses than the equivalent greenfields development.
4. The report incorrectly asserts that betterment charging is solely a 'transfer' issue. Subsidising private redevelopment through concessional betterment provisions has an economic cost, as the subsidy encourages excessive conversion of land to other uses.
5. The consultant also fails to properly assess the economic impact of the development on third parties — namely residents of the area targeted for redevelopment, those in nearby suburbs, and those in newly developed areas.

[179]The assumption made was that if North Watson did not proceed the Better Cities program would be disrupted and any grant deferred. The deferral of the grant was considered an interest free loan to the ACT of $1.5 to 3.5 million, depending on how long it would take to renegotiate the Better Cities Agreement if North Watson were not to go ahead (Access Economics 1994).

6. The consultant ignores important distributional impacts of the development: the transfer of substantial public land redevelopment rights to a small number of private individuals and favouring of 'provider' interests over those of 'consumers' and residents.

Overall the consultant fails to assess rigorously or measure in economic terms the private and potential external costs and benefits of the alternative scenarios — the effect on economic welfare, the essence of a cost-benefit analysis. In claiming these effects are not measurable, the consultant ignores well established empirical techniques for measuring such traffic congestion costs and consumer costs or benefits arising from housing redevelopment. The report thus limits its focus narrowly to public sector resource cost issues. The treatment of the financing of the proposal masks the true economic cost of Better Cities funding.

Each of these issues is examined in turn below.

Public infrastructure costs

The methods used by the Access Economics consultants to compare greenfields and consolidation infrastructure costs are those argued for by the community association rather than the Government (Neutze 1994a). Access Economics agreed with the community association that the Government should have conducted a net present value (NPV) analysis of public capital costs, rather than directly comparing capital outlays. The latter approach substantially understated the cost of redeveloping North Watson due to differences in the timing of capital outlays (Access Economics 1994, p. 13).

The consultants' estimate of $4000 to $6000 per lot in infrastructure savings (giving estimated total infrastructure savings of 6-8.5 million) is considerably lower than the Government's earlier estimate of $11,600 per lot from urban consolidation (ACT [Government Service] 1992), and the $12 million savings or around $10,000 per lot on which the ACT Executive approved the development (ACT, Department of Environment, Land and Planning 1993).

The Access Economics analysis relies entirely on ACT Government data for per lot development costs and unpublished engineering and traffic surveys and material regarding land values. Even so, the report shows that the supposed cost-savings of urban consolidation had been grossly overstated by the Government's advisors.

Despite their comparative modesty, it can be argued that the consultant's figures still overestimate the infrastructure savings from North Watson.

The estimate assumed full pro-rata deferral of social infrastructure at the Gungahlin greenfields location (Access Economics 1993, p. 14). While slower growth will allow a government to reduce the rate of provision of services, to some extent the savings depend on whether local politicians can resist the pressure from Gungahlin residents to provide social infrastructure, notably local high schools, according to accepted community standards and expectations. In the past in Canberra, social infrastructure such as schools and major external roads are provided when the population reaches certain thresholds. Residents in greenfields areas have clear expectations about how long they will have to wait for schools and other services. The savings from delaying social infrastructure provision are therefore unlikely to be fully realised in practice. In spite of this, the consultant's estimate of savings was not tested for its sensitivity to assuming that greenfields social infrastructure provision could be delayed person-for-person by North Watson delaying triggering the threshold for social infrastructure provision in Gungahlin.

It is also questionable whether the per lot costs used by the consultant compare 'like with like', as considerably higher dwelling densities are proposed for the North Watson development than at Gungahlin. The consultant's estimates of per lot costs assumed a total population of 110,000 would be housed at Gungahlin but this has been reduced by around 18 per cent to around 90,000, implying average lot costs there will be higher than assumed (Neutze 1994a). Some of the supposed infrastructure savings may thus be achieved by developing a

similar number of high density lots in Gungahlin. Furthermore, the difference in size between the Gungahlin lots and those in North Watson also means the two products (serviced residential blocks) are not perfect substitutes.[180] Adjusting the consultant's estimates of potential savings (of between $6 and $8.5 million) for the excessive assumed densities could result in the potential total cost savings being overstated by around $1-1.5 million.

The economic costs of the North Canberra sewer upgrade appear understated. The consultant assumed that the development affects only the timing and not the cost of infrastructure augmentation. In addition, it judged that the development brought forward the works by only five years rather than the ten years previously indicated by the ACT administration.[181] This inflated cost-savings for the consolidation option by a further $1 million.

Comparison with alternative development options

Establishing the economic merit of a project requires more than finding a positive NPV. There may well be other development options for the site that would result in a higher NPV.

Finding a positive NPV of infrastructure savings for 1250 lots at North Watson does not necessarily indicate the proposal is the preferred option. The consultant did not compare cost-savings for 1250 dwelling sites with other urban consolidation options for North Watson or elsewhere. For example, one lower cost alternative is redeveloping a smaller number of dwellings on the already developed leases at North Watson. Here most of the necessary on-site physical infrastructure is already in place, and housing development would be unlikely to trigger the need for expensive off-site physical infrastructure augmentation and refurbishment. This would avoid some $16 million of public infrastructure spending triggered by the larger development. This would yield a much higher saving per lot — in a sense, the low infrastructure cost of developing the leased area for housing cross-subsidises the high marginal cost of developing the 'greenfields' portion of the site.

Such comparisons should have been made to ensure the most efficient use of scarce capital, as recommended by the ACT Government's own advisors (EPACT 1992), and to ensure any infrastructure savings from the urban renewal policy were maximised.

Opportunity cost of land, and depletion of public land assets

Most studies of urban consolidation neglect to include land as a resource cost (Abelson 1994). The consultant's study of North Watson was no exception. This is critical to the resource cost issue for comparing urban consolidation with greenfields development.

The consultant's report confused land as a resource *cost* with its market value (or economic *benefit*) as developed lots. It also ignored the significant public sector cost of depleting the ACT land bank by the unrequited transfer of publicly owned redevelopment rights to existing commercial lessees at North Watson.

Economic cost of land

The economic cost of land is its value in the next most valuable alternative use — its opportunity cost. For most cities this will be higher for established areas than land in greenfields locations, although past planning in Canberra has meant these differentials are relatively small and impact upon the government landowner rather than the private sector. Thus higher land resource costs may outweigh any public infrastructure savings from consolidation.

In the North Watson case the alternative use is clearly its use up to the present time: commercial tourism, recreation and leisure facilities. Based on unimproved capital value data

[180] The higher densities at North Watson will also yield fewer children per dwelling, and social infrastructure savings will be reduced commensurately.

[181] In oral evidence given at the PDI Committee hearing the Chief Planner of the ACT Planning Authority, Mr G. Tomlins stated that the sewer would not otherwise be refurbished for around ten years (ACT, Legislative Assembly 1994).

the land opportunity cost of developing North Watson for housing is therefore between $8 and $14 million.[182] This compares to an opportunity cost of land at Gunghalin of around $2.6 million.[183] The North Watson option, therefore, has an additional land cost of $5.4 to $11.4 million.

Thus the higher economic input cost of land at North Watson substantially outweighs Access Economics' estimated savings on public infrastructure costs.

The estimate above will partly depend on whether existing commercial uses are displaced by housing development. This is because the land use change allows both residential and commercial/tourism uses. However, if residential development does not displace existing uses, the anticipated infrastructure savings will not be realised as the Government will remain committed to the off-site infrastructure expenditures needed to support the smaller development on the greenfields part of the site.

Land betterment and redevelopment rights

The ACT has a public leasehold system of land tenure. Hence all additional lease development rights remain with the public landowner. When development rights are increased, a betterment charge is levied along with the lease variation. Policy at that time was to allow a remission of betterment of up to 50 per cent for leases varied for higher density residential use, to encourage residential redevelopment. In practice the full 50 per cent remission applied in most cases of residential redevelopment.

The Access Economics Report stated that the concessional betterment regime for housing redevelopment was a transfer and, therefore, did not affect the economic merits of the proposal.[184] However, the betterment concession has economic significance, providing an incentive for leaseholders to convert existing land-use to residential use in ways that would enhance its value. There is no such incentive to convert non-urban land to urban use.

At North Watson approximately 30 hectares of land is currently leased for commercial uses. The value of betterment revenue foregone when existing leases at North Watson are varied for intensive residential development is estimated to be around $14 million — more than $450,000 per hectare.[185] Besides being a substantial transfer of public assets to the private sector, the betterment subsidy provides a strong incentive for the private leaseholders to redevelop for housing.

No such concessional redevelopment provisions apply for greenfields development such as at Gunghalin. Here, the Government resumes the existing rural leases and auctions them for residential development at their full market value.

The land revenue foregone through the betterment concession (presently around $14 million) to encourage the North Watson redevelopment should thus count as a public sector cost of the development. By foregoing betterment revenue now the Government may get more revenue from higher redevelopment activity in the short term. But this is like selling a house at half price to get a quick sale — the Government gets, say, $5 million in betterment revenue now by selling leases at less than the full value of $14 million. However, it would get a much higher

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[182]This is based on the unimproved capital value of the 30 hectare that is already developed at North Watson of between $100,000 to $300,000 per hectare, and $50,000 per hectare for the unleased portion of North Watson (100 hectares).

[183]This is based on unimproved capital value of a rural lease of $20,000 per hectare for 130 hectares.

[184]The Access Economics Report claimed betterment was an hypothecation by the state of private gains, revealing the consultant's lack of understanding of the ACT land tenure system. In the ACT, land is owned by the public sector under a public leasehold system. Therefore, any increment in land value due to a variation of lease conditions belongs to the public, not the private sector, as under a freehold system. If some of the betterment is gained by the private lessee, it is a transfer of valuable development rights from the public sector to the private sector.

[185]We have assumed the unimproved capital value for 30 hectares of existing leases is $200,000 per hectare and an unimproved capital value under residential use is $1.12 million per hectare. These estimates are derived from values for existing leases in the area as provided orally by the ACT Department of Land, Environment and Planning.

amount by waiting until development or redevelopment of the area is truly economic and collecting the full value of the land betterment at that future date.

Although acknowledging that betterment revenues foregone to promote the North Watson redevelopment are a transfer to private lessees, Access Economics made no estimate of the impact on the public sector balance sheet.[186] As the capital value of public land assets is not published in ACT public accounts, the present and future revenue foregone as a result of the betterment subsidy to urban consolidation in the ACT thus remains hidden from public view.[187]

On the other hand, revenue from residential development of the unleased portion of land at North Watson is likely to be some $6 million higher than at Gunghalin.[188] Again, because the consequent reduction in ACT land assets are not accounted for, these higher land revenues are viewed as a financial benefit of urban consolidation, rather than as the sale of a capital asset.[189]

Private economic impact — travel times, housing choice and dislocation for existing residents

The consultant's report recognized that, as the Industry Commission had pointed out in its Urban Settlement report (Industry Commission 1993), maximising net community benefit required consideration of the demand side, as well as the the resource costs of the urban development options. Private and third party effects should have been included in the evaluation.

Key issues in a cost-benefit equation for urban consolidation are the effects on consumer choice, and the external effects in the form of increased traffic congestion. These are considered below.

Housing choice

The ACT Government advanced 'improved housing choice' as a benefit of urban consolidation at North Watson. There was no assessment of the magnitude of any economic benefit in the Access Economics study. The latter merely noted that

> urban consolidation ought not to be pursued as an end in itself, but as a means of widening consumer choices and ensuring that people have the opportunity to satisfy their need for affordable housing (Access Economics 1994, p. 6).

A comprehensive cost-benefit analysis might measure an increase in consumer choice from the housing development at North Watson in various ways. For example, any economic benefit can be measured by the increased consumer surplus from additions to housing supply in a desired location. This consumer benefit would be revealed in the total value of the market premium paid for residential lots located in North Watson compared to Gungahlin. From a planning perspective it should be noted that this approach places excessive emphasis on the private market in determining the social value of different land uses, understating the value of keeping options open and the social value of land uses (Neutze 1994a).

Data for unimproved residential land values show there is no significant premium for similar sized blocks at North Watson compared to those at Gungahlin. The unimproved values of leases at Watson are about $10,000 per lot more than at Gungahlin, but lot sizes at Gungahlin are much smaller, around 450 m^2 compared to 800 m^2 at Watson.

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[186] By contrast, it counts the Commonwealth Government's Better Cities grant as a benefit to ACT Government finances.

[187] In spite of successive official inquiries recommending a Land Account be established to provide a more transparent statement of ACT land transactions, no action has been taken. However, moves are underway to introduce public accrual accounting.

[188] Based on unimproved capital values at Watson of $70,000 per block and at Gungahlin of $60,000 per block and assuming that 600 blocks are developed on the unleased portion of the site.

[189] This phenomenon, of government authorities 'milking' public owned assets for revenue, was noted in Walsh and Thomson (1993, p. 32), who recommended separate current and capital account statements.

Correcting for lot size, there is, in fact, a locational disadvantage associated with lots at North Watson, located as it is on the fringe of existing suburbs and being further from existing social infrastructure than comparable North Canberra suburbs. The low unimproved land values in Watson compared to other North Canberra suburbs can be seen in Table 9.1.

Table 9.1
North Canberra Unimproved Capital Values of Residential Leases

	1991	*1992*	*1993*	*1994*	*% Change 1991–1994*
Ainslie	57700	77000	86900	103900	80
Braddon	75100	103300	129800	153200	104
Campbell	78100	108400	123200	144100	85
Dickson	45400	57400	65300	75100	65
Downer	44200	56600	64900	76100	72
Hackett	55200	68700	77600	86200	56
Lyneham	56300	72700	81400	90300	60
O'Connor	55500	74700	85200	101200	82
Reid	86300	124400	148400	177000	105
Turner	87500	120900	138200	151400	73
Watson	41700	53500	62200	72200	73
North Canberra (av)	**57700**	**76700**	**88000**	**102200**	**77**

Source: ACT, [Treasury] 1994.

It has also been argued that changing demographic patterns (an aging population and more sole parent families) mean a higher, unmet demand for medium-density housing in established areas (ACT [Government Service] 1992, EPACT 1992). Another approach to estimating the economic benefit from increased housing choice is to see whether the price of medium-density dwellings is rising faster than the prices of traditional dwellings in North Canberra.

No evidence was put forward by either the Government or Access Economics on this issue. However, data on relative prices of medium-density and standard housing for Canberra as a whole showed no such differential trend in price rises for medium-density dwellings (ACT, Legislative Assembly, PDI Committee 1994). The North Canberra area appeared well served with medium-density dwellings, which represent 30 per cent of the area's housing stock compared to 18 per cent Canberra-wide (ACT [Government Service] 1992). Market reports suggested a significant oversupply of medium-density housing throughout Canberra, with higher vacancy rates and weaker price trends (for example, Cole-Adams 1994; Anderson 1994).

There thus appears to be no strong evidence of economic benefit from increased housing choice as a result of the North Watson development. In fact, more recent developments in the ACT housing market suggest that warnings about urban consolidation ignoring consumer preferences for traditional housing (for example, Kirwan 1992) were soundly based.

There remains, however, the possibility of economic costs from significantly reduced residential amenity in the adjacent parts of Watson and Hackett and other external costs (such as traffic congestion) in North Canberra. Unlike greenfields development, consolidation impacts on existing residents. The potential economic costs of urban consolidation was dismissed by the consultant, without regard to previous studies identifying dislocation costs and lost amenity as critical factors in redevelopment projects (Alexander 1978; Beattie 1978). Such studies emphasised the importance of the dislocation of households and the disruption of communities, especially increased traffic hazards, traffic noise, reduced recreational space, and decline in socialbility due to a sense of crowding from higher density developments. The change in tenure is also a factor. The propensity for medium-density housing to be rented may impact on neighbourhood amenity through higher resident turnover and a lower commitment to the property.

The economic impact on existing residents could be partly measured in a similar way to valuing 'increased housing choice'. Lost consumer benefit from redevelopment is measured as the compensation needed to retain previous levels of satisfaction, or the amount residents would be willing to pay to avoid the change. An indication of this might be an estimate of changes in adjacent housing values associated with urban consolidation. While land values may rise in anticipation of the increased value of more intensive development, nearby properties adversely affected by increased traffic, reduced residential amenity or increased housing supply, are likely to fall in value relative to similar properties unaffected by nearby higher density redevelopment.

Alternatively, a survey of residents' total willingness to pay to move out of the area could indicate the magnitude of the economic costs of the redevelopment.

Some indication of the amenity value of not changing the land use at North Watson would be given by examining trends in property values in affected parts of the nearby suburbs of Watson and Hackett. Again, no attempt was made by the consultant to empirically evaluate these costs, presumably due to the time constraint, as the data are readily available within the real estate industry. The loss could be significant, for example a 7 per cent reduction in values (that is, approximately $5000) for 1000 nearby properties would result in an economic loss of around $5 million.

Travel savings

An important economic justification put forward by the Government for the consolidation option was the supposed savings to residents from reduced travel times. Future residents of North Watson were supposed to have better access to employment and other established facilities than future Gunghalin residents. The ACT Government argued that such comparative private economic benefits justified federal funding of the development in spite of the poor financial return to the ACT (ACT, Department of Land, Environment and Planning 1993).

This economic benefit argument needs to be carefully scrutinised in the Canberra context, even if it has validity in centralised cities. The North Watson development would lead to an increase in journey lengths. The past pattern of Canberra development has concentrated settlement around distinct town centres of service and employment. These centres are linked by rapid public transport and expressways, so that travel times between the major centres are relatively short, making access to services relatively evenly spread throughout Canberra.

Centralisation of employment and other facilities at town centres has resulted in a strong tendency for people to live close to their employment, thus producing shorter average trips and a relatively efficient pattern of transport use. It also makes the services of central Canberra less relevant to residents than in other similar sized cities (Alexander 1994). The hierarchy of roads in the newer townships also reduces accident risk and the associated economic costs to considerably lower levels than in other cities.

These characteristics of Canberra's urban structure mean that Melbourne estimates of private economic benefits from reduced travel times for 'urban fringe dwellers' (Neilson & Associates 1987) have little applicability for urban consolidation in the ACT. Although North Watson is physically closer to Civic — the oldest and largest town centre — than Gunghalin suburbs, travel times to existing and future service centres from both areas are no different. The future Gunghalin town centre would be more accessible from Gunghalin than Civic is from North Watson. The ACT Chief Planner conceded that there was nothing to choose between the two development options from the point of view of travel times to Civic (ACT, Legislative Assembly, PDI Committee 1994).

The ACT Government's mistaken use of Melbourne data has implications for comparisons of infrastructure costs and standards for North Watson and Gunghalin. A significant component of Gunghalin infrastructure costs were for major external road links with other town centres or major suburban or arterial roads. Gunghalin will require large road building to provide access to central and south Canberra. The development of North Watson will require just the same (in proportion) additional road capacity. These road building expenditures are

undertaken at Gunghalin to prevent congestion and provide efficient private travel but such expenditures will not be made to ameliorate congestion and traffic risk in North Canberra from urban consolidation at North Watson. As Neutze noted in his review of the consultant's assessment,

> Gunghalin roads can be designed to deal with the traffic that will be generated by the new suburbs. Development at North Watson will increase the traffic on the existing streets of North Canberra which were not designed to handle the extra traffic. Congestion in North Canberra will be worse the more population increases as a result of the [Better Cities] strategy (Neutze 1994a, p. 2).

The community association estimated travel congestion would have a private economic cost of around $25 million on a NPV basis because the North Watson traffic would be added to regional roads that would, as acknowledged in the preliminary assessment (ACT, Planning Authority 1992) be operating at close to capacity (Watson Community Association 1993c, Appendix 4). This is consistent with studies showing an exponential increase in congestion costs as road use approaches capacity (NCDC 1984, p. 84).

The consultant summarily dismissed the possibility of economic costs of higher travel times for existing residents of North Canberra from increased traffic congestion. As the Government's traffic study showed no impact on overall trip times, distances or speeds if the location of the development was varied, the Access Economics' study simply assumed that changing the location of the development would change the location of road network pressures. Details of the traffic model and simulations referred to by the consultants are not available. However, it appears from the preliminary assessment (ACT, Planning Authority 1992) that the model does not estimate changes in travel times and congestion, but merely predicts the flow levels (vehicles per hour) generated on specific roads. Hence, it is likely the model would not reveal any location-specific congestion.

However, assuming Gunghalin, like other new town centres, has employment opportunities and a good range of services, the greenfields option would mean people living there would be less likely than North Watson residents to direct their trips through and around the already congested areas of North Canberra. They would be more likely to travel in and around Gunghalin, and perhaps the other northern town centre, Belconnen.

It is thus implausible to argue that the traffic congestion impact would be neutral between the greenfields and inner suburban locations (Access Economics 1994).

Apparent infrastructure savings from the urban consolidation option may actually represent a cost-shifting from government to the private sector. That is, the economic cost of dealing with Gunghalin traffic as Canberra population expands is shifted from the public sector to households and businesses in North Canberra. Cost savings to the public sector have their counterpart in increased travel times and higher traffic risks for the local community in the established area.

Distributional issues

Cost-benefit analysis is notoriously deficient in its treatment of distributional issues, it being difficult to quantify the value of some non-economic costs and benefits and attach weights to distributional effects.

Approaches to resolve such problems include the Planning Balance Sheet approach. A Planning Balance Sheet helps policy decision makers identify major stakeholders in an urban planning proposal and outlines their interests positively or negatively (McMaster and Webb 1978). This clarifies winners and losers and gives an indication of the overall desirability of a project by giving a feel for the distribution and the magnitudes or intensity of impacts on various interest groups.

No such analysis of the North Watson or North Canberra Area Strategy was conducted (ACT, Planning Authority 1992, Commonwealth of Australia and the Australian Capital

Territory 1992), although Access Economics produced a 'Cost Benefit Balance Sheet'. This reveals a worrying unfamiliarity with the Planning Balance Sheet concept (Alexander 1978), and an apparent ignorance of the planning literature on the distributional effects of urban consolidation. For example, the consultant cited 'more affordable housing' as one of the distributional benefits of the project without determining whether the project was likely to lower housing costs (Access Economics 1994). As Kirwan (1992, p. 16) pointed out, this notion 'simply flies in the face of all we know about the economics of housing markets'. Redevelopment increases the prevalence of townhouses and apartments in the housing stock. Medium-density housing costs more per unit to build, with land costs generally higher in inner areas.

The Government itself indicated that making medium-density housing in inner areas attractive to buyers required restricting greenfields releases (ACT, Department of Environment, Land and Planning 1992), a policy which will tend to push ACT land prices up across the board, making all housing less 'affordable'.

In addition, the 'betterment subsidy' for redevelopment pushes up land prices in the target area as developers bid higher for potential redevelopment blocks. Surveying the experience with the redevelopment of Kingston in the ACT, the Department of Environment, Land and Planning (1992) predicted shortfalls in the supply of housing at the lower end of the market as a result of redevelopment — it is the low cost housing that is redeveloped first. A report recently prepared for the Department and released under Freedom of Information legislation commented that it would become more difficult for low income families to find suitable housing as traditional, standard-density housing was redeveloped to higher density in North Canberra (Masterplan Consultants 1993).

Presenting a less benign view of the distributional effect of the development than the consultant suggests an alternative characterisation of the distributional impact of North Watson redevelopment (Table 9.2).

Table 9.2 shows the main beneficiaries of urban consolidation at North Watson are likely to be:

- public sector providers of services, seeking to divert pressures for efficiency gains into a reduced level and quality of public services;
- the owners or developers of the existing commercial leases, and investors, the main owners of higher density dwellings;
- the real estate industry, from increased turnover of housing and higher tenancy rates generating more commissions and fees on sales and property management;
- an unknown number of existing residents, wishing to relocate from North Canberra houses to medium- and higher-density dwellings at North Watson;
- local and regional shopowners from increased demand by a higher population, without more land being zoned for commercial/retail use;
- some property owners, as land prices increase to reflect redevelopment potential;[190]
- the ACT Treasury and current taxpayers, from increased short-term land revenues.
- The main losers, through reduced open space and residential amenity, as well as increased traffic in established areas of North Canberra will be 'consumers' or community interests including:
- moderate income families facing difficulties in finding suitable housing as low cost standard housing is redeveloped;
- residents of new suburbs at Gungahlin who will have to wait longer for social infrastructure;
- future taxpayers, ratepayers and citizens, faced with the cost of replenishing the ACT's public land revenues as land becomes scarce as the city grows.

[190] The area targeted by the Better Cities Agreement has seen substantially higher than average increases in unimproved capital values of leases (Table 9.1).

Table 9.2
Planning Balance Sheet

Stakeholders	*Interest*	*Impact*[a]
Government		
Land Dept	Land revenue	+
ACTEW	Design, construction and engineering services	+
DUS	Design, construction and engineering services	+
ACTION	Higher passenger loadings	+
ACTHA	Housing mix for clients, land profits	+
Treasury	Minimising current taxation	+
Private Businesses		
Civic Centre	Higher turnover through population	+
Regional	Higher turnover through population	+
Local	Turnover, possible displacement	?
Property owners		
Local	Higher land values and rents	+
Regional	Higher land values and rents	+
Civic	Higher land values and rents	+
Employers/industry	Larger workforce pool	+
Developers	Land and building profits	+
Real Estate Industry	Higher residential turnover, and number of dwellings	–
Future businesses	Supply of suitable land and conditions	
Existing leaseholders, commercial		
TV Stations	Suitable conditions, land values	–
Motels	Change in land use, land values	+
Caravan parks	Suitable conditions, land values	?
Drive In	Change in land use, land values	+
Canberry Fair	Suitable conditions, population	+
Existing leaseholders, Non-commercial		
Polocrosse	Suitable conditions, relocation costs	–
Stables	Suitable conditions, relocation costs	–
Craft Council	Suitable conditions, relocation costs	–
YWAM	Suitable conditions, land values	+
graziers	Supply of suitable land and conditions	–
Canberra Organic Growers	Suitable conditions, relocation costs	–
Majura community groups	Suitable location, relocation costs	–
Residents of Gungahlin		
	access to services	–
	shopping choice	–
Existing residents		
	amenity/character of area	–
	traffic	–
	travel times	–
	construction nuisance	–
	access to services	–
	pre–school/school viability	Nil Effect
	education quality	–
	reduced open space	–
	affordability	–
	social contact/disruption	–
	shopping viability	?
	shopping choice – local/regional	+
	shopping convenience	–
New residents		
	housing choice	+
	affordability	–

	shopping choice	?
	access to services	?
	travel times	Nil Effect
	amenity from mature neighourhood	+
	accident risk	–
Employees		
	Local employment and job competition	–
Environmentalists		
	Land saving	Nil Effect
	Pollution	–
	local ecology	–
Taxpayers		
present	Low cost development & taxation, high net asset depletion	+
future	Low current net asset depletion	–
Ratepayers		
	Minimum rateable values, cost of municipal services	?
Users of North Watson open space		
Walkers	Undeveloped open space, suited to dog–walking	–
Equestrians	Undeveloped, sufficient open space, low population	–
Children	Undeveloped open space, safety	–
Cyclists	Developed tracks, undeveloped open space, low population	?
Employees of leaseholders	Workplace amenity	–

Notes: [a] ? implies no benefit compared to alternatives, or benefits balanced by costs, + implies clear benefits, – implies clear costs.

Based on this characterisation of the distributional impact of the North Watson project, one is tempted to suggest that urban consolidation is a way of distracting politicians from the real issues of urban development, including reforming federal financial arrangements, as well as water and electricity utilities, public transport, education, health and housing authorities to meet the demands for necessary urban infrastructure at a lower cost.

The ACT Better Cities program — 'for better or worse?'

The political imperatives behind the rhetoric of 'Better Cities' have been highlighted by McLoughlin (1991; 1992), viewing the Commonwealth's urban consolidation agenda as a red herring to distract attention from the strains produced by its fiscal restrictions. Badcock (1992) has commented that the emergence of the Better Cities program was due largely to political opportunism, its priorities being shaped on an ad hoc basis by its role as a tool of political crisis management. This is supported by Alexander's review of Commonwealth urban policy during the 1980s and early 1990s, which showed that the Better Cities program was both reacting to and shaped by the Commonwealth's economic rationalist policies and fiscal restrictionism (Alexander 1994).

Originally a needs-based program focussing on distributional issues, the program's original emphasis was on 'Better Cities' rhetoric, then shifted to micro-economic reform and more latterly to 'good old fashioned pump priming prior to the1993 federal election' (Badcock 1993, p. 79). The program was to release 'frozen' funds to correct the under-investment in urban infrastructure that had occurred as a result of federal fiscal policies in the 1980s (Alexander 1994; Badcock 1993).

The history of the North Watson project and the Better Cities grant for the North Canberra Area Strategy (NCAS) parallels these shifts in the Program's emphasis and objectives. As a project approved in what Badcock describes as its most recent reincarnation — coopted to the cause of pre-election job creation — the ACT's proposal also reveals the inconsistencies and tensions arising from being moulded to accord with the rapidly changing political environment

and federal priorities. It also illustrates the Commonwealth's use of tied funding to distort State spending priorities (Walsh and Thomson 1994).

Ironically, the ACT's 'Better Cities' project may provide a stark example of how a program aimed at reducing locational disadvantage may in fact create it, by delaying social infrastructure provision to new areas, and thus creating the worst features of 'urban sprawl'. This in a city that had been successful in avoiding the inefficiencies and inequities of the market-driven, mono-centric pattern of urban development.

The $13 million grant for Canberra

The Better Cities grant for Canberra was mainly provided for infrastructure augmentation and refurbishment needed to accommodate higher population and dwelling densities in North Canberra, including at North Watson (Commonwealth of Australia and the Australian Capital Territory 1992). Urban consolidation was the means of achieving the population objective of the NCAS. However, considerable doubts have been expressed in the literature about the efficacy of consolidation as a single strategy for stabilising city populations (for example, Burnley 1983; Kirwan 1992; Braby 1989).

Implicit in the Better Cities notion of a more efficient city is the idea that urban fringe development (sprawl) is heavily subsidised whereas urban consolidation is not. This view has been challenged by the Industries Commission (1993) and others. Hence it is not apparent how the BBC grant improves resource allocation — indeed it may worsen it. As the EPACT study (1992, p. 30) noted:

> to subsidise redevelopment activity, result[s] in subsidies for both greenfields and redevelopment activities and a consequent misallocation of resources into the housing market as a whole.

Continuing, EPACT noted:

> In order to increase levels of redevelopment activity, it is necessary to change the price signals, which means either increasing the costs of greenfields development to recover a greater proportion of development costs, or encouraging a greater number of urban renewal options ... If significantly higher levels of redevelopment are to occur in an equitable fashion, then pricing will need to be reviewed.

The ACT's Better Cities grant is aimed at subsidising the additional physical infrastructure costs of urban intensification — that is, refurbishing and expanding aging infrastructure to meet the extra demands of higher density redevelopment and infill. The cost of bringing forward these public works to meet the population and other objectives of the NCAS is, in effect, a cost underwritten by the Commonwealth Government.

This raises the issue of how the ACT's grant for the NCAS meets the 'Better Cities' objectives of more 'efficient' cities and a micro-economic reform agenda worked into the Better Cities program by the 'One Nation' Statement of early 1992 (Australia, Prime Minister 1992). Rather than redressing any imbalance in resource allocation between urban redevelopment and greenfields development, the ACT's Better Cities grant simply provides a $13 million subsidy to both greenfields and urban redevelopment.[191]

Instead of improving the efficiency of locational decisions by sending clearer pricing signals about the cost of urban infrastructure with resource costs to improve the efficiency of the city's development, the Better Cities grant allows the ACT public authorities to continue to avoid such pricing reform and perpetuates any misallocation of national investment resources into and within the housing market.

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[191]The ACT Government has itself acknowledged that the additional infrastructure capacity funded under the program, while facilitating 'urban renewal', will ultimately service new development at Gungahlin more than in the program's target area of North Canberra (ACT, Planning Authority 1992).

The ACT Better Cities Agreement has no requirement for the ACT to review its development pricing policies, nor is there any evidence in it that any location-specific charging for the infrastructure financed by the ACT's Better Cities grant is contemplated. No charging policy has been implemented to recoup the additional infrastructure costs of the NCAS from the medium-density residential redevelopments which created the need for the infrastructure upgrade. Purchasers of homes in the ACT's greenfields locations, where the cost of physical infrastructure is built into land prices, might well cry 'locational disadvantage' under these circumstances. The grant may also reduce the prospect of public trading authorities generating the necessary finance for the maintenance, refurbishment and replacement of infrastructure. Without such changes in prices the prospect of efficiency improvements is small. The credentials of the ACT's 'Better Cities' subsidy as a catalyst for micro-economic reform and 'more efficient cities' are questionable.

Of course, infrastructure pricing reform looks less attractive to governments once the distributional implications of recouping the costs of urban growth become clear — housing costs rise. As Kirwan (1992, p. 18) points out, increased housing costs reflect 'the true cost of preventing sprawl and [are] intrinsic to any policy of consolidation'. Perhaps reflecting the emphasis on distributional issues in the original Better Cities program (Badcock 1993), urban renewal of North Canberra is closely linked with the ACT Housing Trust's ambitious redevelopment plans for the area. The Trust owns a substantial proportion (perhaps 30 per cent) of housing in North Canberra and is a joint venture partner in a demonstration townhouse redevelopment at Braddon, the second main element of the North Canberra Area Strategy.

The public housing element appears to be the basis of the project's 'social justice' rhetoric. Documentation for the North Watson development does not specify how the Trust is involved and talks only vaguely about affordable housing and increased housing choice.[192] This corresponds with the experience of other Better Cities projects in Perth (Alexander 1994) and Adelaide (Peel 1993). As in the Adelaide case, the program takes no account of redevelopment displacing the poor, with increased housing prices forcing low income families and older residents to move out. As noted above, urban consolidation achieves affordability by reducing indoor or outdoor space or reducing standards.

The 'green' origins of the Better Cities program, as well as the evolving political agenda of the Commonwealth Government, are also apparent in the environmental benefits claimed for the North Canberra urban renewal strategy. In spite of studies showing the amount of land saved by urban consolidation is small (McLoughlin 1991, 1992), environmental benefits and 'reducing urban sprawl' remained high on the list of 'benefits' claimed in the ACT's urban consolidation policy.

Curiously, one of the important environmental costs of urban consolidation — more intensive environmental stress resulting from denser development — is claimed as an environmental benefit of redevelopment: the augmentation of the sewer and stormwater infrastructure needed to cope with the higher densities in North Canberra is counted as an environmental benefit of the strategy, rather than as a partial amelioration of potential environmental damage, such as water run-off and quality problems. The increased pollution due to greater traffic congestion from urban consolidation is also ignored. Similarly, no economic value is placed on the lost public and private space which results from more compact cities (Stretton 1994). Castles (1992) estimates that living standards in Australia are higher than in denser Japanese cities, in part because of Australians' ability to produce valuable non-market goods and services from private and public space.

[192]The redevelopment of Trust leases through joint ventures with private partners will provide it with substantial below-the-line revenues due to the concessional treatment of residential redevelopment noted above. Such revenues will not be reflected in ACT Budget appropriations for public housing, although they will be available to the Trust as a subsidy for its general operations.

Perverse planning outcomes, and distortion of State government priorities

The move to ACT self-government in 1989 resulted in severe fiscal pressures on the Territory as it moved to the same Commonwealth funding basis as the States. One consequence of this has been a dramatic fall in ACT real capital spending since self-government, in spite of rapid population growth in the late 1980s and early 1990s. Here, as in the States,

> the popularity of urban consolidation among governments owes much to the shortage of funds for urban infrastructure extensions: these necessitated the urban consolidation response in the first place (Alexander 1994, p. 14).

The association of urban renewal or consolidation with attempts to reverse 'inner city decline' reveals the centralising tendencies of urban consolidation. Yet it is just such a monopoly of services by the central city area that is said to contribute to the poor access for residents on the 'urban fringe' in other Australian cities.

In the States, delayed or uncoordinated provision of public infrastructure for new urban development has been at the heart of concerns at the social costs of 'urban sprawl'. However, Canberra's unique design — concentrated development and relatively rapid settlement around dispersed town centres, each with substantial employment and a good range of services — has ensured there have been no significant inequalities in access to such services across the Territory. The non-urban areas around each town ensure open space is close by, and the town centres keep employment close to home and minimise travel costs. Services such as roads, water and electricity are provided when the towns are built and social infrastructure has been provided when certain population thresholds are reached. Many of the inefficiencies and social costs of uncoordinated fringe development characterising unplanned and centralised cities have thus been avoided in Canberra.

Planning the newest town, Gungahlin, with no significant employment opportunities was the first step away from this successful design as neither the Commonwealth nor the ACT Government were prepared to co-ordinate the location of public sector workplaces with the efficient planning of the city's development. Employment is being increasingly concentrated in the established town centres, especially Civic, with the only strategy for dispersion being to allow traffic and parking congestion to build up.

The 50/50 urban consolidation policy supported by the 'Better Cities' program also seems set to introduce the inequities and inefficiencies of other cities to the ACT by moving away from rapid settlement of new town developments and thereby extending delays in the provision of services which are based on specified population thresholds being reached. As noted above, the infrastructure savings anticipated from urban consolidation in North Canberra arise from delaying the provision of social infrastructure, mainly schools but also major external roads, for the newly developed towns of Tuggeranong and Gungahlin. Thus, ironically, the Better Cities encouragement of urban consolidation in Canberra will give rise to the social and economic costs of urban fringe development that it was intended to prevent.

At the same time, it is clear that the fiscal imperatives underlying the Better Cities Agreement have directly contributed to sudden and disruptive shifts in the ACT's planning strategy. Unlike most cities, Canberra has been developed according to a series of strategic plans for the city, commencing with the Burley Griffin plan of 1913 and modified by the 1964 National Capital Development Commission (NCDC) publication, *The Future Canberra,* and more recent plans (NCDC 1984).

Much of the public debate on the Draft Territory Plan between 1991 and 1993 centred on what became know as the 'pink bits', which were areas being investigated for changes in land use. While the Territory Plan approved in 1993 introduced building and approvals criteria to facilitate urban consolidation, the implications of the 'Better Cities' program and the 50/50 policy for land use and residential densities in most of the affected areas were not spelled out in the Plan's land use policies. The major 'infill' sites, such as North Watson, were only identified

on an ad hoc basis as the Better Cities program and the wider 50/50 urban renewal program was announced in mid 1992. As late as August 1993, when the new Territory Plan became law, North Watson was still planned for 'commercial tourism, recreational and leisure' uses.

This underlines the extent to which short-term fiscal considerations — and the 'carrot' of additional Commonwealth funding before the 1993 federal election — distorted well-established and successful planning for a better city in Canberra. It also demonstrates the financial dependence of State governments on the Commonwealth Government, leading to perverse incentives and a reduced political ability by different spheres of government to respond to their constituencies (Walsh and Thomson 1994)

Details of the ACT Better Cities grant and the associated North Canberra Area Strategy were announced soon after the 1992–93 Budget, following several months of negotiations between the ACT and Commonwealth Governments. Press reports at that time suggested that the ACT Government had been having difficulty putting together a project that met the Commonwealth Government's criteria. Indeed the editor of the ACT Royal Australian Planning Institute newsletter commented, regarding this grant, that

> [a]s someone who has been involved in scrutinising most of the Building Better Cities proposals from all the States and Territories (mainly from the perspective of their impact on local communities) I can't help but come to the conclusion that the ACT's proposals were assembled in somewhat of a hurry (Wensing 1992, p. 5).

Conclusion

A number of themes emerge from this summary of a 'Better Cities' urban consolidation project in Australia's best-planned city.

The first is that the urban consolidation policy is a manifestation of the 'crowding out' of public investment in urban capital over recent years — a consequence of the 'public spending is bad, private spending is good' ideology driving Commonwealth fiscal policy. With a growing population, standards of urban amenity will inevitably decline unless there are commensurate increases in public investment for urban development. Unless the electoral consequence of this decline in urban standards is driven home to the Commonwealth Government there will be no impetus for change in the current pattern of declining public investment and diminishing public revenues (Smith 1994b). As Levi (1988b) points out, the legitimacy of taxation comes under challenge where governments break the implicit contract to provide valued collective goods.

The second is that Commonwealth–State financial arrangements, notably the financial dependency of State governments, constrain the various spheres of government from responding appropriately to democratic pressures against federally imposed urban consolidation. Current arrangements mean State Governments spend '60 cent dollars' while the Commonwealth government pays the political prices for $1.50 of taxation for every $1 it spends on its own purposes (Walsh and Thomson 1994, p. 28). Access Economics' treatment of Better Cities money as a gift from the rest of Australia to the ACT Government for the North Watson project is clear evidence of this mentality. As State and local governments see little practical choice but to comply with the federal urban policy agenda, they try and make necessity into a virtue. This helps explain the observed tendency of governments and bureaucrats to propagandise about supposed environmental, social justice and efficiency benefits of 'better living, smarter cities' (Alexander 1994).

Unfortunately, the costs of population growth or reduced public investment cannot be avoided by simply restricting the size of a city and the amount of urban space. An important reason for the relative egalitarianism of Australian cities, notably Canberra, has been the easy expansion to a supply of low cost land, serviced by publicly financed infrastructure. Restricting the supply of these factors, in the face of well-established community preferences for space and efficient private transport, produces rising housing costs and increasing urban inequity. Public and private space has a value which must be accounted for. State and local governments, at the

coal face of community reaction to urban consolidation policies, know that demand, as well as supply, matters for economical city planning.

Which leads to the third theme, which is the quality of policy advice being provided to governments. McLoughlin (1992) has questioned the quality of policy advice on urban consolidation. But this chapter shows further problems, in the quality of decision making when the 'Better Cities' objectives are translated from policy to implementation. It has traced elements of an urban consolidation project funded by the Better Cities program in the ACT and identified the intrusion of political dynamics into the formulation and implementation of the North Watson project. The way in which Commonwealth Government priorities shift and alter planning priorities and policies at the local level has been noted. The circumstances of the ACT's Better Cities grant highlights the highly political agenda for this program. Badcock (1993) identifies the 1992–93 Budget as the occasion when BBC capital spending was accelerated as part of an urgent job creation exercise before the March 1993 federal election.

It has also been observed that contradictory economic and financial arguments have been put forward to different audiences by the ACT Government in support of the North Watson project. Such initial advice to governments and the community has been shown to be based on poor analyses and incorrect or inaccurate assumptions, rather than the factual analysis of actual conditions.

The Access Economics report, with all its weaknesses, is evidence of how the infrastructure and other supposed benefits of urban consolidation projects tend to be overstated by government agencies — miscalculations that suit misguided political, business and bureaucratic interests rather than those of the local community. It is clear that economic cost-shifting is the hidden agenda of urban consolidation.

There is also the question of the conflicting interests of governments as both important providers of urban services and as guardians of 'the public interest' in urban planning. In the ACT, this potential conflict was starkly revealed by the role of the Planning Authority in formulating urban consolidation projects and co-ordinating the involvement of other public sector interests. The same public sector cost-saving perspective is evident in the Access Economics study, conducted for the ACT administration in a belated attempt to redress previous inadequacies in the project's economic and financial justification.

It is easy for government and planning bureaucrats to focus only on 'supply-side' issues — on resource costs such as public infrastructure, rather than on balancing such costs with what the community wants. However, improving the efficiency of public resource use — a fine ideal — risks becoming in practice a cost-shifting exercise. Reduced public road costs mean higher private transport costs. The experience of the 1980s and 1990s show that a call for public sector efficiency also risks being a shield behind which public assets, such as land or infrastructure, are pillaged, dissipated or run down (Quiggin 1996; Walker and Walker 2000). Just as an ACT land account would reveal how the ACT land revenues are used for political ends to subsidise redevelopment and fund current budget expenditures, so a move to capital and current account budgeting and public accrual accounting would provide greater transparency about the costs of government activities and the effects of conflicting policy objectives.

Like other studies of urban consolidation the Access Economics study neglects a critical element in the cost-benefit equation — land costs. This review shows that correct inclusion of land costs may be critical to the outcome of such evaluation of urban consolidation proposals.

The system of public land ownership and leasehold in the ACT highlights another aspect of land economics that is poorly understood in the urban consolidation debate — the importance of who captures the 'unearned increment' in land values for the equitable development and financing of urban growth (Dunkerly 1983). A study by World Bank land economists in the 1980s commented that

> the administration of public leases requires a high degree of integrity in the bureaucracy. Since urban land is such a valuable commodity, and particular locations command semimonopolistic prices, the temptations for corruption and

> favouritism are great. Even in honest administrations, there is constant temptation to use favourable lease terms as a hidden subsidy to deserving groups or individuals (Doebele 1983, p. 8).

Such subsidies may or may not be justifiable on social grounds, but they impede the proper calibration of the true public subsidy system. This is a risk that applies to the redevelopment of cities under a freehold system as well as the ACT's public leasehold system. In the ACT, at least, the transfer of publicly owned redevelopment rights to private developers at a concessional price is a direct loss of public sector revenue from urban consolidation — a loss which Access Economics should have included as a public sector financial cost. This would have been clearly apparent with a more honest public sector accounting, and a better understanding of the connection between urban land values and public sector spending. Under freehold systems, such land gains from urban consolidation accrue to inner city property owners and developers, gains which lie behind the political economy of urban consolidation (McLoughlin 1992).

Finally the question of what happens on the ground when the ideals of 'Better Cities' are imposed from above leads to the observation that it was only the well-informed community pressure and the acquisition of internal Better Cities documentation that forced the ACT Government to assess the actual economic and financial impact of urban consolidation at North Watson. Not all communities have access to such information.

Hence the poor quality of advice on implementation of such 'urban renewal' investment projects means many may have proceeded without proper evaluation of the wider economic and financial costs. This reality should be built into the assessments of the desirability of any urban consolidation policy, as the social, economic and environmental costs of wrong decisions may be at least as high as from getting it wrong on the 'urban fringe'.

Chapter 10
Gambling Taxation — Public Equity in the Gambling Business*

Introduction

Since ancient times, governments have regulated the extent and conditions under which gambling is permitted. Governments also developed an early financial interest in legalising gambling, realising that certain forms of gambling were productive bases for taxation. These dual roles of government as a social guardian and as a gambling operator place it under conflicting pressures to both encourage and discourage gambling.

A leading Italian public finance expert, de Viti de Marco, highlighted the fundamental policy contradiction in his 1930s text, *First Principles of Public Finance* (1936, p. 331):

> the gambling of some people is punished for the purpose of maintaining public morality, and the gambling of others is legalised for the purpose of obtaining a public revenue. This contradiction is sharpened by the very form of the monopoly; for the monopoly unites, in the person of the State, the agency which is called on to combat the vice, with the one which derives profit from it ... There is a fiscal stake involved; this predominates, and paralyses any attempt at repression by the public authorities.

Governments rarely allow gambling to operate in a 'competitive' market.[193] Restricting competition may serve 'sumptuary' objectives of limiting the extent of gambling and thereby controlling its social costs. Monopolists tend to restrict supply to maximise profit. While monopoly is thus usually socially inefficient, the restraint on supply may improve efficiency if it limits provision of a social 'demerit' good (Musgrave and Musgrave 1989, p. 580). The fiscal monopoly created for the State when the law forbids gambling may therefore also further social goals (de Viti de Marco 1936).

Governments may restrict competition or establish monopolies in gambling to reduce its social costs. The nature of the industry or gambling demand may also result in a tendency to monopoly. One reason is that gambling is especially prone to criminal involvement, cheating and fraud. Because of the problems with fraud and excessive gambling during the nineteenth century, many governments prohibited and tightly restricted gambling in the interests of 'consumer protection' and 'public morality'. Governments also closely regulate racing and gaming activities, purportedly to ensure games are 'fair'. Consumer protection has been an important rationale for restricting competition in gambling activities. Monopolistic public provision of lottery gambling has been found in the US to better control fraud and corruption (Clotfelter and Cook 1989). Chapman *et al.* (1997) concluded that limiting gambling industry competition in Victoria facilitated surveillance and control.

However, 'consumer protection' is less than persuasive as an argument for restricting competition, which may also serve less laudable objectives.

Regulating the fairness of games and taking measures to ensure the probity of operators may serve the interests of consumers, operators and treasuries alike. Indeed, it may be difficult to identify in whose interests governments are acting when they regulate gambling. For example, existing regulatory policy of casinos in Australia, namely strict assessment of potential

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* This chapter was published in 2000 as 'Gambling taxation: Public equity in the gambling business', *Australian Economic Review*, vol. 33 no. 2, June, pp. 120–44. In 1999 it was awarded the *Australian Institute for Gambling Research Brian Frost Prize*.

[193] See National Institution of Law Enforcement and Criminal Justice (1977). Much economic research on gambling highlights the non-competitive aspects of the industry. Many economists analyse the industry in a monopoly framework (see Brinner and Clotfelter 1975; Livernois 1987b; Martin and Yandle 1990; Suits 1979).

operators to limit casino ownership and management to 'respectable' elements, is viewed as predominantly industry protection rather than consumer or social protection (McMillen 1996a; Chapman *et al.* 1997). Regulation of lotteries through public ownership and State monopolies has served to protect State lottery revenues, while regulation of gaming machines may be aimed at protecting an industry monopoly as much as protecting consumers. Reducing the risk of gambling through consumer protection regulation is likely to expand the consumer 'market' for gambling.

Another limitation on competition in gambling is that some gambling services have economies of scale. Declining marginal costs of gambling operations may create natural monopolies in some gambling products. For example, Eadington (1984) notes the importance of economies of scale in the casino gambling industry. Cook and Clotfelter (1993) identify scale economies in the consumption of lotto games because consumers prefer high jackpots almost irrespective of odds.

High risks, and the resulting need for a large capital base, are said to explain the concentration evident in English football pools (Rubner 1966). This may also apply to casino gambling, as is reinforced by the recent incorporation of casino gambling into operations of large international tourism corporations (McMillen 1985).

In such circumstances of market power and inelastic gambling demand, cutting gambling taxes to stimulate demand risks overall loss in revenue (Clotfelter and Cook 1989). As a recreational activity, gambling also requires continuous innovations or marketing to maintain consumer interest (Weinstein and Deitch 1974; Johnson 1976, 1985; Clotfelter and Cook 1989; Rychlak 1992; Haig 1985b; Haig and Reece 1985). The operator finds it difficult to increase market share and instead focusses on enlarging the market, through active promotion and marketing. The existence of such 'gambling product life-cycles' appears an important reason governments find it difficult in practice not to get drawn into sponsoring or promoting gambling (Henriksson 1996; Alchin 1989; Haig and Reece 1985).

The above suggests a number of reasons why governments will be drawn into promoting gambling by their fiscal stake in the industry, bringing out the intrinsic conflict with their role as 'social guardians'. Against this background, the following section reviews developments in gambling taxation and gambling policy in Australia over recent decades.

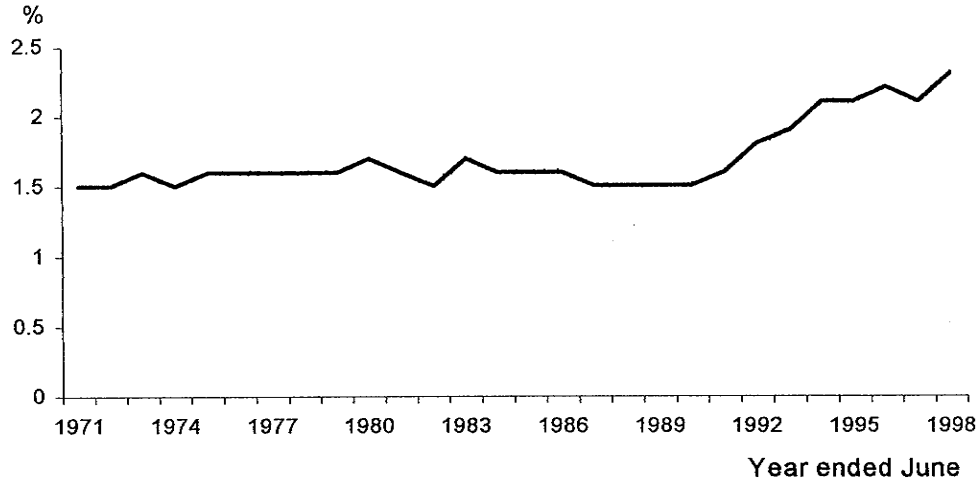
Australian gambling taxation

Trends and patterns of Australian gambling taxation

Although insignificant in Australia's overall tax system — a mere 2 per cent of national revenues — gambling taxes have become increasingly important to Australian State governments (Figure 10.1). The States collected $3.5 billion, or 11 per cent, of their taxes from gambling in 1996–97. Searching for new revenues and jobs, most States have licensed gaming machines and casino gambling for the first time during the ten years to 1995. Fiscal pressures have drastically altered State governments' approaches to gambling since the 1980s, forcing greater uniformity in gambling policies. The dramatic expansion in gambling revenues reflects this expansion of gambling activity, rather than higher tax rates on gambling. Stable for two decades until the 1990s, real per capita gambling expenditures nearly doubled, to over $700 p.a., during that decade.

The role of gambling taxes in Australia, and their recent growth, parallels developments overseas. For example, gambling taxes were around 1–2 per cent of national tax revenues in other developed countries during the 1960s, and lotteries were of a similar importance to Australian State governments as in the United States in the mid 1980s (Rubner 1966; Clotfelter and Cook 1987). Likewise, State and provincial governments' determined pursuit and expansion of gambling revenues during the 1980s and 1990s has reflected similar forces and raised similar issues in the United States and Canada as in Australia (Anon. 1997; Madhusudhan 1996; National Council of Welfare 1996; Lorenz 1996; Grinols 1995; Black 1995; Goodman 1994, 1995; Clotfelter and Cook 1989).

Figure 10.1
Gambling Taxes as a Percentage of Australian Taxation



Sources: ABS, *Casinos*, 1998; Alchin 1989.

Historically, trends in taxation revenues from gambling in Australia reflected State legislatures' attitudes to legalised gambling and responses to illegal gambling. Legal gambling remained around 2 per cent of personal consumption expenditures for several decades between 1920–21 and 1980–81 (Figure 10.2). After immediate post-war highs, gambling and gambling revenues faded during the 1950s, as new entertainments such as motoring, bowls and illegal betting drew consumer interest away from gambling (Haig 1984, 1985a, 1985b).

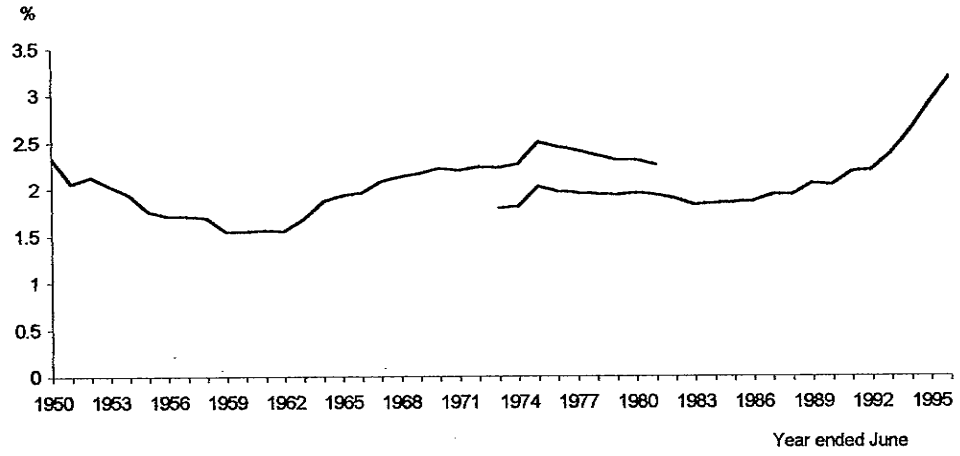
Until the States lost control of income taxation after 1942, gambling taxes had been an insignificant share of State government taxation. As wartime taxation arrangements became entrenched from the early 1950s, several States responded to the loss of income tax revenues by introducing State lotteries. State governments played an increasing role as gambling 'entrepreneurs' from the 1960s, with gambling policies aimed squarely at maximising public revenues (McMillen and Eadington 1986). During the 1960s, State governments maintained gambling revenues by initiating new legal gambling ventures, such as new lotteries. The popularity of jackpot lotteries helped increase gambling revenues to 11 per cent of State taxes in the 1970s.

The focus on revenues represented a fundamental change in Australian State governments' attitudes to gambling, which had previously been directed primarily at curtailing illegal gambling through legalised competition (Haig 1984, 1985b; Quiggin 1985; Anglican Community Services of South Australia 1997).[194] According to McMillen and Eadington (1986), Australian gambling policies until the 1960s reflected British policy principles of catering for unstimulated demand, distinguishing between forms of gambling, and strictly regulating to control crime.

During the 1970s, real gambling turnover remained relatively stagnant, reflecting declining interest in lotteries and the continued downward trend in racing betting. However, with relatively generous Commonwealth grants, States had eroded their major tax bases by granting various concessions and exemptions, notably for land and payroll taxes, and abolishing estate and gift duties. They were thus forced to respond to heavy cutbacks under the Hawke and Keating Governments by raising revenues from their remaining increasingly inequitable, narrow and distorting taxes, including on gambling (Mathews and Grewal 1997, p. 750).

[194]For example, legal off-course betting (TAB) was introduced to reduce illegal betting, as well as defend racing clubs against declining interest in racing.

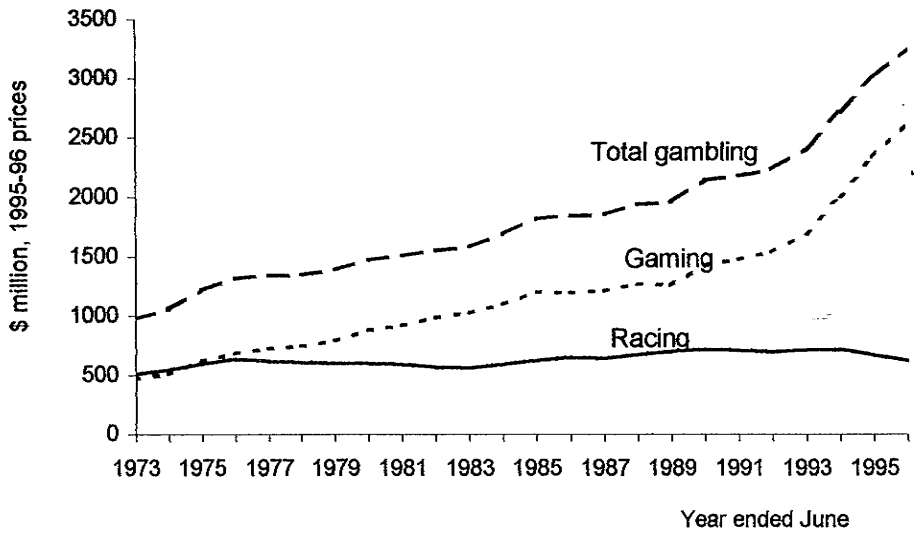
Figure 10.2
Gambling's Share of Consumer Spending, 1949–50 to 1995–96
(percentage of personal consumption/final consumption expenditure)



Sources: The series for the period to 1981 is from that presented in Haig (1984).
The series from 1973 to 1996 is from the Tasmanian Gaming Commission (1997).

State and local government own-source taxes increased from around 20 per cent of national taxation in the 1970s and 1980s to around 24 per cent by 1997–98 (ABS, *Taxation Revenues Australia*, 1998). Gambling taxation played a significant although not predominant role in this expansion, with some governments experiencing an uncharacteristic increase in reliance on gambling revenues as they permitted previously prohibited forms of gambling (Figure 10.3). Nevertheless, gambling taxes remain less important State taxes than payroll taxes, financial transaction taxes or business franchise fees; they are comparable in importance with motor taxes.

Figure 10.3
Real Government Gambling Revenues



Source: Tasmanian Gaming Commission (1997).

'Gambling wars' and fiscal stress

In North America the legalisation of new gambling forms since the 1970s emerged from the financial stresses experienced by State or provincial governments due to recession, local 'tax revolts', and tighter federal fiscal policies. State competition for gambling revenues and the defensive introduction of gambling — characterised as 'gambling wars' — became the primary force for the spread of gambling. Although total gambling activity has expanded as a result, the growth in total revenues has been limited by State government tax competition (Stover 1990; Borg, Mason *et al.* 1993).

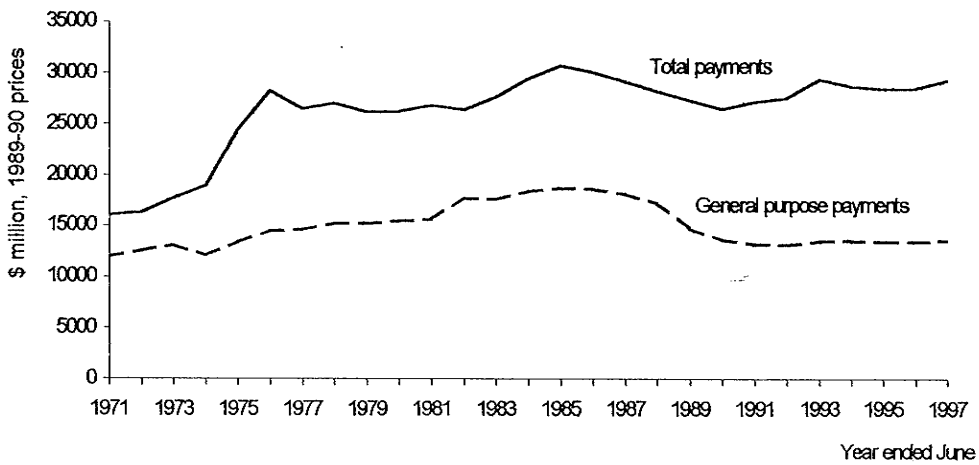
Fiscal pressures and 'gambling wars' have also been a force for expanding gambling in Australia, with a 27 per cent fall in the real value of general revenue grants since the mid 1980s (Figure 10.4). Virtually all States expanded gambling activity as one of their few autonomous tools of revenue policy, with the less affluent States such as Tasmania, Western Australia and Queensland, and recently South Australia, often leading the way (Smith 1993b).

Defending revenues from legalised gambling in other States contributed to the spread of casino and gaming machine operations in a number of Australian States (Alchin 1989; Australian Institute of Gambling Research and Industry Research Unit 1995; New South Wales, Tax Task Force 1988a). Because gambling revenues tend to decline rapidly during a limited product lifecycle (for a discussion of the evidence on this, see Smith 1998a), gambling taxation may exacerbate State government tax rivalry.

State rivalry to promote gambling business has been manifested in pressures on rates of taxation or the extent of public profit sharing. Tax competition is especially intense where there is strong interjurisdictional bidding for business, such as in Totalisator Agency Board (TAB) betting, or 'junket' casino gamblers, or where new forms of gambling have drawn substantial business from existing gambling, such as in racing. Some States have reduced taxation of 'high roller' gamblers at casinos in order to compete for business with other States. Racing tax rates have also been reduced in most States in response to competition from residents placing bets through gambling operations in other jurisdictions (Commonwealth Grants Commission 1997).

Only lotteries, which are protected from intensive inter-State competition by revenue-sharing agreements, have maintained tax yields in the face of intensified competition since the 1980s.

Figure 10.4
Real Value of Payments to States, 1970–71 to 1996–97



Source: Australia, Treasury, State Finances Branch (1997, pers. comm.).

Gambling tax concessions have the same effect on the budget bottom line as expenditures and are known as 'tax expenditures'. The revenue loss or 'tax subsidy' provided in this form can represent a significant element of government spending even though it is not easily scrutinised by the public.

Estimates of the budgetary cost of State government tax expenditures are rare.[195] In New South Wales (NSW) the 1988 Tax Task Force broke new ground in identifying and costing a number of tax expenditures in respect of gambling, as well as other State taxes (NSW Tax Task Force 1988a, b). Around $75 million of NSW tax expenditures in 1986–87 were attributable to gambling tax concessions, equal to 13 per cent of gambling revenues that year. It mainly represented the bookmakers tax concession, costing $69.8 million.[196]

No comparable study has been done for other States. The extent of gambling tax concessions is likely to have increased since 1986–87 (for example, see Honeysett 1996; McCrann 1997). If the NSW 1986–87 concessions applied Australia-wide in 1995–96, the cost would have been around $400 million.[197] Measured against national gambling revenues of $3.3 billion annually, this amounts to more than $400 million of tax concessions — a significant loss of revenue and a substantial tax subsidy to some operators in the gambling industry.

The changing gambling tax base

As a result of the turnaround in State government attitudes to gambling since the mid 1980s, there have been dramatic changes in the extent and nature of gambling in Australia. Over the decade to 1995–96, total player losses ('expenditures') on gambling more than doubled in real terms, parallelling a dramatic growth in gaming and gambling industry profit (ABS, 1997, *Casinos*, 1999). By 1995–96, the total amount wagered annually (gambling 'turnover') was $72.9 billion, or $5375 per capita. On average player losses accounted for 3 per cent of household budgets (Tasmanian Gaming Commission 1997).

The change in State government policies can be seen in the rising share of gambling losses in household disposable incomes (HDIs) since the late 1980s. According to the Tasmanian Gaming Commission, gambling expenditure has also increased sharply in nearly all States since the mid 1980s.

From the mid 1980s, casino gambling was licensed on the mainland, and by the early 1990s, a number of States were removing prohibitions on gaming machines. The licensing of casinos in Queensland, South Australia and Western Australia in 1985–86[198] was followed by the introduction of gaming machines in most States.[199]

Although casino gambling has taken the highest profile in public debate, the spread of gaming machines in clubs and hotels[200] has produced the most dramatic increases in government revenue and is largely responsible for the rise in the overall national significance of gambling revenue.[201] By 1996–97, casino and gaming machine taxes together provided from 20 per cent to as much as 65 per cent of individual States' gambling tax revenues (Table 10.1).

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[195] Issues regarding estimating the cost of tax expenditures are discussed in Butler and Smith (1992).

[196] A concessional rate of 1.25 per cent was applied to bookmakers' turnover compared to the 6.5 per cent equivalent on TAB bets (see Smith 1998a).

[197] Of course, neither the level nor the nature of tax concessions in NSW will necessarily reflect the situation for other States. Other States may have different concessions, and use somewhat different tax bases. This estimate excludes new tax concessions since 1986–87 as well as the concessional treatment of clubs compared to hotels.

[198] Tasmania introduced its casino during the early 1970s, with the ACT in 1992–93, Victoria in 1994–95, and NSW in 1995–96.

[199] NSW had introduced poker machines in 1956 and the ACT in 1976. Queensland did so in 1991–92, South Australia in 1994–95.

[200] While most casinos have gaming machines, only around 7 per cent of machines were in casinos in 1994–95 (ABS 1997a).

[201] The ABS includes only ongoing casino and poker machine licence fees in its definition of taxes, viewing initial casino fees as receipts from the sale of intangible assets. Similarly, the Tasmanian Gaming Commission data exclude these initial fees from estimates of State casino revenues.

Table 10.1
Gambling Revenues as a Percentage of State Taxation

	NSW	Vic.	Qld.	SA	WA	Tas.	NT	ACT	Aust.
1970–71	19	9	10	7	8	7	na	na	12.9
1975–76	13	9	7	5	6	6	na	na	9.8
1980–81	14	10	6	7	6	9	na	na	10.5
1985–86	11	9	10	8	6	9	5	na	9.7
1990–91	10	9	10	9	7	8	9	7	9.2
1995–96	10	12	12	11	7	8	10	9	10.9
1996–97	10	13	12	12	6	9	9	8	10.9
1997–98	9	13	10	11	5	8	9	8	10.0

Sources: ABS, *Taxation Revenues Australia*, 1998; Alchin 1989.

Although in 1970–71 racing accounted for around 70 per cent of gambling revenue in most States, gaming is now the predominant source. Overall, casinos contribute around 12 per cent of aggregate gambling revenues, while gaming machines in hotels and clubs provide over 40 per cent. In NSW and Victoria, the new casinos presently provide 7 per cent and 11 per cent of State gambling taxes respectively.

The different State trends evident in Table 10.1 mainly reflect differences in policy regarding numbers and location of gaming machines, the timing of legalised casino gambling, and the strength of the racing industry in individual States. NSW has long permitted poker machines, whereas States like Victoria and South Australia only recently legalised gaming machines, and Western Australia limits gaming machines to the casino. Where casinos are well established, these revenues account for up to 50 per cent of State gambling taxes. In Western Australia, where racing remained important until the early 1980s, expanding casino revenues[202] have ended the dominance of racing in gambling revenues. South Australia has seen the importance of casino revenues fall sharply, from 12 per cent to 7 per cent of gambling revenues, since introduction of poker machines. Licensing gaming machines in Queensland left most of the State's casino revenues largely intact. However, there have been dramatic falls in casino tax receipts in the Australian Capital Territory (ACT) since the opening of the Victorian and NSW casinos (ABS, *Taxation Revenues Australia*, 1998). While the importance of poker machines revenue is unchanged in NSW compared to the early 1970s, Victorian gaming machine revenues grew dramatically in importance since their introduction in 1991–92, to the present 54 per cent of the State gambling revenues. Similarly, poker machines in South Australia now provide half of the State's gambling taxes, from virtually nothing in the early 1990s.

The level of taxation on gambling

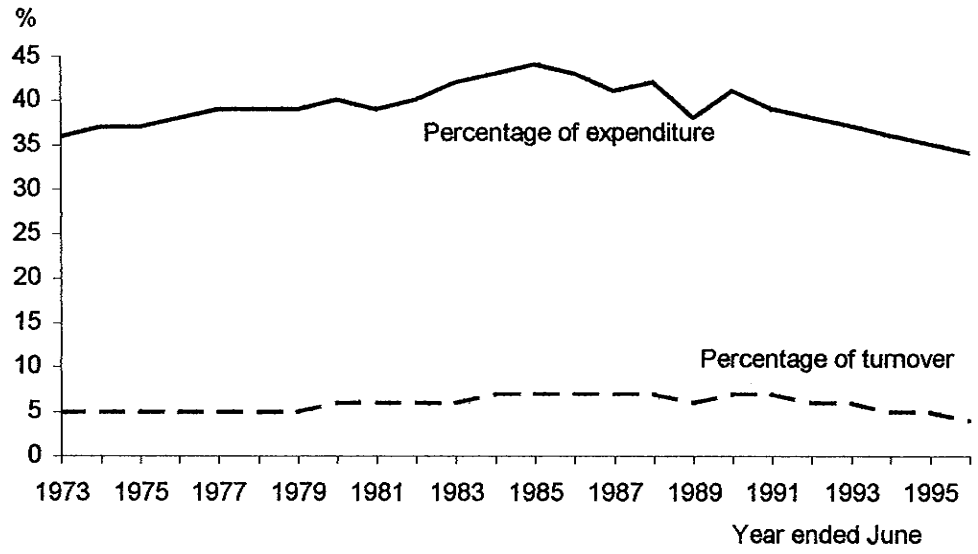
The overall rate of tax on gambling can be assessed by comparing total gambling tax revenue with gambling tax activity. Tax rates can also be measured as a percentage of the gross, or net, 'price' that is, on a tax-inclusive or tax-exclusive (*ad valorem*) basis. As is clear from Figure 10.5, the tax rate on gambling peaked in the mid 1980s at around 7 per cent or 44 per cent, depending on the tax base used,[203] and has been declining since. By 1995–96, the average

[202] In Western Australia and Tasmania gaming machines are only permitted at the casino.

[203] There are various different ways of measuring this overall tax rate because there are a number of definitions of the tax base (Johnson 1985). One approach compares tax revenues with *gross expenditures* or turnover, a method commonly used to compare the 'take-out' rate on lotteries. This expresses the tax as a percentage of the gross 'price' paid by consumers, that is, of 'turnover'. Comparing tax revenues with *net gambling expenditures*, or 'player loss', indicates the government revenue share of the gambling enterprise's 'net takings' (that is, after payout of winnings). Net expenditure is the most common measure used by economists for measuring gambling, and reflects the actual cost to individuals. It is also used in the National Accounts, which treat winnings as transfers between individuals. Measuring tax revenues against *gross turnover less government revenues* provides another indication of gambling tax rates.

rate of tax on gambling had fallen to 4–5 per cent on turnover, and 34 per cent on an expenditure basis.

Figure 10.5
Tax Rates on Gambling, 1972–73 to 1995–96



Source: Smith 1998a, derived from Tasmanian Gaming Commission 1997.

Table 10.2
The Composition of Gambling Revenues
(percentage of total gambling revenues)

	NSW	*Vic.*	*Qld.*	*SA*	*WA*	*Tas.*	*NT*	*ACT*	*Aust.*
1985–86									
Lotteries	32	58	57	57	38	61	75	na	44
Poker machines	34	na	na	na	na	na	na	na	16
Casino	na	na	7	8	8	17	na	na	2
Racing	34	41	36	34	52	21	25	na	37
Other	na	1	na	na	2	0	na	na	0
1991–92									
Lotteries	24	58	60	60	53	52	38	32	43
Poker machines	35	na	2	na	na	na	na	48	16
Casino	na	na	13	12	23	21	23	na	5
Racing	34	37	25	28	24	24	38	19	32
Other	8	4	na	na	na	2	na	na	4
1996–97									
Lotteries	21	24	34	26	45	31	34	24	26
Poker machines	44	54	34	49	1	na	na	53	43
Casino	7	11	15	7	35	50	20	8	12
Racing	27	10	17	19	20	18	14	14	19
Other	0	1	na	na	na	2	na	0	0

Source: ABS, *Taxation Revenues Australia*, 1997

Table 10.2 shows gambling tax rates from Johnson (1985) for the early 1980s, and rates calculated for 1989–90 and 1995–96 using Tasmanian Gaming Commission data on revenue, turnover and expenditure. Racing taxes in Australia are around 5 per cent of gross wagering or 'turnover', but around 37 per cent of expenditures. In the United States in 1987 pari-mutuel racing taxes were 4 per cent of gross wagering and 21 per cent of expenditures (Clotfelter and Cook 1989). Australian lotteries, mainly operated by the public sector, have the highest implicit tax, with revenues of around 32 per cent of sales (equal to a profit mark-up of around 80 per cent) since the 1980s. This parallels the generally high profitability of overseas State-run lotteries (Rubner 1966; Brinner and Clotfelter 1975; Livernois 1987b; Clotfelter and Cook 1989). Australia-wide taxation on gaming machines and casinos was a relatively low 27 per cent and 20 per cent respectively of expenditures in 1995–96 (around 3 per cent on a turnover basis).

National gambling revenues would be around $80 million or 2–3 per cent higher if 1987–88 average gambling tax rates for individual gambling applied to actual expenditures on these products in 1995–96.[204] While this partly reflects State tax competition, and more generous tax concessions to the gambling industry, the main reason for the declining average taxation of gambling is the shift in gambling activity towards lower-taxed casino and gaming machine gambling and away from lotteries. Revenue in 1995–96 would have been around $800 million higher if gambling activities including casino and gaming machine gambling were levied at the same rates as racing and lotteries, that is, if the 1995–96 levels of gambling activity yielded the same average revenue as in the mid 1980s. This suggests diminishing marginal returns to revenue from the recent expansion of gambling activity, even if total revenues are increasing.

The pros and cons of gambling taxation

> Taxes are imposed to obtain Government revenue. Taxes are imposed to redistribute the national income. Taxes are imposed to discourage undesirable — but legal — social or economic acts. Taxes are imposed to provide the State with a tool for prosecuting promoters of illegal activities. Taxes are imposed to transfer to the State private windfall profits generated as a result of State actions (Rubner 1966, p. 62).

Gambling taxes have considerable appeal to governments, as gambling taxation is perceived as voluntary and is, therefore, less resisted by the general taxpayer. Gambling has also long been a productive revenue base and makes a rapid, if minor, contribution to public revenues.

However, because gambling is a very narrow base, gambling tax revenues are more subject than are broader based taxes to marketing effects and are less predictable from general trends in consumer purchases and income levels (Weinstein and Deitch 1974). Because of a strong product life-cycle effect, revenues tend to grow rapidly in the early years, but stagnate or decline substantially in the medium to longer term (Stover 1987; Goodman 1995; Henriksson 1996; Madhusudhan 1996; Rychlak 1992). In Australia the NSW Tax Task Force (1988a) found considerable year-to-year volatility in New South Wales gambling revenues. It should be noted however, that the issue of gambling tax volatility is complex and controversial (Szakmary and Szakmary 1995; Clotfelter and Cook 1989). An American study found lottery revenues more volatile than other State taxes (Clotfelter and Cook 1989). However, statistical volatility in part reflects the sharp upward trends in early years, not an undesirable feature from the viewpoint of governments.

High initial levels of government revenues from a new gambling operation may be in effect a 'bringing forward' of revenues, financed by a small number of gambling debtors at highly unfavourable interest rates because many heavy gamblers borrow to finance their gambling. Sustaining revenues against such trends depends on gaining new heavy gambling customers.

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[204] This assumes NSW poker machine tax rates in 1987–88 were applied to gaming machine expenditures in States that had licensed them in 1995–96, and Queensland's 1987–88 casino tax rate of 20 per cent were effective for the ACT, Victorian and NSW casinos in 1995–96.

Gambling revenues are also vulnerable to increased competition from other tax jurisdictions and from new forms of gambling. 'Predatory federalism' and 'competition policy' in Australia have accelerated the market competition in casino gaming, between the different forms of gambling and between States (McMillen 1996b). More intensive competition arising from the National Competition Policy is predicted to erode the economic rents created by restricting gambling markets and the shrinking base for taxing gambling will eventually reduce State gambling revenue (Chapman *et al.* 1997). The 1990s financial crisis in Asia, and flow-on effects on Australia's casino industry (McCrann 1997; Muller 1997; Lines 1997), highlight the precarious nature of gambling as a source of long-term revenues.[205] Relying on such a risky source of revenues may produce an excessive government interest in sustaining gambling activity with undesirable social and political consequences. The public may end up with the risks and a high share of the costs of producing gambling profits, without necessarily sharing the returns received by private shareholders.

Are gambling taxes 'fair'?

Whether gambling taxes are 'fair' has long been a focus of gambling policy debates. In one view, gambling taxes are a 'voluntary' and, therefore, fair tax on discretionary spending. Others suggest gambling taxes are a regressive and discriminatory levy on the leisure pursuits of the disadvantaged, attractive to politicians as a 'tax reform avoidance' mechanism.

As only a small component of the total tax system, gambling taxes at present levels are unlikely to have major significance for the overall fairness of the Australian tax system. The regressivity of other State government revenue sources also partly mitigates their use of regressive gambling taxes — State governments have only limited access to progressive tax sources. There is also uncertainty about the true economic incidence of gambling taxes. Most studies of the incidence of gambling taxes assume consumers pay the tax. However, the true economic incidence of gambling taxes depends on the particular characteristics of the gambling market. One of the attractions of gambling as a tax instrument is said to be that its final economic incidence is on the gambler, regardless of who the tax is applied to (Rubner 1966). The NSW Tax Task Force (1988a) concluded that a high proportion of gambling taxes were shifted forward to the final consumers of the service, with a small percentage of this falling on inter-State or overseas residents. Warren (1979) came to a similar conclusion. On the other hand, in some cases the role of gambling taxation is essentially to tax economic rents created by government restrictions on gambling. Gambling regulations which restrict entry to the industry create monopoly rents, for example in the case of casino operators. In such cases it is possible that gambling taxesmay fall on monopoly rents received by gambling operators, rather than on gamblers.[206]

The significance of gambling taxes for tax equity lies mainly in the opportunity provided by gambling revenues for governments to reduce reliance on more equitable but perhaps more politically contentious taxes and to defer necessary reforms to the taxation and Commonwealth–State finance system. Which alternative avenues for taxation are side-stepped by legislators if gambling revenues are available? Resort to gambling taxation has often been a strategy to avoid or delay introducing more progressive taxes, such as income taxes, which are nevertheless, more controversial politically. Because gambling is a more important recreational expenditure for lower socio-economic groups, some analysts suggest State gambling taxation is a tax-shifting strategy by the middle class.

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[205] The operating profit of Australia's 14 casinos fell sharply from 1996–97, reflected in a 1 per cent decline in tax receipts that year, after a 27 per cent increase from 1994–95 to 1995–96. In 1998–99, casino profits have recovered from the 10.8 per cent loss in 1997–98. Large drops in takings from overseas 'high-rollers' were offset by a large expansion of takings from casinos' gaming machines (ABS, *Casinos*, 1999).

[206] Economic theory suggests that a profit maximising monopolist will absorb a tax on profits, as the firm will have maximised profits prior to tax and can do not better after the tax is imposed. On the other hand, a tax may induce a firm to make fuller use of its monopoly power, and to the extent this occurs, the tax burden is passed on (see Musgrave and Musgrave 1989, p. 265).

Increased resort by State governments to gambling revenues highlights the need for debate:

- on whether giving lower priority to distributional objectives is a transparent and desirable shift in taxation policy; and
- on whether reducing reliance on gambling taxation by boosting progressive tax revenues, such as income or assets taxes, would improve overall tax equity.

Assuming gambling taxes do fall on gamblers, the main equity issues are therefore:

- How regressive is gambling taxation compared to other available sources of revenue?
- Are different forms of gambling less regressive than others?
- How does the level of taxation on gambling compare with tax rates on other recreation expenditures?

The extreme concentration of gambling spending among a few heavy gamblers, and correlations between geographic location and levels of gambling, also raise other key equity issues.

- How does widening access to gambling alter the distributional burden of gambling taxation?
- Is taxation of gambling really a 'voluntary tax' and therefore 'fair'?

Overseas studies leave no doubt that gambling taxes are very regressive, assuming of course that the economic incidence of gambling taxes is on gamblers, not operators. A few forms of gambling, such as casino table games, have in the past been the preserve of the well off and hence relatively less regressive or even progressive. However, as gambling becomes more accessible, the burden of gambling taxation is shifting towards lower income groups.

Debates over gambling's distributional impact often focus on 'the typical player' and their income characteristics. As the typical player may be a middle or high income earner, reflecting the wide public participation in gambling, some argue gambling taxes are not inequitable. However, the measure commonly used in economic studies of tax incidence is how expenditure varies as income increases. A tax is regressive if it falls as a percentage of income as income rises and is progressive if it rises.

Calculating an index of the inequality of distribution of the tax burden based on the concept of the Gini measure of inequality of income distribution, Suits (1977a) found American gambling taxes with an index concentration of -0.16 were as regressive as the American sales tax (S = -0.15).[207] Casino taxes in Nevada were moderately progressive at that time (S = 0.26), even more so than the American income tax (S = 0.19). This partly offsets the very regressive effect of other forms of gambling, notably instant lotteries (S = -0.31) and numbers games (S = -0.44). Johnson (1976) found the implicit tax on North American lotteries was more regressive than sales taxes.

Gambling taxes were also found to be moderately regressive in Australian studies carried out during the late 1970s and early 1980s (Warren 1979, 1989; Kakwani 1983), and are comparable to the Commonwealth sales tax. Perhaps reflecting the nature of earlier casino taxes, a Committee of Inquiry in Victoria (Victoria, Committee of Inquiry into Revenue Raising 1983, p. 85) judged gambling taxes to show 'an unstable but distinctly progressive trend'.

However, the shift in consumer demand towards more regressive forms of gambling, notably gaming machines, and increased accessibility of gambling for lower income groups suggest that gambling taxation is becoming more regressive. Different types of gambling have different distributional effects. Casino taxes were progressive when the main clientele was

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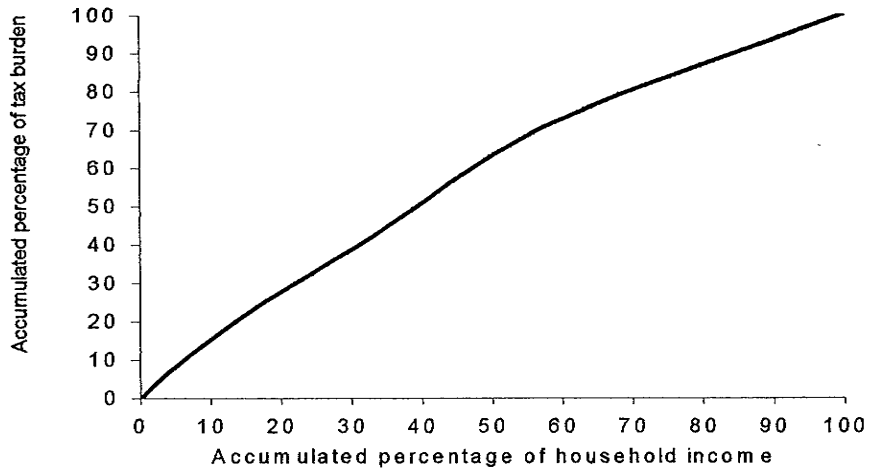
[207] See Suits (1977b). The S index is defined as $S = 1-(L/K)$ where $K = 5000$ and $L = \sum_{i=1\ldots10}(½)[T_x(y_i)+T_x(y_{i-1})](y_i - y_{i-1})$, where $T_x(y)$ is the accumulated percentage of the total tax burden for a given accumulated percentage of the income variable y.

wealthy tourists or visitors and the cost of inter-State air travel access to early, remotely located casinos precluded significant participation by other than the affluent.[208] As gambling moved from the resorts to the suburbs, the burden of gambling taxes appears to have changed. In the United States Mason, Shapiro *et al.* (1989) found casino gambling expenditure was highly regressive, confirming earlier findings by Suits (1977a) for local gamblers in Nevada.

In Australia, analysis of household expenditure survey data on gambling expenditures suggests gambling taxation is regressive, and increasingly so (Figures 10.6 and 10.7). Sample size difficulties and reporting biases limit the usefulness of the HES data on gambling,[209] and the distribution of the gambling tax burden does not necessarily equate with gambling expenditures.

Nevertheless, gambling losses have become a greater burden on lower income groups since 1984. By 1993–94, gambling had increased from around 8–9 per cent of recreational expenditures to around 10–11 per cent for households in the bottom two income quintiles, while it reduced substantially in the higher income quintiles. Overall, gambling spending has nearly doubled as a share of income in the poorest 40 per cent of households, while falling from already low levels in the incomes of the most affluent 40 per cent of households. The regressivity of Australian gambling taxation has been confirmed by a growing number of studies of its impact (Productivity Commission 1999; Smith 1998a; Melbourne Institute of Applied Economic and Social Research *et al.* 1997).

Figure 10.6
Lorenz Curves for Gambling Expenditures,1984

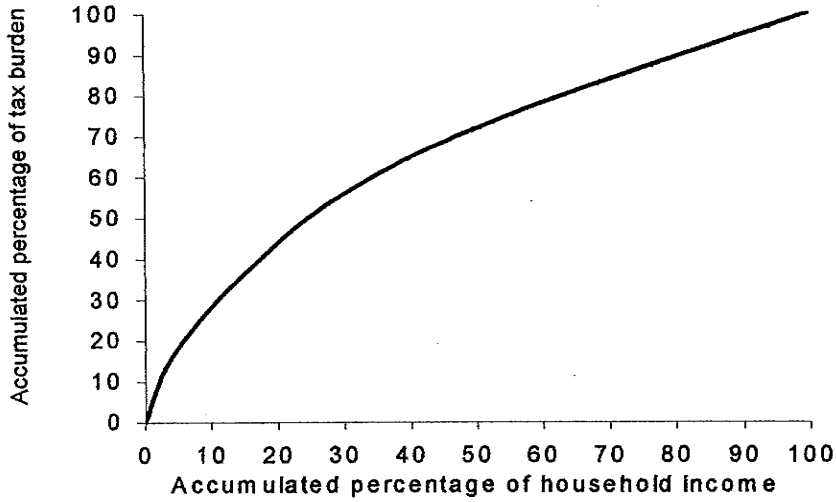


Source: Smith 1998a, derived from ABS 1986, 1996.

[208]Nevada was the only State permitting casino gambling at the time of Suits' study. Similar factors would have influenced the distribution burden of Tasmania's Wrest Point casino tax burden during the 1970s and early 1980s.

[209]Gambling expenditure data from the HES are somewhat unreliable due to the likely underestimation of gambling losses, and overestimation of gambling winnings by households. Sample sizes for different types of gambling are also too small to allow the incidence to be estimated by attributing tax rates to each category of gambling. Relative standard errors are too large even for reliable estimates of total gambling expenditures.

Figure 10.7
Lorenz Curves for Gambling Expenditures,1994



Source: See Figure 10.6.

Using a 'Suits index' of the regressivity of gambling losses based on HES data for gambling expenditures, a uniform tax on gambling in 1984 would have been roughly proportional to income (tax concentration index S = 0). By 1993–94, the index suggests a highly regressive tax regime, with a concentration index of -0.31. This compares with an index for income tax of 0.2 and for a uniform tax on all commodity and service expenditures of -0.16.

Gambling spending is also heavily concentrated among relatively few households and individuals so that average figures on gambling expenditures give a misleading picture of its incidence. The heaviest 20–30 per cent of gamblers typically account for some 80 per cent or more of total gambling expenditure (Clotfelter and Cook 1987, 1989; Grinols 1996). Australian data suggest around 90 per cent of reported gambling expenditure derives from the heaviest 10 per cent of gamblers.[210] The latter implies that as much as a third of Australia's spending on gambling came in 1991 from the 1.3 per cent of the population that were compulsive/pathological gamblers.[211] Gambling taxation may thus be much more regressively distributed among gambling households than across the general population, if the incidence of heavy gambling is greater in lower income groups than in the population as a whole.

This pattern of revenue-raising from addicted gamblers elicits important questions about whether most gambling revenues are 'voluntary' and 'painless', and about the fairness and ethics of governments raising perhaps a third of their $3.5 billion annual gambling revenues by exploiting the vulnerability of around 200,000 individuals and their families. It also has important implications for public policy, as discussed below.

The concentration of gambling spending, and the disproportionate share in the incomes of poorer households, also has important geographic distributional implications. If low income

[210]See also AGB McNair (1995). The accuracy of the above estimate is uncertain because of the known and mainly intractable problems with HES gambling expenditure data. However, the concentration of gambling expenditures estimated for Australia in Smith (1998a) has been confirmed by Productivity Commission research, which shows around one third of gambling revenues come from problem gamblers (Productivity Commission 1999) .

[211]Compulsory/pathological gambling as defined by the South Oaks Gambling Screen criteria was estimated at 161,592 adults, 1.3 per cent of the population in 1991 (Dickerson 1992).

revenue since the early 1990s has been accompanied by a declining rate of taxation on gambling, on a widening base. The differences in tax rates on gambling have also been narrowing. Expansion of gambling revenue may not necessarily imply greater efficiency losses from gambling taxation.

As Brinner and Clotfelter (1975) point out, any evaluation based on demand curves and conventional applied welfare concepts rests on assumptions that individuals are best able to judge what is good for them and that there are no externalities in consumption or production. Indeed, the economic impact of gambling regulation is likely to be more significant than the efficiency consequences of gambling taxation.

Putting this major issue aside, the economic efficiency cost of gambling taxation depends in part on whether gambling taxes fall on consumers as consumption taxes, or whether they capture from gambling operators the windfall gains arising from government restrictions on the competitive supply of gambling services. Taxes on gambling might also be interpreted as returns on the implicit public equity in the industry, or as 'user charges' for the legitimacy and implied government guarantee of operator probity that is bestowed on the industry by tight public regulation and control. The economic efficiency of gambling taxation also depends on whether high gambling taxes effectively discourage gambling activity or attribute its costs to those who generate them.

Where governments restrict gambling activity, 'economic rents' or windfalls accrue to the few enterprises permitted to provide gambling services. Raising revenues as far a possible from taxes on 'economic rent' minimises the efficiency costs of taxation (see Musgrave and Musgrave 1989, p. 282). Taxing economic rents may also improve equity by transferring to the State 'private windfall profits generated as a result of State actions' (Rubner 1966, p. 62). An important role of gambling taxes is to capture unearned economic rents in the gambling industry for public revenue (Holloway 1973).[213] Surveying current gambling taxes in Victoria (Chapman *et al.* 1997) concluded taxation of economic rents was a key objective of State gambling tax policy, and 'capturing these rents ... appeared to be the main role of much gambling taxation' (p. 75).

One approach to the taxation of such economic rents is to sell the rights to conduct gambling operations to the highest bidder, through up-front bidding for a licence.[214] Such one-off licence fees for casino and gaming machine licences have become an important element of gambling 'tax revenues' although, in effect, they represent returns from a public asset sale. For example, casino licence fees were paid to Queensland and the ACT in 1992–93, to Victoria in 1993–94 and 1994–95, and to NSW in 1994–95 (Commonwealth Grants Commission 1997, p. 134). In Victoria, initial casino licence fees totalling $358.4 million (Chapman *et al.* 1997) compare with Victorian casino taxes of $481 million between 1993–94 and 1996–97 (ABS, *Taxation Revenue Australia*, 1998). However, up-front licence fees will only fully extract economic rents if bidding is competitive.

Potential monopoly and geographic market power from holding a casino licence provides incentives for 'rent seeking' by gambling operators, and encourage 'directly unproductive profit seeking' (Grinols 1996, p. 20). This wastes economic resources and erodes democratic decision-making processes. Bilateral or even multilateral negotiations between potential operators and a State government make it difficult to assess whether the full market price of granting the gambling monopoly is reflected in the fee paid by the winning tenderer. Government may reduce licence fees as an implicit subsidy to operators to meet objectives such as promoting development or tourism. In effect the government contributes financial equity to

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[213] Whether such taxes on rents fall on the supplier or are passed on to the consumer depends on whether a position of monopoly is fully exploited in practice. In principle, however, taxes on monopoly profit are paid by the supplier because supply is already at profit maximising levels (Musgrave and Musgrave 1989).

[214] This is an approach recommended for other industries with significant economic rents, such as the mining industry. Because of uncertainty about future taxation, and the risk aversity of firms, competitive bidding will not extract all rents, and hence ongoing taxation/profit sharing is a common supplement to auctioning licences. See Church (1985) for discussion of these issues and an extensive bibliography.

populations and heavy gambler populations coincide in the same geographic area, the adverse social and economic impacts of gambling will be heavily concentrated in particular localities.[212]

Another more contentious aspect of tax fairness is horizontal equity. Other 'luxuries'—the entertainments of the well off such as overseas holidays, recreational goods and equipment or restaurant meals — have not been comparably taxed (Johnson 1985) because Australian consumption taxation has largely excluded most services. High gambling taxation, alongside minimal taxation of other recreation or leisure activities, is horizontally inequitable.

The goods and services tax (GST) taxes expenditures on recreation and leisure at similar rates, and improve horizontal equity. The 10 per cent GST represents a tax cut for many gambling activities (Table 10.3). However, as discussed below, it is not proposed to abolish existing gambling taxes.

Table 10.3
Tax Rates on Gambling for Three Expenditure Bases (per cent)

	Gross expenditure	*Net expenditure*	*Gross expenditure less government revenue*
1980–81			
Racing	4	29	6
Lotteries	30	76	46
Poker machines	3	21	3
Casinos	na	na	3
Total gambling	5	34	6
1989–90			
Racing	5	41	6
Lotteries & soccer pools	32	80	46
Poker machines	3	25	3
Casinos	3	18	3
Total gambling	7	41	7
1995–96			
Racing	5	37	6
Lotteries & soccer pools	32	82	48
Poker machines	3	27	3
Casinos	3	20	3
Total gambling	4	34	5

Sources: Tasmanian Gaming Commission 1997; Johnson 1985.

Important vertical equity implications of the GST on gambling arise from a later amendment to the 1999 GST legislation. Under this amendment, which forgoes around $30 million p.a. of revenue, the regressivity of the GST and gambling taxation overall is increased by defining 'rebates' on losses by 'high roller' casino gamblers as 'winnings', and therefore outside the GST. More questionable is an associated amendment specifying that such rebates to high roller gamblers are not a 'consideration' for GST purposes, despite the casino paying such rebates to the gambler as a consideration for his custom.

A GST also raises the vertical equity issue of whether consumption tax policy should continue to distinguish between 'essentials' and 'luxuries' such as gambling. A uniform GST

[212]There is some evidence that disadvantaged groups or low income earners are deliberately targeted in location of gambling facilities (see Kaplan 1989; Rychlak 1992).

levied on net gambling expenditures would collect only a third of the revenues formerly obtained from gambling. There are considerable administrative and other difficulties of distinguishing luxuries from essentials, and vertical equity issues may usually be best dealt with through progressive income taxation rather than through the consumption tax system. However, if specific taxes on gambling were abolished, the lowering of gambling taxes under a revenue-neutral and uniform GST is in effect funded by higher taxes on what many would view as 'necessities', such as basic food items, which were not previously subject to sales tax.

As a tax on a discretionary expenditure, gambling taxes are often viewed as 'voluntary' and, therefore, fair and painless. Those viewing gambling tax as voluntary tend to discount its regressive effects. As J.S. Mill commented (quoted in Holloway 1973, p. 38), 'The indulgences of the poor are as fit subjects for taxation as the indulgences of the rich'. Reflecting a widely held view that essentials should face lower taxation than luxuries, Rubner (1966, pp. 64–5) comments:

> The rough justice involved in taking away in taxes the same proportion of stake money from rich and poor punters is surely a price worth paying for collecting efficiently the highly moral taxes on gambling.

However, the aggressive marketing of gambling to low income groups and heavy gamblers raises important economic, political and moral issues about gambling as 'voluntary' taxation. As noted earlier, a large share of gambling revenues comes from compulsive gamblers, and the marketing strategy is aimed at encouraging more usage among established players rather than at recruiting new ones (Clotfelter and Cook 1989). The view of gambling taxation as 'voluntary' is severely undermined where demand is created by intensive marketing aimed at the gullible or uneducated and where the consumer 'choices' are those of gambling 'addicts'.

Some argue the fairness of gambling taxation must account for how the revenues are spent, especially as many gambling taxes are 'earmarked' for or tied in some way to expenditures for worthy social purposes (Clotfelter and Cook 1989). This is known as its 'budget incidence' (Musgrave and Musgrave 1989). However, the consensus among economists is that earmarking gambling revenues does not generally increase overall funding for such programs.

Thus the main role of earmarking is not economic or financial, but political, allaying public disquiet about community coffers profiting from gambling, while neutralising opposition from socially concerned groups and creating a political constituency in favour of gambling. Although the public perceives that gambling revenues contribute importantly to social services, such as hospitals or education, earmarked revenues are usually only a minuscule proportion of total funding for such programs. It is also unlikely earmarked gambling taxes have provided significant additional funding for any particular public programs as earmarking does not prevent legislatures reshuffling government spending and revenues or raiding gambling revenue funds. Most studies also find the budget incidence of gambling taxation is regressive as the programs financed by gambling revenues benefit well off groups (for example, Livernois 1987a; Campbell and Ponting 1984).

Are gambling revenues economical?

> Unless there are strong reasons to believe that people are participating in lotteries against their own interests or that lottery operation creates strong externalities, lowering the take-out rate would increase net welfare. If on the other hand, lotteries as seen as a social evil, as they seem to have been in every State and province before 1964 — then a higher rate may be justified as a sumptuary tax. (Clotfelter and Cook 1987, p. 536)

In a conventional economic framework, welfare is improved the lower the tax rate, because higher taxes distort consumption and production decisions. The rapid expansion of State gambling tax revenues since the early 1990s is an element in increased State taxation which is said to imply a rising economic cost of taxation, because of the narrow and fractured State government tax bases (Albon 1997). However, as shown above, the surge in gambling

the project through such concessions. Similarly, net public revenues are reduced if there are significant public infrastructure costs of establishing and expanding a gambling operation, and this can be viewed as the public taking an unlisted financial stake in the industry.

If gambling taxes are viewed as taxes on a 'product' or commodity, and the fairness of taxation is not an issue, the efficiency implications depend on how high the tax rates are and how responsive consumer behaviour is to changes in the tax rate. Theoretically, revenue is most efficiently raised if the economic distortion ('marginal deadweight loss') from an additional dollar raised by the tax equals that raised from other taxes. This approach is known as 'Ramsey taxation'.

However, empirical research on the elasticity of gambling demand has provided little practical guidance along these lines for taxation policy and design (Reece 1984; NSW Tax Taskforce 1988a; Clotfelter and Cook 1989).[215] Estimating gambling demand elasticities is complicated by the extent to which different gambling products are substitutes.[216] There is also ambiguity about how to specify the 'price' of gambling, including whether taxes may apply to turnover or player losses.[217] Based on existing research on demand elasticities for gambling, Haig and Reece (1985) found Australian gambling tax rates approximated optimal (revenue maximising) tax rates based on existing knowledge.

As shown earlier, gambling taxation in 1995–96 averaged 34 per cent of gambling expenditure, or 51 per cent on an *ad valorem* basis[218] if expenditure (that is, player loss) is viewed as the 'price' of gambling. The highest taxed form of gambling was lotteries at 82 per cent, with the lowest rate applying to the net takings of casinos, taxed at an average of around 20 per cent, or 24 per cent *ad valorem*. Gaming machine takings were taxed at around 27 per cent and racing at around 37 per cent.

Most taxes on gambling are relatively low compared to rates for other excisable goods. Albon (1997) estimates *ad valorem* rates of taxation of 89 per cent on beer, 234 per cent on spirits, and 42 per cent on wine. Tobacco pays 212 per cent, while petrol and cars pay around 120 to 130 per cent. Gambling taxes are higher than sales tax, which generally applied at 22 per cent. Tax rates on gambling are also high compared to those on many other recreational expenditures or entertainment services: these attracted sales tax at low or zero rates.[219]

As evident in Table 10.4, a tax rate of 5 per cent implies an average efficiency cost (marginal deadweight loss) for gambling taxation of 8 cents in the dollar at an elasticity of -1.5. For an elasticity of -0.4. this falls to 2 cents in the dollar. The gambling tax rate in the mid 1990s, averaging 35 per cent of gambling expenditure, implied a marginal excess burden

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[215]Most gambling tax analysis assumes that gambling behaviour is relatively unresponsive to the level of taxation, making it an efficient source of revenue. The incidence of gambling taxes is also typically assumed to fall on gamblers (for example, see Rubner 1966) implying the supply of gambling services is highly flexible, and consumer demand relatively unresponsive to price.

[216]Existing studies of gambling demand elasticities usually focus on only one type of gambling, for example, racing or lotteries, and relate to the United States and are of limited usefulness because the cross price elasticities with other forms of gambling are not known. Early studies of demand for racing betting showed it to be relatively price responsive, with uncompensated elasticities of demand averaging around -1.5 per cent. However, without knowing how expenditures on racing relate to other gambling expenditures, or what the underlying elasticity is for gambling as a whole, it is difficult to draw a firm conclusion about the effect on government revenue of reducing the tax rate.

[217]In the following analysis, the tax base is taken to be gambling expenditure. Nevertheless, because the 'price' of gambling is unclear, so too is the theoretical tax 'base'. Most studies of determinants of gambling demand take the 'price' of gambling to be a function of the takeout rate, that is, of gambling expenditures. However, the theoretical tax base might be either gambling turnover or gambling expenditures, depending on what consumers are 'purchasing' when they gamble and the structure and level of payouts, that is, the odds of winning and concentration of prizes. For some gambling products the price may be better reflected by turnover, for others by gambling expenditures (player losses).

[218]Sales and excise taxes are usually expressed as a 'tax exclusive' or '*ad valorem*', basis. The *ad valorem* tax rate expresses the tax rate as a percentage of the net-of-tax-price, that is, the ratio of tax to 'net price kept by the seller' (Musgrave and Musgrave 1989, p. 250). This results in higher percentage tax rates than rates expressed as a percentage of the gross price paid by the consumer.

[219]With the introduction of GST from 1 July 2000, most services were taxed at 10 per cent. As discussed earlier in this chapter, tax rates on gambling after the GST depend on the policies of State governments.

ranging from 12 cents in the dollar for inelastic demand and up to 64 cents in the dollar if gambling demand were elastic.

As shown above, even low tax rates on gambling might have a high efficiency cost if gambling demand were very price sensitive.[220] However, most gambling revenues in Australia come from the lower-taxed gambling activities. Furthermore, the expansion of revenues has not come from rate rises but from expanding the tax base by lifting restrictions on gambling activity. That is, the resource allocative consequences of gambling taxation are less significant than the economic consequences of the policy-induced growth of the gambling industry.

Table 10.4
Economic Cost of Gambling Taxation:
Marginal excess burden for varying tax rates and price elasticities
(cents per dollar of revenue)

Tax Rate (%)	*Inelastic demand of –0.4*	*Elastic demand of –1.5*
5	2	8
22	8	37
35	12	64
42	13	80
48	15	95
51	16	103

Because of the complexity of applying differential rates of taxation to every commodity, and the scope for exercising political influence to levy discriminatory taxation, tax policy favours uniform commodity tax rates over 'Ramsey taxation' (Stigler 1988). Taking this approach, some argue tax rates on different forms of gambling should be similar in the interests of tax neutrality (Alchin 1983a). This argument is also extended to gambling tax rates vis-à-vis other recreation or leisure expenditures.

Replacing existing gambling revenues with a proportional tax on net expenditures would require a rate of taxation on gambling of around 34 per cent. This would increase the rates of taxation on casino and poker machine gambling and drastically reduce it on lotteries.

Considered in the context of a 10 per cent GST, a uniform tax on gambling net expenditures would raise just over $1 billion of revenue, $2.5 billion less than State government gambling receipts. A greater proportion of this revenue than at present would come from casino and gaming machine gambling and less from lotteries. The 1975 Asprey Report on Taxation recommended retaining specific taxes, such as those on alcohol, tobacco and gambling, if the Australian sales tax were replaced by a broad based valued added tax such as the GST (see Australia, Commonwealth Taxation Review Committee 1975).

The original 'A New Tax System' (ANTS) package envisaged an eventual reduction of around $500 to 600 million p.a. in the gambling taxes of State governments, with the lost revenues recouped by State governments through their receipts of GST revenues. The 1999 Agreement on Financial Relations between Australian governments states that the States will adjust their gambling tax arrangements to take account of the impact of the GST on gambling operators (Australia, Treasury 1999, Appendix B).

From the revenue viewpoint, the GST may thus represent a 'no-change' policy. How this adjustment is being made, and according to what principles, have not been publicly Stated,

[220]For example, Albon (1997) estimates that, at a 35 per cent gambling tax rate, an own price elasticity of demand for gambling of -0.4 implies a marginal deadweight loss at between 10 and 22 cents in the dollar. More elastic demand, at say -1.0, would raise the economic cost of gambling taxation to the high levels estimated for tobacco taxes (40 cents in the dollar).

but may have major implications for gambling policy and the effective tax burden on different parts of the gambling industry.

Taxes on sin and social costs

If society considers gambling a 'demerit' good to be discouraged in the interests of a wholesome society, gambling taxes may improve social welfare by reducing gambling activity. Similarly, if providing or participating in gambling results in significant adverse consequences for others, economic resources will be used for more desirable social purposes if these activities are taxed at higher rates reflecting the social costs of those 'externalities' (Musgrave and Musgrave 1989).

However, the pattern of Australian gambling taxes suggests ('sumptuary' taxation) objectives of reducing spending on gambling, or penalising the most socially harmful forms of gambling ('Pigovian' taxation), are not predominant in the design of gambling taxes (Chapman *et al.* 1997). The rates of taxation on gaming machines, agreed to be most addictive and producing the highest rates of problem gambling, are relatively low. Taxation of lotteries, generally seen as benign and less likely to generate social costs (but see below), is very high. While there are significant differences of emphasis between States, gambling tax policy in Australia appears to be directed more at revenue objectives than discouraging gambling or taxing most heavily the most addictive and socially harmful forms of gambling.

Taxation is also perhaps an overly blunt instrument for achieving the social goals of gambling policy. Regulation may be more effective at restricting gambling and limiting the harmful effects of problem gambling than higher tax rates. Because excessive gambling impacts on a gambler's family and friends, high gambling taxes may worsen financial difficulties for problem gamblers and add to the difficulties of children and spouses financially dependent on heavy gamblers. That is, prohibitively high rates or 'user pays' taxes on gambling may produce more gambling problems than they prevent.

Collection costs of gambling revenues

The final aspect of the 'economy' of gambling taxation is the collection cost. Gambling taxes typically cost more to collect than most other taxes, although how much so is a matter of debate. In New South Wales the Tax Task Force (1988a, pp. 91–2) found collection costs of gambling taxes were higher than for other State taxes at around 1–2 per cent of net revenue. Lottery revenues cost between 5 per cent and 13 per cent of net revenues to collect in the larger Australian States, but this exceeds 30 per cent in the smaller States. In Victoria, casino regulation costs represent around 10 per cent of State casino tax revenues (Chapman *et al.* 1997; ABS 1997). By comparison, Australian income tax administration costs around 1 per cent of revenues to collect, while sales tax costs just over 0.5 per cent (NSW Tax Taskforce 1988a).

However, State government tax systems are relatively narrow, so a reasonable benchmark for efficient State taxes is around 2 per cent of revenues (Victoria, Committee of Inquiry into Revenue Raising 1983). Furthermore, how gambling tax collection costs should be measured is controversial, depending on the perceived objective of gambling policy (Johnson 1976). Fundamentally at issue is whether to count the payment of prizes and the costs of regulating or running gambling enterprises as tax-collection costs.

Properly distinguishing regulatory costs may reduce the apparent high cost of collecting State gambling taxes. However, if the primary purpose of licensing gambling activities is to raise revenue, it is appropriate to include regulatory costs or operating costs of State-run gambling enterprises as tax collection costs.

Policy implications

Gambling revenues are a politically easy tax. Gambling taxation may also serve social objectives. Governments are usually closely involved in the gambling industry to limit the

harmful social impact. However, government involvement also benefits the industry because the potential market is enlarged by government validation of the integrity and honesty of gambling operations.

In recent times, however, State governments in Australia and in other federal systems have allowed substantial expansion of the industry in search of jobs, investment and revenue. A global trend to centralise revenues leaves sub-national governments with insufficient taxation avenues to respond to the demands of their citizens. Competing for gambling business with other States and jurisdictions, State governments have found their fiscal and political fortunes increasingly tied to the profitability of the gambling industry. This has created what many citizens have viewed as an excessively close relationship between the industry and the government regulator.

This in turn has led to an unbalanced government focus on economic and financial returns from expanding gambling. As competition between governments for gambling businesses has intensified, tax and other concessions have been granted to attract new gambling enterprises and new gambling customers. The expansion of previously prohibited forms of gambling, such as casino and poker machine gaming, has reduced the tax yield per gambling dollar. Because political sensitivities restrain aggressive marketing and promotion of gambling by public gambling enterprises, State governments increase potential gambling profits and bring forward future gambling revenues by selling off monopoly privileges to private operators.

Only recently has public policy focussed seriously on the longer term fiscal, economic and social consequences of deregulating and expanding the gambling industry, and governments' complicity in such trends. These newer and more addictive forms of gambling impose higher social costs; expanding the industry thus has 'diminishing fiscal returns'. It is also clear that gambling industry profits depend on encouraging heavy gambling, because so much of industry turnover comes from a small number of problem gamblers. Heavy promotion and advertising is a key element in maintaining the profitability of gambling enterprises.

Market saturation and the effects of the Asian downturn on the tourist market have reduced the viability of some gambling operations. Operators have turned to local gamblers for revenues, and a public backlash has emerged.

However, the close relations between the gambling industry and governments encourage pressures for public financial support and other concessions to preserve the profitability of gambling concerns. This can take the form of further tax or regulatory concessions, infrastructure subsidies, or release from those contractual obligations which operators find onerous.

When a government accedes to such requests to share gambling industry risks with gambling enterprise shareholders, it is not acting as a government regulator acts to protect gambling consumers, but as an unlisted equity shareholder. Regulations that protect consumers against advertising or other pressures to gambling may be weakened, but regulations that bestow economic privilege on the industry are typically not. The government 'integrity guarantee' which ensures a mass market for gambling is important in underwriting the value of the gambling industry.

The main policy implications of the above are thus:

- Meaningful reform of *Commonwealth–State finances* is needed to reduce the fiscal pressures to expand gambling activity. The Agreement between the State and Commonwealth governments on the introduction of the GST could provide such a framework, but it depends on a number of complexities regarding how the change is implemented.
- *Institutional reform* is also needed to give State government gambling regulators and policymakers greater independence from fiscal or gambling and tourist industry pressures to promote gambling.

- There is a need to *expose and review* the unjustified fiscal privileges of some gambling operators and to provide greater public transparency about financial arrangements between industry operators and governments.
- As problem gambling underpins the profitability of the industry, *self-regulation will be ineffective*. Taxation is also a defective instrument of gambling policy because of the regressivity of lottery and gaming machine taxes.
- Governments should be mindful that their scrutiny and regulation of operators help underpin the mass market for gambling. The costs of regulation to ensure probity should be met mainly by the industry on *the 'benefit' principle*.
- The regressivity of gambling taxation is exacerbated by *concessional tax treatment of 'high roller'* gamblers. Granting such concessions to ameliorate the effects on casino profits of the decline in overseas high roller gamblers draws government directly into sharing the risks and costs of promoting gambling industry activity. There is no evidence this policy generates significant offsetting economic benefits. A recent amendment to GST legislation entrenches the privileged tax status of 'high net worth' gamblers in the GST.
- *Restrictions on advertising and promotion* of gambling are a key element of effective public policy, because of the importance of 'children, madmen and fools' among gambling consumers. So too are other measures to *narrow the present wide accessibility* of gambling opportunities and to ensure the *gambling environment* does not stimulate overspending and impulsive as well as compulsive gambling.

Public concerns about government policies supporting gambling expansion led to the announcement in early 1998 of an inquiry into gambling by the Commonwealth Government's Productivity Commission. As a Commonwealth body inquiring into an area of State government responsibility, the Productivity Commission was asked only to provide an information report, 'to assist government decision-making', rather than to make policy recommendations.

Its report, brought down in late 1999 (Productivity Commission 1999), is a valuable compilation of information and analysis of the key social, economic and fiscal issues in gambling policy. The Productivity Commission commissioned extensive research, which validated many concerns raised in the public debate about excessive accessibility of gambling, especially of gaming machines, and the importance of problem gamblers to industry profitability. It also:

- found existing arrangements did not provide for informed choice by consumers;
- confirmed deficiencies in State government policymaking processes arising from the fiscal stake of governments in the industry;
- criticised 'exclusivity' arrangements and tax concessions favouring some operators; and
- concluded that the economic benefits of gambling and casino development in terms of jobs and investment were overplayed and largely offset by losses to other industries.

Unfortunately the lack of involvement of State governments in the process of establishing the Inquiry and the subsequent lack of formal recommendations mean the Commission's exhaustive investigations may have little practical effect on public policy. At worst, and despite its best efforts, the Inquiry may have simply diverted and dissipated public pressures for gambling policy reform.

The Howard Government's response to the Productivity Commission's 1999 Report was strong on rhetoric but lacked commitment to meaningful action. While it has only a limited constitutional jurisdiction over gambling policy, it is common for the Commonwealth government to express a strong commitment to public policy outcomes in areas outside its responsibility by attaching 'strings' to its grants and payments to States. For example, it does this to ensure compliance with National Competition Policy, and by conditions attached specific purpose or other payments steers States' policies on health or housing.

By contrast, there is no indication the government will use such fiscal coercion to influence the States' demonstrably flawed gambling policies. The Commonwealth has also showed little willingness to exercise strong leadership on national gambling policy in areas where it does have responsibility — for example, regulation of Internet gambling. This appears to confirm the observation at the time the Inquiry was appointed that governments typically appoint inquiries to quieten public criticism rather than remedy underlying problems (Smith 1998b).

The Productivity Commission Inquiry into gambling coincided with major changes to Australia's system of indirect taxation. While the GST may be revenue-neutral overall, the end result of 'adjustments' by State governments may have significant gambling policy implications. It is, therefore, a concern that the 1999 Agreement on the GST between Australian governments gives no weight to issues raised by the Productivity Commission Inquiry in respect of the community and the States' gambling policies, or to the desirable direction for changes to gambling policy and gambling taxation. Taking account of the Productivity Commission findings, for example, would see

- downward relative adjustments to taxation of lotteries; and
- upward adjustments in taxes on club gaming.

It would be desirable for this gambling tax 'adjustment' process to be more transparent and conducted according to sound policy principles, rather emerging from behind-the-scenes lobbying by gambling operators.

There was no indication from the Productivity Commission Report that maintaining the relative value of tax concessions for 'high roller' gamblers was justified by any significant economic or fiscal benefits. This applies equally to GST and State gambling tax concessions.

Conclusion

Adjustments of States' gambling taxes in response to implementation of the GST represents one last opportunity for Australian parliaments to stand back and make a balanced assessment of the costs and benefits of the expanded gambling revenues of the 1990s. Such assessment might well include gambling's demonstrated social, economic and fiscal costs, as well as the well publicised — but largely illusory — employment and investment benefits, and the highly visible profit to government and commercial stake-holders in the gambling industry.

Chapter 11
Public Health Financing and the Private Health Insurance Incentive Scheme*

Introduction

At various times in Australia's recent history, the Commonwealth government has used the tax system to support its public health policy goals. In July 1997, the Coalition Government introduced an income-tested tax rebate for private health insurance premiums. At the same time, middle and high-income individuals or families who chose to self-insure or rely on Medicare were penalised through a 1 per cent Medicare levy surcharge. Soon after, this income-tested rebate was scrapped in favour of a 30 per cent rebate on private health insurance from January 1999. This was similar in character to the rebate that has been in existence for around two years in the early 1980s, although unlike the earlier rebate, benefits can also be claimed directly through private health insurance funds, and the rebate is *ad valorem* not fixed in amount.

Like the tax rebate for private health insurance operating briefly in 1981–82 and 1982–83, the latest scheme is very costly to public revenue. When introduced, it was costed at $1.09 billion in 1999–2000 (the first full year of its operation), rising to $1.36 billion by 2002–2003. In 1999–2000, its actual cost according to the Australian Institute of Health and Welfare (AIHW) was $1.6 billion (AIHW 2001), and some estimate the cost could reach $2.4 billion a year (Segal 2000). With insurance coverage rising sharply to around 40 per of the population in June/July 2000, costs are likely to rise further.

At the end of a decade in which fiscal constraints produced unprecedented 'queuing' at public hospitals (Deeble 1999) and saw various public health programs abolished (Duckett and Agius 2000), who benefits from this public largesse warrants careful scrutiny.

Evidence from surveys suggests that those purchasing health insurance are likely to be earning high incomes (Schofield 1997; Wilson 1999). For example, in 1995, those with incomes above $50,000 a year were three times more likely to have private health insurance than those earning less than $20,000 (McAuley 1998). Around two-thirds of this high income group were private health fund members.

However, because of the limited data available on the income characteristics of the insured population, there has been no systematic analysis of how the benefit of tax concessions for private health-related expenses are distributed across income groups.

Taxation statistics, despite their limitations, are one way of assessing the likely distributional effects and implications of the Government's assistance policy for the private health insurance industry. Data on how tax concessions are distributed across income groups, and how much such concessions cost in lost revenue is available back to 1960–61. It can show both the pattern of and trends in how the benefits of tax concessions for health-related expenditures are distributed.

This paper examines health system funding in Australia and the efficacy and the equity implications of subsidizing private health related expenditures in order to inject new funds and produce savings for the public health system. As it is necessary to use taxation statistics and estimates of tax expenditures to assess the distributional consequences of the policy, the tax expenditure concept is explained, and some related issues reviewed. Summary estimates of the distribution of tax rebates and deductions, for the lower, middle and upper third of taxpayers by income group between 1960–61 and 1997–98 are then presented. The final section sets out the policy implications of the chapter's findings.

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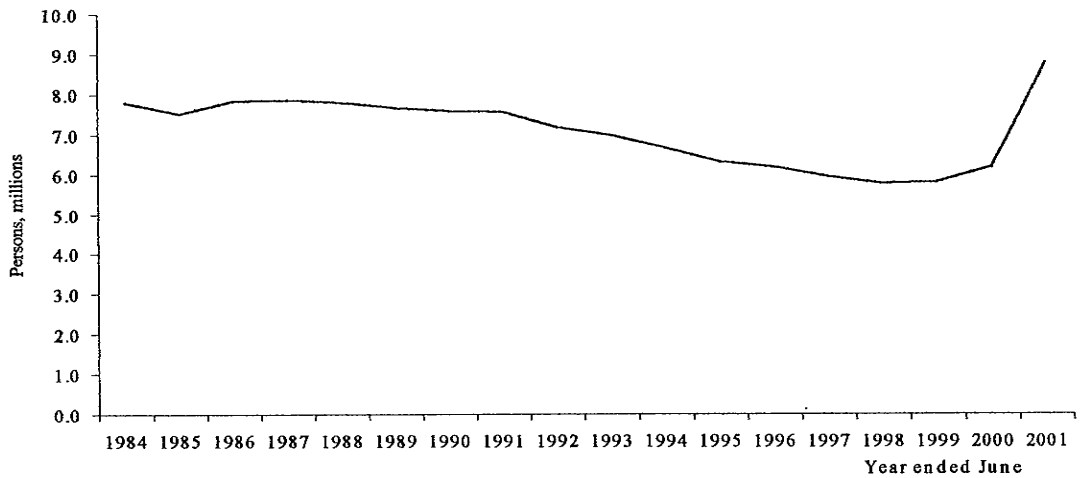
Private health insurance and public funding

A package of reforms to encourage private health fund membership was introduced by the Commonwealth Government in 1997. It purportedly aimed to increase the private funding of health care, reduce pressure on the public hospital system and increase consumer choice. The Australian Health Insurance Association told a Senate inquiry the rich would subsidise the poor as a result of the new incentive scheme for private health insurance, known as the Private Health Insurance Incentive Scheme (PHIIS), because the new system was about 'ensuring the rich add to health financing moneys' (Australian Health Insurance Association Australia, Parliament, Senate Community Affairs Legislation Committee 1998, p. 7).

There has been a steady decline in fund membership since the early 1990s, with a slight recovery when the PHIIS and the 30 per cent private health insurance rebate were introduced, and a strong rise from June/July 2000 associated with the deadline for the Life Time Health Cover Scheme (Figure 11.1). However, the available AIHW data (2001) show tax and other incentives for health fund membership has reduced rather than increase the private share of national health services funding because of the increased government contribution through tax concessions.

Figure 11.1
Private Health Insurance Coverage, 1984 to 2000



Source: Private Health Insurance Administration Council 2001.

Health spending in Australia has historically been funded by a combination of the Commonwealth, State/local, and non-government sectors. The non-government sector includes registered health benefits organisations and individuals but some funding comes from workers' compensation and motor vehicle third party insurers. Historical trends in sources of funds for health expenditures are presented and discussed in Butler (1998).

Tax expenditures played an important role in financing health care from the early 1960s to the mid 1970s (Butler and Smith 1992). This reflects the heavy reliance on tax deductions for medical expenses and private health insurance over the period 1960–61 to 1974–75. An implication of this is that health expenditure data that excluded tax expenditures understated the extent of public sector financing in health care prior to the introduction of Medibank. Furthermore, the growth in public sector financing due to the introduction of Medibank and later Medicare is overstated because, to a significant degree, the abolition of concessions for

health-related private expenditures helped offset the budgetary cost of introducing a public health insurance scheme.

This highlights the importance of a comprehensive framework for evaluating the source of funds for health care expenditures, a problem addressed from the early 1990s when the AIHW began producing annual estimates of health funding sources that adjusted for tax expenditures. Table 11.1 sets out figures derived from AIHW data showing tax expenditures as a share of total funding for health services, and as a share of Commonwealth health services expenditures from 1974–75 to 1999–2000.

It can be seen that in 1974–75, just before the introduction of Medibank, tax concessions for health-related private spending accounted for around 12 per cent of total health services funding and represented one-third of the Commonwealth's funding for health. Tax expenditures represented 4.6 per cent of health services funding before the introduction of Medicare in 1984 and fell to less than 1 per cent after the associated elimination of the tax rebate for private health insurance.

Table 11.1
Tax Expenditures[a] Share of Health Services Expenditures

Year ended June	*Taxation expenditures as per cent of total health services expenditures*	*Taxation expenditures as per cent of Commonwealth health services expenditures*
1975	11.8	28.1
1976	1.7	3.4
1983	4.6	14.4
1988	0.2	0.4
1989	0.2	0.4
1998	0.6	1.3
1999	0.6	1.4
2000	0.6	1.3

Note: [a]Excludes cash rebates for private health insurance paid by the HIC.

Sources: AIHW 2001; Butler and Smith 1992.

Despite the substantial growth in tax expenditures on private health insurance since 1997–98, tax expenditures have remained a small proportion, around 1.3 per cent, of Commonwealth health spending and less than 1 per cent of total health services expenditures. This reflects, in part, the growth in overall health services expenditures over the last decade. It is also because a large proportion of PHIIS expenditure and of the 30 per cent rebate for private health insurance premiums is paid out directly by the Health Insurance Commission (HIC) as a cash rebate and is, therefore, not recorded as a tax rebate.

For example, in 1999–2000, the HIC paid $1,414 million as direct subsidies for private insurance, alongside the $220 million paid that year through tax rebates. In 1997–98 and 1998–99, the corresponding amounts were $252 million and $782 million respectively (AIHW 2001).

If these payments of what may be characterized as 'refundable tax credits' are counted with tax expenditures, total tax expenditures rise to 3.3 per cent of total funding rather than 0.6 per cent in 1999–2000. Likewise private health insurance subsidies would account for nearly 7 per cent, rather than 1.3 per cent, of Commonwealth health care funding.

Looking at Table 11.2, it can be seen that the rising Commonwealth share of health services funding since the early 1970s is as much a reflection of the declining State government funding role than a result of declining non-government funding. In fact, the non-government share of health financing in the last decade is slightly higher than it was in 1974–75.

Despite the recent policy emphasis on increasing the financing role of the private health insurance funds, AIHW data show a fall in the non-government share of health services funding from 32.8 per cent to 28.6 per cent between 1996–97 and 1999–2000. More specifically, the share of health care financing costs borne by private health insurance funds has fallen to 7 per cent in 1999–2000 from around 10 to 12 per cent during the last two decades, and from 17 to 22 per cent during the period of the Fraser government (AIHW 2001).

Table 11.2
Source of Funds for Health Service Expenditures, Adjusted for Tax Expenditures

Year ended June	*Commonwealth health services expenditure, current prices*	*State/local*	*Government sector*	*Non-government sector*
1975	42.0	31.2	73.1	26.9
1976	50.7	22.6	73.3	26.7
1983	32.0	32.3	64.3	35.7
1988	38.2	32.0	70.2	29.8
1989	42.6	26.0	68.6	31.4
1998	45.4	23.9	69.3	30.7
1999	46.8	23.2	70.1	29.9
2000	48.0	23.3	71.4	28.6

Sources: AIHW 2001; Butler and Smith 1992.

Meanwhile, the 'out of pocket' contribution by individuals has risen to 16 per cent of total health funding in 1999–2000, a level that is, nevertheless, below the 33 per cent share of the financing burden carried by individuals during the 1960s before introduction of Medibank (Butler 1998). To the extent that these rising out of pocket medical expenses are reflected in increased taxpayer claims for the net medical expenses tax rebate, there are also further implications for Commonwealth budgetary costs.

Thus, it remains to be seen whether the recent rise in private health insurance coverage significantly changes the overall funding balance, but the evidence so far is for a reduced non-government contribution to health funding resulting from fiscal incentives for private health insurance.

Tax expenditures on health — the level and distribution

The previous section has outlined the place of tax concessions for health related expenditures in the overall financing system for health care services in Australia. Despite the significance of tax expenditures, no previous study has analysed their distribution across taxpayer income groups or considered the implications of long-term trends. Existing Australian Bureau of Statistics data on health insurance status and income is too sporadic and dated to provide a picture of long term trend or the impact of the PHIIS rebate. The following examines the level and distribution of tax expenditures on health related expenses for selected years from the 1960s to the present using data derived from taxation statistics.

Historical estimates of the value of tax expenditures

The policy of providing incentives for private health insurance through the tax system highlights the role of 'tax expenditures' as a mechanism for publicly subsidising privately financed health spending in Australia.

A tax expenditure is a departure from the generally accepted tax structure, which produces a favourable treatment of particular types of activities or taxpayers (OECD 1984). Proliferation of tax expenditures may undermine tax system integrity. Subsidies provided through tax concessions (such as for health insurance contributions and private medical expenditures) substitute for direct budget expenditures. Conventional tax expenditure analysis criticises the often poor design, budgetary control, transparency and accountability aspects of tax expenditures. The pattern of distribution of tax expenditures may be quite different from that of direct expenditures. Unlike direct subsidies, tax expenditures have traditionally been subject to little scrutiny. As the OECD (1996, p. 7) has pointed out:

> The concept of a tax expenditure was developed because accounting for the costs and benefits of tax measures is often less rigorous than for direct expenditures, despite the fact that a tax system can be used to achieve similar goals as those of public spending programmes. As governments increasingly broaden tax bases and lower tax rates, tax expenditure accounts have become an important tool in analyzing tax reform.

Tax expenditure reporting began in the late 1960s and was adopted in most industrialized countries during the 1980s (Organisation for Economic Co-operation and Development (OECD) 1996).

Since 1986, the Commonwealth Treasury has produced an annual set of estimates of tax expenditures of the Commonwealth Government, published as the *Tax Expenditures Statement*. From the late 1980s, the AIHW has provided official annual data on tax expenditures for health (AIHW 2000)[221] while Butler and Smith (1992) provide the main consistent estimates for tax expenditures on health in Australia for the years 1961–62 to 1988–89. All estimates are based on data from taxation statistics published annually by the Australian Taxation Office (ATO), derived from tax administrative processes (ATO, various years).

Some features of this data warrant mention.

- The (*de jure*) unit of income taxation in Australia is the individual, which is the unit presented in taxation statistics. However, the household is often the *de facto* tax unit and is the more usual unit for distributional analysis.
- The coverage of taxation statistics can also vary over time with changes in the tax structure and exemption levels. Taxation statistics exclude income earners who are not required to lodge income tax returns. This is unlikely to have implications for the present analysis because all individuals benefiting from tax rebates are included in taxation statistics. However, it does complicate comparisons of trends based on the distribution of household or family incomes.
- The estimates of the value of tax expenditures are based on data for 'taxable individuals' and thus exclude the value of rebates accruing to 'non-taxable' individuals. 'Non-taxable' individuals represent 5–6 per cent of the total taxpayers over the last two decades and account for a similar, stable proportion of the value of rebates allowed in 1982–83 and 1997–98. (Prior to that date, taxation statistics

[221] The AIHW attributes funding for health services expenditures to the income year in which the qualifying expenditure was made, while the *Tax Expenditures Statement* attributes the cost of tax expenditures to the year in which the Budget revenue cost was incurred. AIHW estimates for net medical expenses are more accurate, as they remove unrelated small rebates included in the *Tax Expenditures Statement*.

provide insufficient detail to assess effects of excluding non-taxable incomes.) Estimates based on data for taxable individuals could thus be expected to provide an accurate picture of trends for the total individual taxpayers for at least the last two decades.

- A significant number of high income earning individuals in the 1997–98 taxation statistics are recorded as receiving the income tested rebate that was in effect for the 1997–98 income year. Advice from the ATO is that threshold adjustments for taxpayers with several dependent children may allow access to the rebate by some high income taxpayers with large families. Later auditing may also alter the statistics as originally published.

Income tax concessions for health related expenditures have taken three major forms in Australia (Butler and Smith 1992):

- *deductions* from taxable income, allowed until 1974–75 for net spending on medical services and expenditure on health insurance taken out with registered medical benefit funds;
- tax relief allowed under the *general concessional rebate*, as occurred for 1975–76 and 1976–77, and the *concessional expenditure rebate* operating from 1977–78 to 1984–85;
- tax concessions provided by way of a universal or income tested *separate tax rebate*, such as the private health insurance rebate in 1981–82, 1982–83, and the private health insurance rebates from 1997–98 to the present.

The recently introduced exemption from the Medicare levy surcharge for private health insurance fund members represents the most recent type of major tax provision for private health insurance, although it was not initially reported as a tax expenditure (Australia, Treasury, *Tax Expenditures Statement*, 1999).[222]

Details of tax rebates and deductions applying to private health related expenditures since the early 1960s are set out in Table 11.3.

As can be seen, there have been important changes in the nature of public funding of health expenditures over the last four decades. A shift from deductions to concessional rebates and abolition of tax concessions for private health insurance was associated with tax reforms during the early 1970s and with the introduction of Medibank in 1975. Likewise, the changes during the 1980s were associated with introduction of Medicare in 1984 and with reforms to income tax concessions from 1985.

Table 11.4 presents estimates of the value of tax expenditures on health for the period 1980-81 to 2002-03. All estimates are derived from taxation statistics.

The recent shift towards funding health expenditures through tax subsidies is evident in the rising trend in tax expenditures for health related spending since 1997–98. This was associated with changes in health care financing policies introduced in 1997 following the Industry Commission (IC) inquiry into private health insurance (Industry Commission 1997).

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[222] The appropriate treatment of the Medicare levy surcharge arrangements in the *Tax Expenditures Statement* remains contentious; while the surcharge might be viewed as a 'tax penalty', an alternative view is that the surcharge exemption should be reported as a tax relief for certain taxpayers and, hence, as a 'tax subsidy' (Smith 2001). Treating the arrangements as a tax relief for taxpayers with private hospital insurance, who are exempted from the additional Medicare levy, the revenue forgone would be up to around $750 million on 1997–98 statistics (Smith 2001). Viewed on the other hand as a 'tax penalty' the arrangements are a 'negative' tax expenditure, yielding revenue of $105 million for the 1997–98 income year (Australia, Treasury, *Tax Expenditures Statement*, 2001).

Table 11.3
Tax Concessions for Health-Related Expenditures, 1961 to 2001

Year	*Medical expenses*	*Health fund contributions*
1960–61	Deductible to limit of $150	Fully deductible
1963–64 to 1974–75	Fully deductible	Fully deductible
1975–76	General rebate of $540 plus 40 cents in the dollar for eligible expenditure above $1350	As for medical expenses
1976–77	General rebate of $610 plus 40 cents in the dollar for eligible expenditure above $1525	Not allowable after October 1976
1977–78	Concessional expenditure rebate at 32 cents in the dollar for eligible expenditure in excess of $1590	Not allowable
1978–79	Concessional expenditure rebate at 33.5 cents in the dollar for eligible expenditure in excess of $1590	Not allowable
1979–80	Concessional expenditure rebate at 33.07 cents in the dollar for eligible expenditure in excess of $1590	Not allowable
1980–81	Concessional expenditure rebate at 32 cents in the dollar for eligible expenditure in excess of $1590	Not allowable
1981–82	Concessional expenditure rebate at 32 cents in the dollar for eligible expenditure in excess of $1590	Separate rebate at 32 cents in the dollar of eligible expenditure for basic hospital and/or medical insurance only
1982–83	Concessional expenditure rebate at 30.67 cents in the dollar for eligible expenditure in excess of $1590	Separate rebate at 30.67 cents in the dollar of eligible expenditure for basic hospital and/or medical insurance only
1983–84 and 1984–85	Concessional expenditure rebate at 30 cents in the dollar for eligible expenditure in excess of $2000	Not allowable
1985–86	Net medical expenses rebate at 30 cents in the dollar for eligible expenditure in excess of $1000	Not allowable
1986–87 and 1987–88	Net medical expenses rebate at 29.42 cents in the dollar for eligible expenditure in excess of $1000	Not allowable
1988–89	Net medical expenses rebate at 29 cents in the dollar for eligible expenditure in excess of $1000	Not allowable
1989–90 to 1996–97	Net medical expenses rebate at 29 cents in the dollar for eligible expenditure in excess of $1000	Not allowable
1997–98	Net medical expenses rebate at 20 cents in the dollar for eligible expenditure in excess of $1250	From July 1997, income–tested rebate of up to $150 ($250 for a couple; $450 with dependent child). Medicare levy surcharge exemption for private hospital fund members
1998–99 and onwards	Net medical expenses rebate at 20 cents in the dollar for eligible expenditure in excess of $1250	From January 1999, 30 per cent rebate for private health insurance. Medicare levy surcharge exemption as above

Sources: AIHW 2000; Butler and Smith 1992.

Table 11.4
Tax Expenditures on Health, 1980–81 to 2002–2003
($,000, current prices)

Year ended June	Net medical	Health insurance	Total
1981	17,211		17,211
1982	21,107	455,479	476,586
1983	25,350	548,264	573,614
1984	16,747		16,747
1985	19,660		19,660
1986	22,875		22,875
1987	33,878		33,878
1988	37,000		37,000
1989	47,000		47,000
1990	61,000		61,000
1991	85,000		85,000
1992	82,000		82,000
1993	91,000		91,000
1994	95,000		95,000
1995	91,000		91,000
1996	105,000		105,000
1997	125,000		125,000
1998	130,000	160,000	290,000
1999	145,000	180,000	325,000
1900	125,000	220,000	345,000
2001[f]	150,000	310,000	460,000
2002[f]	160,000	320,000	480,000
2003[f]	165,000	330,000	495,000

Note: [f] Treasury forecasts (Australia, Treasury, *Tax Expenditures Statement*, 2001). These forecasts relate to the year in which the claim is assumed to affect the Budget, that is, to the year after the income year for which the tax rebate claim is made. The AIHW (2001) attributes tax expenditures to the same year for which the claim is made, as does the ATO in its *Taxation Statistics* (ATO 2000) and Butler and Smith (1992). In this table, the estimates are attributed to years on the same basis as for Butler and Smith, AIHW, and the ATO; Treasury estimates and forecasts are, therefore, attributed to the year prior to that in which they are reported in the *Tax Expenditures Statement*.

Sources: For 1980–81 to 1988–89, Butler and Smith (1992, p. 49); for 1990–91 to 1999–2000, AIHW, 2001, Table 13); for 2000–01 to 2002–2003, Australia, Treasury (*Tax Expenditures Statement*, 2001, Table 5.1).

A number of conceptual and measurement issues arise in the estimation and interpretation of the fiscal cost of tax expenditures. For example, one problem is identifying what a tax expenditure is as distinct from a part of the benchmark tax structure.[223] The norm, or benchmark, may differ between countries and over time.[224]

There are also various approaches to measuring tax expenditures:

- the 'revenue gain';

[223] The main conceptual issues arising in estimating tax expenditures are discussed more fully in Butler and Smith (1992).

[224] Such differences in the benchmark for measuring tax expenditures include: how the tax base and tax-paying unit is defined; whether it is adjusted for inflation; what degree of integration between corporate and individual taxation is considered desirable; which accounting period is appropriate; whether a realisation or accruals basis is used for assessment; and how tax penalties and negative tax expenditures are assessed. The benchmark adopted by the Commonwealth Treasury for estimating Australia income tax expenditures is discussed in detail in Appendix A to its annual Tax Expenditure Statement (Australia, Treasury, *Tax Expenditures Statement*, 1999).

- the 'outlay equivalent'; and
- the 'revenue forgone' approach.

These approaches reflect different assumptions about taxpayer behaviour and the scope of the estimates rather than differences in the underlying concept of what is being measured (Butler and Smith 1992). Estimates using the revenue gain approach conventionally incorporate the effects of price and behavioural changes due to the tax concession, whereas those using the revenue forgone approach do not.[225] Most studies of tax expenditures in Australia use the 'revenue forgone' approach. For example, this is the approach taken in the historical series produced by Butler and Smith (1992) and used for the Commonwealth Treasury's *Tax Expenditures Statement*.

Another issue is how to determine the actual beneficiary of a tax expenditure. The reduction in tax liability accrues in the first instance to consumers of the subsidised commodity. However, the ultimate economic incidence of tax concessions will depend on the elasticities of supply and demand for the tax-preferred commodities. For example, while the legal beneficiary of the health insurance rebate is the individual taxpayer or fund member, the Government has promoted the health insurance rebate on the basis of helping the health insurance industry and organisations. Where the package of financial incentives for private health insurance is passed on as higher premiums, the economic benefit is effectively captured by the funds and/or health service providers rather than fund members. While recognising that the question of who finally bears the tax burden (or tax relief) may be unresolved, the OECD observes that this problem arises similarly in allocating direct subsidies. Most OECD countries allocate tax expenditures 'by allocating subsidies to the taxpayer who immediately and directly benefits from them' (OECD 1984, p. 22).

This question of incidence is also relevant to the issue of fiscal targeting. Effectiveness or efficiency in meeting public policy goals is often more difficult to evaluate for a tax expenditure than for a direct grant or subsidy because the objective is less clear. Because tax expenditure programs are typically subject to less public scrutiny and fewer evaluation processes than Budget appropriations, distribution of their benefits is also less transparent. Tax deductions and rebates are often of least benefit to those on low incomes, producing an 'upside-down' distributional effect (Surrey and McDaniel 1985).[226] Whether this is a useful design feature of a tax concession, for example designed as an incentive to target the more price-elastic behaviour of high income earners, is contentious (Steinberg 1997). The regressive incidence of tax expenditures may simply reflect the exercise of political influence or ideology with little regard to efficiency in the use of public resources (Chesterman 1999; Surrey and McDaniel 1985).

Bearing in mind such issues and caveats about taxation statistics, the distribution of tax expenditures across taxpayer income groups for 1997–98 is set out in Table 11.7, with a detailed breakdown for net medical expenses and private health insurance in Tables 11.5 and 11.6.

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[225] Such estimates gauge the magnitude of tax expenditures arising from a particular tax concession by reference only to the market for the particular commodity or activity in isolation. That is, they use what economists call a 'partial equilibrium' framework, which assumes a zero 'cross price elasticity of demand' between a commodity (such as private health insurance) and any other commodity (such as net medical expenses). It also ignores any product/factor market interactions or macro-economic implications. This means, for example, that if a tax concession makes private health insurance cheaper, and this significantly affects taxpayers' claims for net medical expenses, the total revenue cost of the concession may be either over- or under-stated. Also, adding together the cost of various tax expenditures, such as for net medical rebates and private health insurance, may result in inaccurate totals.

[226] This is especially so for tax deductions because the value of the concession is greater to taxpayers facing higher marginal tax rate.

Table 11.5
Distribution of Tax Expenditures on Health: Net Medical Expenses

Year ended June	*Lowest third*	*Middle third*	*Highest third*
1963	7	28	66
1971	8	27	66
1975	7	29	64
1983	na	na	na
1989	20	24	56
1997	18	27	55
1998	17	27	56
1999	17	27	56

Source: Derived from ATO, various years.

Table 11.6
Distribution of Tax Expenditures on Health: Contributions to Health Insurance Funds

Year ended June	*Lowest third*	*Middle third*	*Highest third*
1963	*6*	*29*	*66*
1971	7	28	65
1975	7	30	63
1983	18	33	48
1989	0	0	0
1997	0	0	0
1998	18	36	46
1999	12	27	61

Source: See Table 11.5.

Table 11.7
Distribution Of Tax Expenditures on Health: Total

Year ended June	*Lowest third*	*Middle third*	*Highest third*
1963	6	28	66
1971	7	27	66
1975	7	29	64
1983	18	33	48
1989	20	24	56
1997	18	27	55
1998	18	32	50
1999	14	27	59

Source: See Table 11.5.

It can be seen that the distribution of tax concessions for private health related spending of individuals is heavily skewed towards those with taxable incomes at the top end of the income distribution. More than half of the value of tax expenditures on health-related private spending benefits those with the highest third of taxable incomes. The share of the top third of the income distribution has increased since the early 1980s, after shrinking in the 1970s.

The combined effect of the tax rebate for net medical expenses and the private health insurance tax rebate was to provide those with annual taxable incomes above $35,000 with tax subsidies of at least $146 million in 1997–98 and $192 in 1998–99 (Table 11.4 and Table 11.7).

For most of the period, the distributional patterns are similar for net medical expenses and private health insurance (Tables 11.5 and 11.6):

- However, in 1997–98 means testing of the PHIIS rebate meant it was less regressively distributed than net medical expenses, while the move to the 30 per cent rebate reversed this in 1998–99.
- A minimum $74 million (46 per cent) of the $160 million PHIIS tax rebate for private health insurance premiums for 1997–98 went to around 250,000 individuals in the top third of the income distribution, with taxable incomes exceeding $35,000 per annum.
- Around 56 per cent of the value of the rebate for net medical expenses accrued to the highest income third.

Just 18 per cent of the value of tax expenditures ($29 million) subsidised the private health fund membership of the bottom third taxable income group in 1997–98 (Table 11.6). These individuals had taxable incomes of less than around $20,000 per annum. In 1998–99, when the 30 per cent rebate was in operation for 6 months of the income year, this proportion fell to 12 per cent.

These estimates exclude the $252 million rebate paid directly through health funds in the 1997–98 income year ($782 million in the 1998–99 income year) and do not reflect the cost impact of the rise in fund membership from June/July 2000. It is not clear to what extent higher income earners are over-represented and lower income earners under-represented in the taxation statistics. However, these direct payments through the HIC would also disproportionately benefit high income earners, and tax statistics provide some indication of the income distributive effects of the financial incentives for private health insurance introduced from 1997.[227] With current estimates of the total subsidy from the rebate for private health insurance ranging up to $2.4 billion (Segal 2000), tax rebate statistics suggest that at least $1.5 billion might accrue to those in the top third of taxable incomes.

Based on recent AIHW data, at least a quarter, that is, $280 million, of this subsidy for private health insurance by the top third of taxpayers will be directed to providing ancillary insurance (covering mainly dental, optometrist and allied health services) (AIHW 2001, Figure 7).

Estimates based on both the 1997–98 and 1998–99 income year tax statistics considerably understate the proportion of the current private health insurance rebate claimed by high income earners because the income-test was abolished in January 1999. The new rebate is also *ad valorem*, or open ended, rather than fixed in amount (see Table 11.1). The share of tax subsidies for private health insurance accruing to the top third of the taxpayer income distribution in 1998–99 was 61 per cent; this will increase in 1999–2000 to around 70 per cent based on disaggregation of the 1998–99 data.

Also noteworthy in Tables 11.5 to 11.7 is that the tax deductions in the 1960s and early 1970s were generally more skewed in favour of higher income groups than the tax rebates

[227] Lower income earners may have a higher representation among those receiving the cash rebate through the HIC and health funds than among those receiving the rebate through the tax system. If this were the case, the estimates of the distribution of the tax rebate for private health insurance will be more skewed towards higher income earners than the cash rebate.

allowed for health insurance and net medical expenses in the 1980s and early 1990s. For example, in 1982–83, around $263 million of the value of the tax rebate for private health insurance premiums (48 per cent) were paid annually to taxpayers with the top third of taxable incomes, compared to around 63 to 66 per cent during the 1960s and early 1970s. This is because deductions were of greatest value to those with the highest marginal tax rates and, during those decades, marginal income tax rates were around 66 per cent for high income earners. However, the effect of a half-year of the 30 per cent rebate in 1998–99 was to bring the tax expenditure share of the top third of the income distribution to similar levels as in the period of tax deductibility before Medibank was introduced in 1976.

Conclusion and policy implications

The use of the tax system since 1997–98 to provide subsidies for private health insurance undermines the progressivity and effectiveness of the national health care financing system. The private health insurance industry now receives more budgetary assistance than provided to the mining, manufacturing and primary agricultural production industries combined (Duckett and Jackson 2000). Despite its cost and its regressivity, studies have shown the subsidy has had only minimal effect on increasing private health financing. The effect of this industry assistance scheme on the efficient allocation of resources requires urgent and broad ranging review. Furthermore, there appear to be no significant benefits in designing a scheme which is not income tested as a tax concession, but there are potential costs to tax system integrity because of potential adverse effects of increased tax system complexity and inequity on taxpayer compliance and effective tax administration.

One of the basic strengths of Australia's public health system is that universal access to free public hospitals and cover against specified medical costs has been financed substantially through progressive taxation. The present extent of public assistance to the health insurance industry including through tax concessions significantly distorts this progressive pattern of health care financing in Australia because it has an 'upside-down' distributional effect. The current financial incentives for private health insurance cost $1.6 billion in 1999–2000, and may exceed $3 billion per annum, extrapolating from Treasury forecasts of the private health insurance rebates claimed through the tax system.

This chapter, based on taxation statistics, shows that tax concessions for health are increasingly heavily skewed towards the affluent. For 1997–98, when the rebate for private health insurance was subject to a means test;

- around a half of the value of tax concessions for private health insurance went to the most well off third of taxpayers; and
- less than a fifth of these concessions went to the third of individuals in the lowest taxable income group.

According to taxation statistics, the income tested PHIIS rebate for health insurance was at least as regressive as the universal rebate existing in the early 1980s.

The removal of the income test in January 1999 makes the current rebate even more inequitable. It is likely that well over a billion dollars of public money is underwriting the health care of Australia's richest individuals and families. Furthermore, around a quarter of the tax subsidy is directed to ancillary rather than to hospital insurance.

This skewed distribution of financial incentives for private health insurance contrasts sharply with the progressive distribution of direct public spending on health, for which there is a wide range of evidence (Harding 2000; Schofield 1998; Withers, Throsby and Johnston 1994).

Furthermore, it can be argued that assistance for private health insurance through the tax system has been severely understated, with an additional expenditure on account of the Medicare levy surcharge arrangements of up to $750 million (Smith 2001). There is also a possibility that the cost of the tax rebate for net medical expenses may expand along with increased private health insurance coverage.

One rationale put forward for the present policy of encouraging high income earners to take out private health insurance is that they can afford to pay more for health care. Yet far from being a 'Robin Hood' policy, tax incentives for private health insurance erode the progressivity of taxation. Exempting the insured from the Medicare penalty and subsidising their insurance premiums effectively absolves high income earners, most of whom are insured, from contributing appropriately to the community's health care costs. A more effective and equitable way to increase the contribution of the rich to health care costs would be to abolish the exemption from the Medicare levy surcharge and channel the revenues into the public health system.

Another argument for the substantial public subsidy of private health insurance is that it is unfair for the insured to pay twice for their hospitalisation (Richardson 1998). Some consider that those able to afford it should use private health insurance, and it has been argued that expanded private health insurance permits better targeting of public health funds to those in need because of the additional private funds injected into the system (IC 1997; Owens 1998).

However, this view of 'equity', which is akin to the argument that those choosing private education for their children should receive a public subsidy equal to any cost savings to the public system, reflects a view of the role of the state that is based on the nineteenth century 'charity' law model for provision of health, welfare and education services and is contrary to the underlying principles of the modern welfare state (Chesterman 1999). It also assumes that private health insurance fund membership does produce substantial and measurable public cost savings when this is not at all clear from available evidence.

The criticisms of the equity implications of the PHIIS scheme would have less force if it operated as an effective incentive for private financing of health care. However, on available statistics, subsidising private health insurance has little, if any benefit in the form of increasing non-government funds for health services. While encouraging private health insurance membership is said to take pressure off public hospitals, there is compelling evidence that the cost of the private health insurance rebate far exceeds any financial gains to public hospitals (Segal 2000). Shifting demand to the private hospital sector would save less than $1.3 billion annually, ignoring continued use of public hospitals by the privately insured. The research by Segal confirms previous work, that concluded that the private health insurance rebate is a very inefficient way of meeting the demand for hospital services (Duckett and Jackson 2000). Furthermore, the scheme is ineffective and wasteful as an incentive to private health insurance fund membership. Recent research shows demand for health insurance is relatively unresponsive to price (Butler 2000) at around -0.5 per cent, while demand for ancillary cover is even less price elastic. Most of the increase in membership of health fund since mid 2000 can be attributed to the Lifetime Cover scheme (Butler 2001).

With budget constraints on Commonwealth funding for health care, subsidies for private health insurance will tend to displace other public health funding priorities. With the financial incentives for private insurance now accounting for around 7 per cent of Commonwealth health funding, Commonwealth subsidies for private insurance are likely to be at the expense of additional funding for Medicare. Each year, the private health insurance rebate alone is drawing some $2 billion of government funding away from public health care provision and the Medicare benefit payment for private in-hospital medical services adds at least $0.9 billion annually to this subsidy to the private system (Duckett and Jackson 2000).

Public sector cutbacks over the last decade have produced queues in public hospitals (Deeble 1999) and the axing of public dental care services such as the Commonwealth Dental Health Program (Duckett and Agius 2000). Yet, through the rebate for private health insurance, the Commonwealth government now provides a large public subsidy for high income earners to jump hospital queues, obtain dental care and pay for their gym club membership. For example, through the 30 per cent rebate for ancillary insurance, the Commonwealth is now spending around $180 million per annum funding dental services mainly for the affluent (Duckett and Agius 2000).

income tax collection costs are around 1 per cent of revenues (New South Wales Tax Task Force 1988a).

- Most of the rebate is also paid to those with existing private health insurance rather than to new members. For example, if 60 per cent of high income earners are already health fund members, even a 20 per cent increase in membership due to the rebate still means around four-fifths of the subsidy is a windfall to those who are already members (Richardson 1998).

Current financial incentives for middle and high income earners to take out private health insurance and abandon Medicare are thus a drain on the public purse as well as a threat the progressive principle underpinning Australia's public health care financing system.

The private health insurance rebate should be abolished, particularly for ancillary insurance. By doing so, at least $2 billion of additional funding could be earmarked for improving access to medically necessary hospital services, public dental and allied health programs.

The Medicare levy surcharge is an untapped opportunity for expanding a progressive funding base for health care. Extending the Medicare levy surcharge to all high income earners would substantially expand available revenue systems for public health care and would at the same time enhance the progressivity of health care financing.

Existing incentives for private health insurance lack transparency about the extent and beneficiaries of public support for private health insurance. With both the Tax Office and the Health Insurance Commission administering the scheme, structuring the incentive as a tax measure has increased the scope for fraud and administrative duplication, without clear justification in terms of reducing the costs of administration and assessment of eligibility. Restructuring the PHIIS scheme as a public spending program rather than a tax measure would enhance transparency and accountability of the Government, and encourage its systematic evaluation against the usual criteria of public policy. It may also reduce the potential threat to tax system integrity posed by a tax provision which is unrelated to revenue raising objectives, which appears to be highly regressive, and which complicates tax administration and compliance without any clear rationale for it being an element of the income tax system.

The Commonwealth Government has repeatedly affirmed its stated commitment to Medicare. However, its actions in support of the private health insurance industry belie that claim. While its objective is stated to be to preserve 'choice' for health consumers, the Commonwealth Government has effectively removed the option for middle and high income earners to commit to the public health care system. It is indirectly subsidising though private health insurance markets many services not funded under Medicare or public programs and has removed community-rating requirements for private health funds premiums from September 1999. The Commonwealth has thus moved decisively away from the model put forward as providing wide and uniform access to private health care as an alternative choice to public provision (Owens 1998).

This will have profound long-term consequences. Medicare and public hospital care will increasingly become the preserve of the poor, akin to the manifestly inadequate United States' Medicaid system for that country's welfare recipients. It also opens the way for advocating the United States' system of employment-based health insurance, which is costly, provides patchy coverage and is unfair to many ineligible unpaid, low paid and casual workers. Furthermore, the Australian public will massively subsidise the private health insurance industry.

This policy is contrary to both the defensible models for government policy regarding the Australian health insurance industry (see Owens 1998). It amounts to a 'privatisation' of the most profitable part of the private health care financing 'market', accompanied by an expanded public subsidy underwriting the profitability of an increasingly 'deregulated' private health insurance industry. Such a trend, evident in other countries and other sectors, has profound implications for the future role of the public sector in its relations with corporations and private markets in health, education and welfare (Whitfield 2001).

The evidence in this study of tax concessions for private health related spending shows there is a need for renewed public debate on 'choice' in Australian public health financing: on whether we should resource and improve an equitable and cost-restraining public health care system with its single national insurer through a progressive financing arrangement, *or* whether we should exploit the coercive powers of the public revenue system to support a wasteful and heavily subsidised private insurance system for financing health care that has been abandoned in nearly every developed country because of its rising costs and gross inequity.

Chapter 12
Land Value Taxation: An Admirer's Critique of 'The Perfect Tax'*

Introduction

Land value taxation is an attractive revenue-raising tool. However, its rationality is its defect. The paramount rule of taxation is 'plucking the goose so as to obtain the largest amount of feathers with the least amount of hissing' (Jean Baptiste Colbert, 1619–83, quoted in James 1981, p. 176). Taxing unearned increments in land values threatens Australia's most powerful interest groups, offending this primary rule. History demonstrates Australia's governments lack the qualities needed to sustain land value taxation against attack by vested interests.

'Tax Reform: a Rational Solution' (Day *et al.* 1996) proposed a 'community charge' of 100 per cent on land rental values to reduce income taxes, as an alternative to the Goods and Services Tax (GST). The authors consider this 'logically and morally unassailable' (p. 8). The only barrier is cultural: 'private appropriation of land values has been taken for granted and institutionalised' (p. 10). As 'recouping the whole of the annual rental value would reduce the price [of land] to zero' (p. 10), they propose introducing the charge gradually. With compensation for unconscionable equity effects, the system would be 'transparent, simple and cost effective, equitable, efficient, and incapable of avoidance' (p. 8). It would also 'provide free market economics with a universally applicable moral base' (p. 10–11), by distinguishing between land and commodities and services, which are the fruits of human labour.

Here it is argued that the advantages of the supposedly perfectal revenue instrument contribute to its political vulnerability. Another rule of taxation is 'the only good tax is an old tax'. A 'good' tax — which raises revenue — is the one left after the most powerful groups in society have had their say. In our imperfect world, democratic political institutions are flawed and mobile capital exercises significant economic power. The inevitable, if unethical and irrational, consequence is that tax burdens are shifted onto labour. Taxes on unearned increments in land values never become old and 'good', because powerful landholder opposition nobbles them, if not at conception, then soon after birth.

Are governments moral and rational?

'Tax Reform' presumes government revenue raising policy is motivated by ethics, to achieve rational, stated objectives.

Although taxation policy is a 'values-added' issue, prevailing political ideologies discount social or ethical concerns and governments defer to values generated and revealed in 'The Market' by those with economic influence.

Public debate is carried on using objective terms such as achieving efficient, equitable, simple, easy to enforce and comply with, and transparent taxes. However, governments do not make policy by rational consideration of all relevant issues; economic policy is 'the science of muddling through' (Lindblom 1959). In the historical 'March of Folly' — 'the persistent pursuit by governments of policies contrary to their own interests' — neither logic nor morality have predominated (Tuchman 1984, p. 2).

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* In 1998, an earlier version of Chapter 12 was joint winner of Land Values Research Group Prize for Tax Reform Challenge Competition, the judging panel chaired by Emeritus Professor R. L Mathews. It was published in 1999 as 'Australian land value taxation', *Centre for Economic Policy Research Discussion Paper,* no. 415, Australian National University, Canberra.

Governments' stated objectives are rarely their real ones. Their real tax objectives are identified by Colbert quoted above — minimising hissing, while plucking maximum revenue from the goose.

On traditional public finance criteria, appropriating unearned increments in land values is an exemplary source of revenue. The merits of land value taxation have been known for a long time and are widely accepted. Over a century ago, reformers argued compellingly for public appropriation of the unearned increment in land (Brennan 1971). Modern town planning has strengthened the original rationale.

> Recent international discussions have served to underline the widespread conviction that these surplus values should accrue to the public, since they are produced mainly by public or community efforts and are unearned by the private holders (Dunkerley 1983, p. 23).

Yet, governments have largely ignored the revenue potential of land value taxation. Indeed, successive governments have eroded or abolished existing levies of this kind at every opportunity.

What really drives tax policy?

Tax policy is about raising revenue. As governments seek revenue, the privileged and powerful try shifting the tax burden by threatening to take their capital, and sometimes their labour, elsewhere.

A 'global economy' and capital mobility challenges governments' ability to tax according to ability to pay, indeed, to tax capital[228] at all. The tax burden is shifting from capital, which is more mobile, to labour, which is much less mobile (Graetz 1985). Meanwhile, governments' increasing revenue needs are said to foreshadow a fiscal crisis of the State (O'Connor 1973).

Immobile factors — labour and land — must ultimately bear the burden of all taxation as globalisation bypasses national revenue systems (Courchene 1993). For two decades, Australian governments have seen a goods and services tax (GST) as a panacea for their taxing problems. Worshipping mythical advantages of taxing labour income when spent, rather than taxing it when earned, they have left taxes on land, that other immobile factor, to languish or wither away.

Do governments have the integrity to sustain ethical and rational revenue policies?

Changing economic conditions make levies on land rental values vulnerable to erosion by vested interests groups.

Public appropriation of development rights, the major element in the value of land, is politically difficult. It also requires very large, high-level administrative skills beyond the current capability of many governments. Since urban land is so valuable, and particular locations command semi-monopolistic prices, public efforts to capture full land rental values are compromised by corruption and favouritism (Doeble 1983). Indeed, early Australian land policy was

> a dispiriting story of the lack of foresight, faulty legislation, poor administration, political corruption, dishonest practices, moral cowardice and human greed (Brennan 1971, p. 16).

The influence and capabilities of democratic political institutions such as those in Australia are crumbling under the force of vested corporate interests and the increasing

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[228]Some skilled labour is also highly mobile.

integration of the world economy. Modern governments cannot cope effectively with the problems our society confronts because:

- governments are unresponsive to the needs of disadvantaged groups, yet responsive to the demands of strong private interests which they helped entrench;
- political parties are powerless to resist pluralist and corporatist influences;
- distinctive public interests are not articulated or are applied by ineffective or irresponsible bureaucracies beholden to powerful interests (Hutton 1995; Saul 1997; Self 1985).

One can only conclude that even if the rational and ethical community charge proposed by Day *et al.* (1996) were introduced, governments do not have the integrity and sophistication to maintain it.

Previous Australian experience

Weakened by its assumptions in conception, the 'perfect tax' could also be flawed in execution. The 'community charge' invites political attack and erosion because in practice it may generate inequity, economic damage and other problems. Its revenue yield might be minimal.

The unearned increment in land values comprises several elements. The most important are: 'development gains', due to permitted changes in land use or shifts in locational advantage; public spending on infrastructure provision, associated with 'betterment' taxes or 'special assessments'; and 'land gains', arising from the general progress of an economy.

Each element must be dealt with differently to fully capture unearned increments. A levy on the annual rental value differs from levying changes in value. A fixed annual charge on land rental value would not fully capture development gains or value increments due to public infrastructure spending.

Land prices also rise for reasons other than unearned increments in land value. As prices reflect the capitalised values of anticipated income flows, values vary with high interest rates or rising prices, as well as with fluctuations in the profitability of land use.

Hence, the proposed community value charge might overtax or undertax true land rental values.

A 'comprehensive' and 'ethical' approach may not generate revenue from taxing the development gain. Without affecting the underlying demand or supply of land, planning decisions cannot affect overall land values (Prest 1983). Avoiding 'confiscation' by compensating planning 'wipe-outs' means little revenue, as losses at one location will offset gains in value elsewhere. Equitable compensation for recent land purchasers and the 'asset-rich, income-poor' would open costly loopholes.

Careless administration of land levies also produces inequities and damaging economic effects (Mathews 1992). Valuation remains an art, not a science; practices vary. Problems arise in assessing unimproved values without an active local market in raw land.

These practical flaws turn 'hissing' by vested interests at a 'perfect' tax into plausible complaints of 'confiscation' and 'theft'.

It is not feasible in practice to tax imputed rental income at 100 per cent. Historically, governments have been unable to charge more than 30–40 per cent tax rates on land or mineral resource rents, even where the public has legal title. The ethical argument of 'community rights' over land will not silence the voice of historical fact — private ownership and appropriation of value increments. Gradual introduction is no remedy. A 10-year transition to levying 100 per cent of land rents is akin to announcing all land value will be confiscated by the end of the period. If the threat were credible, current market prices of land would quickly fall, to little more than the discounted value of the interest on the revenue payments for the ten year period (Walters 1983).

Converting freehold land into long leases with reversionary rights to the State (Royal Commission of Inquiry into Rating Valuation and Local Government Finance 1967) or capturing future development values (Australia, Commission of Inquiry into Land Tenures 1974, 1976) may achieve similar ends. However, as Prest points out,

> the fact that the first approach was outlined by Marshall in England in the 1880s and the second by J S Mill in the 1840s without any action being taken should be a warning to enthusiasts about there being a very stony furrow to plough (Prest 1983, pp. 10–11).

Experience with Australia's land taxes, the Australian Capital Territory (ACT) public leasehold, development rights charges and taxation of Crown minerals proves the point. So too does capital gains taxation. Each of these taxes are levies on economic rents or windfall gains, which have all proved exceptionally difficult to effectively tax in Australia for political reasons. The conceptual links between public leasehold and taxes on land are explained in the Report of the Commission of Inquiry into Land Tenures (Australia, Commission of Inquiry into Land Tenures 1974, 1976). Prest (1983) discusses the different types of land taxes including development rights and betterment charges, and shows that most gains in land values are essentially capital gains, which may likewise be taxed on an accruals or realisation basis. The basis for resources rent taxes is as a means of charging for private exploitation of public property rights over minerals (Smith 1997), comparable with charges for the use of publicly owned land, while the similarity in the character of land rental and resource rental taxes is sketched in Reece (1986).

Land taxes

Australia levies unearned land value increments through land taxes and rates on unimproved values (Garland 1934; Else-Mitchell 1974; Neutze 1977; Groenewegen 1979; Mathews 1992). The rationale for land taxation has a long history, going back to Locke, the Physiocrats and the classical economists such as J. S. Mill. It because a popular cause in Australia from the 1890s due to the influence of Henry George.[229] Legislators' primary motive for introducing such levies was revenue during a fiscal crisis, such as the 1890s Depression. These land taxes captured only a fraction of the unearned value increments because of the landholders' influence in the legislatures (Smith 1993b).

The spectre of capital flight in the 1880s and 1890s frightened legislators. 'Capital', they heard, was a beneficent genius. 'But she is shy, and can easily take wings and fly from land to land (Catherine Spence, quoted in Goodwin 1966, p. 125). Few distinguished investing in speculative asset holding from investing in productive capacity.

Because landowners have political clout, farmers and pastoralists received generous exemptions. Although combined federal and State land taxes were initially heavy (Mathews 1992), even the highest rates were far below 100 per cent of rental value. And though the 1910 federal land tax levied crown leases, organised landholders and pastoral interests soon overturned it. Reimposition in 1914 produced such a sustained hue and cry from pastoral lessees that their legislative representatives overturned it again a decade later — also trying to make the change retrospective! Governments' slow reaction to double taxation and low farm prices in the late 1920s meant some land taxes were paid out of capital. This fuelled taxpayer discontent. By 1933–34, rates were half wartime levels (Mathews 1992).

In 1952 the Menzies government abolished the federal land tax, so the States might replace lost income tax revenues. The States did no such thing. By the 1950s States' land taxes had already been substantially eroded. Reflecting the political power of the farm lobby, and in response to political pressures from homeowners, land used for primary production had generally been exempted, as had land used for the principal place of residence (Mathews 1992).

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[229] The history of the case for the land tax is discussed in detail in Groenewegen (1979).

This occurred because inflation and misuse of the land tax as a 'progressive' tax had damaged the political viability of the tax and weakened its rationale as a tax on unearned increments. Changing economic conditions made it increasing unlikely that such taxes would fall only on pure 'land rents'. Land values were rising not just from population pressures, but because farm prices and profits were also rising. Variations in land fertility and the effect of changing farming technology on land productivity meant careless valuations could penalise improvements. Changes in inflation and interest rates also altered the rate of return for those 'investing' in landownership. Higher interest rates made the land taxes into taxes on capital.

As more of Australia's wealth took the form of assets other than land, strong pressures emerged to exempt rural and residential land from 'discriminatory wealth taxes'. Exemption of various landowner categories during the severe inflation of the 1970s made the land taxes inequitable. Inflation pushed more taxpayers into higher tax rate categories, causing politically embarrassing cases of hardship. Intense criticism by urban landowners forced changes in the basis of rating as urban land prices accelerated in the 1980s (Mathews 1992). Now, substantially a tax on urban land, land taxes became highly volatile. Boosting revenues meant lifting already high rates on a small, influential group of taxpayers. Archaic administration and the variety of valuation procedures produced inequities and anomalies, arbitrary jumps in land valuations and tax assessments unmatched by taxable capacity (Mathews 1992). The result:

> No political party now seems anxious to allow the land tax to operate as a means of taking from the landowner any part of the value of land as an unearned increment or for that tax to produce the effect of compelling owners of large or valuable holdings to dispose of or subdivide them (Australia, Commission of Inquiry into Land Tenures 1974, p. 19).

The largest State tax loopholes are now found in land taxes, which have only ever accounted for around 5 per cent of State taxes. In New South Wales (NSW), concessions are five times greater than the revenue collected (Walsh, 1990b).

As land-owners are one of the main identifiable political groupings on which State politicians depend on to get elected, there is little scope to increase revenue from taxes on land. Land and property interests make important contributions to political party finances. Despite the merits of reforming land taxes to make them more comprehensive (Albon 1990), State governments prefer higher taxes on payrolls and business franchises. As George Bernard Shaw (1856-1950) pointed out, 'a government which robs Peter to pay Paul can always depend on the support of Paul' (quoted in Jay 1997, p. 337).

Public leasehold

Under the 'Tax Reform' proposal, land tenure arrangements would be unchanged. However, what matters is not land tenure but how economic equity in the land is allocated between public and private 'stakeholders'. A charge equal to full market land rental amounts to public capture of all existing private financial equity in land value. If the public cannot even collect the full value of unearned land value increments in the ACT, where it has full legal ownership, then capturing it on land held under private title is a pipe dream.

Canberra's public leasehold system is rooted in the arguments made in the same era as land value taxation. There was unparallelled unanimity of public opinion at Federation that land in the national capital should be publicly owned (Brennan 1971). A key objective was to avoid unproductive land speculation and unrequited public expense or inequitable wealth accumulation by public capture of increments in national capital land values.

Long delays in adjusting rents had already eroded the public's equity in Canberra land values by the late 1960s. Irregular revaluations produced arbitrary rises in land rents during the inflation of the 1960s. Rents on residential leases were abolished as a political gesture from 1 January 1971.

Public capture of land value increments was still feasible in relation to non-residential leases, or when residential lease values rose due to planning changes. However, these were only

half-heartedly pursued. Pressure from local land and property interests, combined with weak and inept administration, allowed private appropriation of most remaining public equity.

- Lessees were never levied the full increment in value on lease purpose changes.
- Commercial and rural lessees were permitted to increase their economic equity by 'paying out' leases.
- The ACT government bestowed 'a gift to sitting owners of commercial and industrial leases' (Stein *et al.* 1995, p. 218) by waiving lease renewal fees.

There is, it is said, 'no ethical or economic reasons why such a gift of a national asset should be made' (Stein *et al.* 1995, p. 218). Yet local land and property owners persuaded the Commonwealth government to glue the national land grab into place by authorising perpetual leasehold, drawing spurious arguments for equity, 'freehold rights' and investment incentive.[230]

Despite unwavering community support for the public leasehold system, non-residential lessees have exercised their political power to change the rules in their favour (Neutze 1995). They were aided and abetted by government and the bureaucracy:

> Administrators, and on occasions politicians, have been markedly impervious to criticism and persisted in pursuing practices which have jeopardised the integrity of the leasehold system (Stein *et al.* 1995, p. 47).

Lack of political integrity, bureaucratic incompetence and indifference, combined with powerful local land and property interests and threats of capital flight, defeated effective capture of land values in Australia's national capital, even under public land ownership (Brennan 1971; Neutze 1987; Smith 1997; Stein *et al.* 1995).

Betterment taxes

An alternative approach to capturing unearned land value increments is to levy development gains from public planning changes. NSW introduced such a charge in 1970 following recommendations by a Royal Commission (New South Wales, Royal Commission of Inquiry into Rating Valuation and Local Government Finance 1967). However, the scheme was short-lived, being abolished within a few years. Those who stood to profit from rezoning decisions convinced decisionmakers the measure was pushing up land prices (Neutze 1977; Mathews 1992; Prest 1983).[231]

Unless backed by the threat of compulsory public acquisition, landowners have shown they will undermine such a policy by raising prices. However, as Prest comments, '[acquisition] is a policy which most governments are more willing to talk about than implement (1983, p. 15).

Similar issues arose from recommendations by the Land Tenures Inquiry in 1976 (New South Wales, Commission of Inquiry into Land Tenures 1976). But pleas for ethics and rationality fell on deaf ears. Threats the tax would raise land prices won the day.

Resource taxes

Taxes on land value are conceptually similar to mineral 'resource rent taxes' (Reece 1986). Like land value taxes, properly designed levies on these mineral 'rents' can produce substantial revenues without undermining returns to genuine enterprise (Smith and Ulph 1979; Swan 1984). They can also conserve scarce resources and prevent premature exploitation and dissipation of value (Swan 1984).

Australian governments own all minerals. However, the political power wielded by mining capital, and the ever-present threat of its flight, has meant the community's resource rents on minerals have not been captured for public profit.

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[230] For example see the ACT (Planning and Land Management) Amendment Bill 1997.

[231] If developers or landowners expected the charge would be removed, they had an incentive to delay development.

In a rare burst of reformist zeal, the Commonwealth Government introduced a 40 per cent Resources Rent Tax in 1984 within its limited jurisdiction over offshore resources. However, backed by the mining industry, State governments refused to replace inequitable and economically wasteful existing mining taxes and royalties (Livingstone 1979) with the Resources Rent Tax (Lloyd 1984).

Capital gains taxes

The case for taxing 'land gains' is 'part and parcel of the case for taxing capital gains'(Prest 1983, p. 12). However, for nearly a century Australian parliaments proved incapable of taxing capital gains at all.

Most capital gains remain untaxed. The present levy falls only on realised gains and has major loopholes through roll-over into other assets. All assets acquired before 1985, and owner-occupied homes are exempt. Rural pressure resulted in assets being deemed unrealised on death, emasculating the tax as a partial levy on land value gains. As an American property millionairess Leona Helmsley says, 'only the little people pay taxes' (quoted in Jay 1997, p. 174).

Summary and conclusions

> There are grounds for believing that many of those responsible for public policy view the taxation system merely as a symbol, which can be used to defuse complex and controversial issues of social and economic policy so long as it gives the appearance of contributing to Stated goals. Whether or not this is so, it is time that we began to evaluate the tax system by reference to the effects which it actually achieves and not the effects which governments say they intend to achieve (Mathews 1983, p. 24).

Raising public revenue by taxing unearned increments in land values has produced disappointing results. Weak or inept administration, combined with the practical flaws in 'the perfect tax', leaves the way open for plausible protest at public capture of unearned increments. Government inability to distinguish genuine concerns from the squeals for abolition undermines land levies' political viability.

Tax policies are not rational if judged by their stated objectives. They are rational if viewed as rhetoric, hiding the reality that the public is the 'goose' that should be hissing.

Modern governments have proved unable to defend 'the public interest' against coalitions of private vested interests profiting from community-owned land value increments. It is not surprising, as Seligman commented a century ago, that

> The constitutional history of England is to a large extent a history of the struggle of the people to gain control of the Treasury (Seligman 1900, p. 76).

Chapter 13
Deficiencies in the Current Tax System*

'Would you tell me please, which way I ought to go from here?' 'That depends a good deal on where you want to get to', said the Cat (Lewis Carroll, *Alice in Wonderland*.

Introduction

The problem posed by the tax debate of the 1990s is where, if anywhere, to go on tax reform. The answer depends not just on where we want to go but also on where we are, and where we have been.

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

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

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

The tax system of the late 1990s appears inadequate to meet the challenges of revenue-raising and achieving Australia's social and environmental objectives in a global economy.

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

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

In this chapter I outline the major deficiencies in the Australian tax system by the mid 1990s, a time of apparent deadlock in the tax reform debate. I work from a broad historical perspective on how we have arrived at the current situation and how the terms of Australia's 'fiscal contract' have been drawn up. By trying to understand what has brought us to where we stand now, I hope to make clearer where we might go.

The first section briefly outlines how we got where we are and what lessons we might draw from that. It argues that the continuing inequities in our tax system and the unbalanced

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revenue allocation across Commonwealth, State or local government, along with the perceived inequities of reform, create a deadlock on moves to reform indirect taxes. The subsequent section identifies the key deficiencies in the existing system, deficiencies that must be remedied for progress to be made on a broader tax reform front.

Background

> 'I have with me two gods, Persuasion and Compulsion' (Themistocles 528–462 BC, from Plutarch, *Lives*).

Taxation reform proposals since the 1980s have been closely linked to improving Australia's savings performance. According to Australia's national savings and fiscal guru, Vince Fitzgerald, the long term decline in national savings is predominantly (although not solely) due to a structural decline in public savings (that is, reduced surpluses/increased deficits on current transactions (1993).

For the last two decades, taxes as a percentage of gross domestic product (GDP) have been relatively stable, or even declining (see Table 13.1). However, substantial rises in public expenditures for health, education and social security were not matched by increased revenues.

Table 13.1
Taxation as a Percentage of Gross Domestic Product 1949–1991[a]

Year ended June	*Commonwealth*	*State*	*Total*
1949	22	3	25
1959	17	4	21
1969	20	3	23
1977	23	6	29
1985	25	6	31
1989	25	6	31
1991	25	7	32

Notes: [a]Australian National Accounts (ANA) basis. This may differ slightly from OECD data because of a) differing ANA treatment of fees, fines and penalties, b) figures are for the fiscal not calender year and c) figures are on an accrual not cash basis.

Source: Smith 1993b.

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

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

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

Taxes are 'the dues that we pay for the privileges of membership in an organised society' (Franklin D. Roosevelt, quoted in James 1981, p. 179). In other words, taxes are one element in a fiscal 'contract' between Australians and their governments.

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

The EPAC survey also showed the community has no overall desire to reduce their own tax bill in exchange for reduced government services. Consumers are aware of the need for the collective provision of certain goods and services and understand that the quality and level of provision of such goods and services depends on the direct and indirect tax contributions of all citizens.

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

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

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

However land, estate and gift taxes — 4 per cent of national taxes in the 1950s — were eroded or abolished after inflation undermined their fairness from the 1950s. We came to rely disproportionately on the income tax to maintain tax progressivity. The search for 'revenue with equity' led Australia to a single tax, the Commonwealth income tax. Accounting for just over 40 cents in every dollar of tax collected in the late 1950s, income tax represented nearly 60c of every dollar in the 1990s (Tables 13.2 and 13.3).

Inflation, tax avoidance and income tax concessions also eroded the progressivity of income tax since the 1960s. It increasingly fell to low and moderate income 'Pay As You Earn' (PAYE) taxpayers to finance Australian's fiscal 'contract'. Meanwhile, the contribution to revenue of major indirect taxes, wholesale sales tax, customs and excise duties, has dwindled to 21 per cent of national revenues compared to 34 per cent in the late 1950s.

As inflation and cuts to top marginal tax rates turned the progressive income tax into an approximate flat rate income tax, horizontal equity became another casualty.Although a move to tax rebates from dependent child tax deductions after 1975 had improved equity, as high marginal rate taxpayers no longer received greatest financial benefit, it still disadvantaged low income earners having insufficient tax liability to receive the full rebate. The tax rebate and child endowment were thus merged into a family allowance payment in 1976. However, when cashed out and paid to mothers, tax allowances which had represented a value around 12 per cent of male earnings in the 1950s were labelled 'middle class welfare', eroded by inflation in the 1970s and means tested from the 1980s. Thus what had seemed to be a sensible social reform, allowing more to be paid directly to those who needed it, became a means to shift the tax burden to those with children.[232]

At the same time, a range of child-related payments conditional on women's choices between paid and unpaid work or study, and how couples arranged their financial assets gave effect to an unspoken strategy of 'divide and rule' 'one income' pitted against 'two income families' (Smith 1994a; Lambert *et al.* 1996). A sterile 'one income/two income' policy debate ignored the complex reality of women's lives and the economic value of unpaid work, while denying the aspirations of the nine out of ten mothers who prefer part-time employment when their children are young.

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[232] As most, though not all, individuals have children at some time during life, and those with children make up a large proportion of total taxpayers, the essential issue is how the tax burden is spread over individuals' lifetimes, rather than how it is distributed between those with children and those without.

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

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

Table 13.2
Taxation 1958–59

	Commonwealth		*State and local*		*Total*	
	$ million	*%*	*$ million*	*%*	*$ million*	*%*
Customs and excise duties	616	27	0	0	616	23
Sales tax	287	13	0	0	287	11
Income taxes	1,214	54	0	0	1,214	44
Estate and gift duties	31	1	54	12	85	3
Stamp duties, nei	0	0	57	12	57	2
Land taxes	na	0	31	7	31	1
Other taxes	117	5	323	69	440	16
Payroll		4		na		
Motor taxes		na		18		
Total	2,265	100	465	100	2,730	100

Source: Smith 1993b.

Table 13.3
Taxation 1990–91

	Commonwealth		*State and local*		*Total*	
	$ million	*%*	*$ million*	*%*	*$ million*	*%*
Customs and excise duties	14,924	16	0	0	14,924	13
Sales tax	9,365	10	0	0	9,365	8
Income taxes	66,377	71	0	0	66,377	56
Estate and gift duties	0	0	0	0	0	0
Stamp duties, nei	229	0	3,983	15	4,212	4
Land taxes	0	0	1,602	6	1,602	1
Other taxes	2,428	3	20,373	78	22,801	19
Payroll		na		22		
Motor taxes		na		9		
Gambling		na		7		
Business franchise		na		10		
Total	93,323	100	25,958	100	119,281	100

Note: [a] Until 1988–89 the ACT was included in the Commonwealth sector and from 1989–90 it was included in the State and local sector. Land taxes do not include local government rates.

Source: Smith 1993b.

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

Proponents of reform also failed to assure Australians that compensation would be more than temporary and that compensation would travel from the trouser pocket to the shopping

purse. It failed to convince that the move was not motivated by an ideological desire to reduce the overall progressivity of taxation under the banner of 'changing the tax mix'.

And it failed to convince others, attracted to the strong revenue base afforded by a consumption tax, that reform was not motivated by an ideological desire to force cuts in valued government services, as had occurred in New Zealand and had been attempted less successfully elsewhere (Evans 1988). Indeed, the New Zealand example showed that the risks to low and moderate income earners of eroded compensation and increased vulnerability to social security and family assistance cutbacks were very real (Smith 1998c).[233]

Public support for taxation and perceptions of its fairness also mean no 'free riders' — tax dodging (Levi 1988b; Scholz 1994). Tax avoidance, ineffective or half-hearted tax enforcement and policies allowing special privileges to sectional interests have done untold damage to our community's attitude to taxation and to tax compliance, especially the income tax. As Seligman pointed out in *Essays in Taxation*, 'the honest taxpayer would willingly bear his fair share of the burden, but even he cannot concede his obligation to pay other men's taxes' (1900, p. 31).

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

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

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

It has been said that 'the lone honest taxpayer in a country of shirkers is a fool not a moral paragon' (Scholz 1994, p. 21). Since everyone benefits from public expenditures whether or not they pay, the rational player will avoid paying and free ride on others, ensuring that everybody is worse off, as valued public goods and services can not be provided.

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

If some can opt out of paying tax, as it seems they can, the very basis of the tax system is threatened because a viable tax system requires the voluntary cooperation of taxpayers. This will only be forthcoming if all are perceived as paying their 'fair share'. As an American scholar, W. Pedrick, commented on the ludicrous decision to abolish rather than reform Commonwealth estate and gift duties in 1976, 'Revenue acts are not the acts of a hostile enemy of occupation. They are the means by which the community maintains itself as a community responding to the needs of its members' (Pedrick 1981,p. 134).

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[233] Introducing the GST left many low and moderate income families facing very high effective marginal tax rates on their income because of compensation received under income tested family assistance and social security programs. The accompanying cuts to income taxes for high income earners left a fiscal hole that was later filled by an uncompensated rise in GST and cuts to the level of social security benefits to deal with the problem of unacceptably high wage replacement rates and poverty traps arising in part from the previous GST compensation package.

Major deficiencies in Australia's taxation system

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

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

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

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

Federal tax sharing and tax competition

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

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

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

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

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

Public perceptions and the visibility of taxes

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

The balance of taxation between indirect and direct taxes is also comparable with that of other countries. However, because the burden of progressivity is not shared by general assets

taxes, the direct taxation that Australia does levy is more concentrated on income taxation. As income taxes are very visible to taxpayers, this creates perceptions that income taxes are high.

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

However, this has not always been the case. For example, Commonwealth land taxes and customs and excise duties were originally linked to the introduction of the 1909 Commonwealth age pension, payroll taxes with child endowment, and the post-war expansion of income tax to ordinary wage earners to new social security measures such as unemployment and widows pensions. The introduction of the Medicare levy and various earmarked petrol taxes continued the political tradition (Smith 1993a).

Australia's taxation is also more burdensome to businesses and individuals than is apparent from OECD data because Australian governments' taxation powers are used to compel billions of dollars of payments annually to private superannuation funds rather than to the public purse. Compulsory superannuation payments are not counted as taxes by OECD definitions, as the proceeds do not go to governments. 'Tax room' that might otherwise be available to strengthen the nation's public finances is thus wasted.

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

Taxation of assets

Since the abolition of taxes on the transfer of wealth — estate and gift duties — in the 1970s, Australia forgoes several billion of revenue annually.[234] Asset taxes contribute to both horizontal and vertical equity, and can reduce economic distortions arising from income tax avoidance. We thus miss an important opportunity toenhance tax fairness, improve economic efficiency and maintain revenue.

Concerns may be raised about incentives to accumulate. However, like old age, such taxes may be preferable to the alternative — raising other taxes, such as income taxes or indirect taxation, or State government taxes to replace lost revenue may be much more damaging to productive effort, capital accumulation and thrift. No doubt it was for such reasons that the FitzGerald Report on national saving reminded the Labor Government of this option (FitzGerald 1993).

Australia's leading tax economists maintain that wealth taxes must be an important element of any shift from income to consumption taxation (Mathews 1983; Groenewegen 1985; Head 1991).

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

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

[234] During the 1970s, an annual wealth tax was estimated to raise some $500 million annually. In the mid 1980s, John Stone estimated that death duties would raise from one half to three quarters of a billion in three years (Groenewegen 1985, p. 306).

tax system to recognise the advantages which accrue from the ownership of wealth' (Australia, Treasury 1974a, p. 3).

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

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

While imposing a wealth tax raises some significant issues of administration and valuation, these are not insuperable. The OECD Committee on Fiscal Affairs concluded after reviewing member countries that 'no country with a net wealth tax considered it more difficult to administer than income tax and some specified that it was less so' (OECD 1979, p. 127 quoted in Mathews 1980, p. 41).

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

Income tax expenditures

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

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

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

A *partial* revenue cost estimate for existing tax concessions by the Commonwealth Treasury is $18 billion a year, about 15 per cent of Commonwealth Government outlays. By far the largest items are tax concessions for superannuation contributions, fund income and payouts at over $8 billion, with industry assistance and development accounting for $2.8 billion (see Table 13.4).

Table 13.4
Major Income Tax Expenditures 1994–95

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

Source: Australia, Treasury, *Tax Expenditures Statement*, (1995).

These estimates understate revenue costs, excluding items arguably included as part of the 'benchmark' (for example, capital gains tax on a realisation not an accruals basis and interest withholding tax (IWT) concessions for multinational companies based in Australia). Also, the cost of other tax expenditures, such as certain exemptions from capital gains tax,

income tax, or IWT and dividend withholding tax (DWT) are not calculated.[235] As noted below, the 1995 Treasury estimates also understated the large current potential cost of concessions on private borrowing for infrastructure projects.

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

Had the present $10 billion annual subsidy to superannuation contributions by high income earners (Australia, Treasury, *Tax Expenditures Statement*, 2001) been subject to the usual public and bureaucratic scrutiny of social security expenditures, it is unthinkable that such expenditures would have been approved. Representing a huge net drain on public saving for at least 25 years, and directing $800 billion of savings to superannuation funds over the next 25 years, the present superannuation scheme was postulated to increase national savings by just 4 per cent of GDP. By comparison, increasing economic activity and Commonwealth budget measures were estimated to achieve the same thing in four years from 1993 (Davidson and McClelland, 1996). With a more transparent decision-making process, claims that tax subsidies will be effective in increasing private savings would have been publicly tested against international empirical evidence that they are not (OECD 1994b).

'Things which are Caesar's'

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

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

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

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

Allowing capital gains to be adjusted for inflation, but permitting deductions of nominal interest payments, provides continued opportunities for tax avoidance and senseless subsidy of borrowing-based speculation. Major avoidance of capital gains tax also occurs through levying

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[235]The estimates are partial because of how the benchmark tax system is defined and because some concessions are not costed. The benchmark adopted excludes taxing capital gains on a realisation rather than an accrual basis and exempting from withholding tax certain dividends paid to non-resident shareholders by Australian resident multi-national companies. There are no estimates of revenue losses from exempting imputed housing rents from income tax, from exempting dividends or interest paid to various non-resident organisations, businesses and Australian governments from interest or dividend withholding taxes, and from exempting from capital gains tax all pre-1985 assets, all owner-occupied dwellings, and from taxing real rather than nominal capital gains (Australia, Treasury 1995).

it on a realisation rather than an accrual basis, as this permits taxable income to be converted into unrealised and, therefore, presently untaxed capital gains.

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

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

The detection of and legislative action against emerging technical loopholes in tax law are too slow, if they occur at all. Anti-avoidance activity is largely ineffective against widespread avoidance as it is based on administrative action from a limited number of audits.

Taxable capacity of parents

One of the most notable problems of horizontal equity is the lack of recognition of the fluctuation in income[236] and ability to pay tax during the child-raising years. Also, means testing of child payments based on family income has produced very high effective marginal tax rates on second earners in families, with potentially strong disincentives to paid employment.

This has been a key issue facing those advocating a move to GST, as compensation provided through the social security system increases the number of families with children who are forced to rely on social security and child payments for a decent standard of living. As the compensation paid increases benefit levels and replacement rates, it is vulnerable to being cut in future budgets to improve work incentives, as New Zealand experience shows (Smith 1998c).

High effective marginal tax rates arise from various family income and assets tests. These effective rates of taxation are far higher than would be acceptable for any high income taxpayer, and particularly affect women as the second potential earners in many families.

Indirect taxes

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

The indirect tax base (wholesale sales tax, petrol, tobacco and alcohol taxes, State franchise taxes etc.) has been diminishing for a number of reasons during the last two decades. For example, the policy priorities given to tariff reductions, constitutional challenges to State indirect taxes and the changing structure of consumption and relative prices, along with the introduction of new technologies have eroded indirect tax revenues, while exacerbating the inefficiencies associated with levying high rates of taxation on a narrow base (Warren 1995).

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[236] The adoption of an annual period of assessment for income is somewhat arbitary and produces inequity if income fluctuates significantly. Thus, the tax system in effect extends the tax accounting period for those such as primary producers whose income fluctuates sharply from year to year. It has been argued that a similar principle should be applied to the fluctuation in women's incomes associated with withdrawal from paid employment during the childbearing years (Grbich 1984).

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

Effect on incentives, investment, economic growth and living standards

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

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

The Commonwealth–State taxation imbalance leaves too much revenue with the Commonwealth, to be spent on less valued services such as defence and general administration, and too little with State and local governments, responsible for producing services people value more, including health services, retraining and education, policing, environmental protection, sports and recreation facilities, and roads (Withers *et al.* 1994; Withers and Edwards 2001).

The imbalance may also contribute to sub-optimal levels and allocation of public infrastructure investment (Walsh 1992) an issue that has been examined in detail in Chapter 8. Inadequate public infrastructure inflicts a high cost on business (Allen Consulting Group 1993). Commonwealth income tax concessions that subsidise private infrastructure financing exacerbate such distortions in national investment priorities, as well as open up new avenues for tax avoidance by high income earners.[237] The EPAC Task Force on Private Infrastructure found the tax concession for private infrastructure borrowing unjustifiable and recommended its abolition (EPAC Task Force on Private Infrastructure 1995, pp. 81–4), but this has not been accepted.

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

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

Likewise, taxes on certain unearned land value increments, such as infrastructure-related betterment taxes or levies on changes in permitted land use, are likely to be less distorting than those raising equivalent revenue on profits or incomes. They may also assist in ensuring a more socially efficient and environmentally appropriate use of land and direct investment into genuine enterprise rather than into speculation in land or property (Australia, Commission of Inquiry into Land Tenures 1974, 1976).

Major income tax concessions, allowances and loopholes distort the after tax return on investments (Pender and Ross 1995), directing savings and investment to socially less

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[237] Although the *Tax Expenditures Statement* gives a nil revenue cost to the exemption from taxation of interest on borrowings for eligible infrastructure facilities, this grossly understates the current and prospective cost. On 10 September 1996, the Treasurer capped the cost of this concession at $150 million for 1995–96 and $200 million for 1996–97. This followed applications totalling $26 billion (a total which implied the approximate associated revenue cost would have been around $860 million).

productive investments or to particular financial intermediaries, for example, to superannuation funds or into speculation in existing financial or capital assets. Costly subsidies for retirement savings might provide more effective and more equitable incentives for private saving if redirected to removing asset or income tests on age pensions or into tax rebates for long-term saving of various kinds.

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

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

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

Greater reliance on family income tested social security systems to redistribute income, for example as compensation for increased indirect taxation also makes more acute the issues of dependency and the unequal distribution of income within households (Smith 1998c).

Summary and conclusions

Taxation is an important instrument for social cooperation, for making an economy into a society. It plays a crucial role in shaping society to meet collective ideals and aspirations. As the EPAC survey showed, 'Australians are willing to pay their proper share of tax to secure the collective and individual benefits of public expenditure, provided that every one else does the same' (Withers *et al.* 1994, p. 39).

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

> Speculative and self-serving international capital flows, now running at perhaps a trillion dollars a day and swamping commodity trade and productive investment, have virtually made it impossible for governments to govern in the interests of their own people, for example, by successfully pursuing policies of full employment. If the world's government's are to regain control of economic policy from the financial and foreign exchange markets, it is time that they considered what role taxation itself might play to this end. In particular, they might take up the proposal of Nobel Laureate James Tobin for a world-wide, low-rate tax on all foreign exchange transactions' (Mathews 1994a, p. 130).

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

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

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

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

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

> The adoption of simplified administrative procedures usually involves a considerable loss of equity. In practice it is therefore necessary to compromise between equity and administrative practicability (Downing *et al.* 1964, p. 122).

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

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

Failure to address these deficiencies as a package of fair tax reforms means economic effort and incentive will remain directed at investments that are not valued, and at neglecting activities or depreciating investments that are.

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

Chapter 14
Concluding Remarks

Taxation is a neglected dimension of Australian economic history. Australian personal income taxation is relatively high and important to revenue, yet overall taxation and social spending is low: since the interwar period Australian taxation and social spending has lagged other similar countries notwithstanding its early leadership in the size of government, in progressive taxation and in 'practical socialism'. Despite the distinctiveness of Australia's wage earners' welfare state approach to social protection, it is unclear what role taxation has played in this redistributional system and why it evolved the way it did.

This thesis has inquired explored how and why the distributional role of taxation has changed since Federation, and in particular, how it was affected by economic change and fluctuation and how it interacted with Australia's distinctive labour market institutions and the federal Constitution. Using a combination of statistical analysis and historical narrative and interpretation, it has examined the problem of tax policy through analyzing selected aspects of its history, and through exploring the implications of federal finance arrangements. The later chapters have drawn links between Australia's tax history, and the current problems of taxation in an increasingly integrated international economy.

Chapter 2 has already provided an overview of the thesis, discussed the significance of each of the case studies, and shown how these different aspects of taxation policy relate to each other. In closing, this chapter briefly reviews the main findings of this thesis, draws out some implications and raises issues for future consideration. It argues that understanding how governments managed redistribution and social protection in a federal system during the past century can provide historical insights of value for policymaking in the twenty-first century.

Findings and significance

Returning to the questions raised at the beginning of this thesis, the three important issues raised there have been addressed. These issues concerned how and why the redistributional role of taxation has changed, including, in particular, what role the economy played in shaping tax policy, and what was the impact of federal fiscal institutions. Exploring these issues has increased our understanding of Australian distinctiveness and the place of income tax and federalism in Australia's social protection scheme, as well as of fiscal development more generally.

Economic forces

Firstly, this thesis has shown the important role played by economic fluctuations and economic structural change in bringing about change in Australia's fiscal system.

- Just as economic vulnerability, fiscal crisis and social hardship during the 1890s elicited social protection in the form of industrial arbitration, a national age pension and new income and land taxes, the chapters in Part I have shown how post-World War I inflation and unemployment during the Depression created political demands for new social services and requirements for new revenues during the 1920s and 1930s.
- The 'tax handles' which were available to governments to fund their services changed over the century: as closer settlement, industrialisation and urbanisation proceeded, more incomes came within the reach of an income tax (the revenue necessities of Depression mothering its invention as a mass tax). Growth of domestic industry and a declining import share diminished the tariff's revenue role during the interwar period and precipitated the wholesale sales tax (WST) while changing patterns of consumption fuelled the shift from the 1930 WST to the goods and services tax (GST) of June 2000.

- The major changes in income and consumption tax systems were precipitated by external or war-related economic shocks in 1895–6, 1914–5, 1929–32 and 1942–3, which created new demands on government to fund social protection at the same time as damaging traditional revenue sources.

Secondly, through considering the 'political economy' of taxation within the social protection scheme of the Australian wage earners' welfare state (Castles 1985), this thesis has also pointed to a new interpretation of taxation and social security policies (and their centralization) since Federation, and presents a historical context which makes the ambivalent attitude to income taxation by the Australian labour movement more understandable:

- Chapters 5 and 6 identified the decisive role played during the 1920s by industry and employer interests attempting to shift to the community the costs of maintaining the workforce which these interests bore through regulated wages. Inflation and declining industry competitiveness during the 1920s and experience of wage cuts and unemployment during the Depression produced by the mid 1930s an alliance of manufacturing employers and farmers with social reformers and labour unions seeking the same end — social security financed from general taxation rather than employer levies or wage regulation. This led to Australia's distinctive system of means-tested family support and unemployment payments, financed from income taxation, as a supplement to the wages arbitration system which from 1932 had moved decisively and publicly to a 'capacity to pay' rather than 'need' basis for wage-setting.
- As shown in Chapters 4 and 5, Australia's income taxes on wage earners were expanded from the late 1920s to pay for benefits which were restricted mainly to non-earners (widows and children) whereas in other OECD countries social security taxes and contributions initially funded entitlements for wage earners themselves. This helps explain Australia's relatively low tax and public expenditure ranking among OECD countries (Tanzi 1998b). Financing through progressive personal income taxes was more progressive than via payroll levies or social security taxes, although this was altered by the Pay As You Earn (PAYE) scheme which removed a major political constraint on expanding the less progressive component of personal income taxation.
- The change in the nature of income taxes from a tax on elite incomes to a mass tax changed fiscal politics beginning in the 1920s and culminating with the entrenchment of Uniform Taxation and the Social Security Tax from the 1940s and 1950s. By the 1980s, this produced a realignment in the direct versus indirect tax debate, as predicted in a 1969 paper by Musgrave: 'not only does the middle and lower income voter become more hesitant to vote new programmes as the marginal tax dollar shifts downwards, but he also grows weaker in his allegiance to income and his opposition to consumption taxes as the nature of the income tax changes' (Musgrave 1986b, p. 144).
- Chapters 3 and 4 signalled this long term significance of PAYE with regard to the progressivity of the Commonwealth income tax in the post-war period. Given the tendency for 'taxation by political inertia', and with personal income tax both invisible and unavoidable for PAYE taxpayers, the Commonwealth's revenues rose both amply and easily during the 1950s and 1960s while inflation diminished the structural progression of personal income tax. As the increased revenues had mainly funded expansion of social security during this period, a growth in the number of beneficiaries as unemployment rose from the 1970s appears to have produced a political reaction from low and middle income wage earners seeking less, not more, taxation and social spending, and the 'contributory' scheme of compulsory private superannuation introduced in the late 1980s.
- Later chapters of the thesis, in Parts II and III, have shown these findings on the political economy of taxation during the interwar period are also relevant to the post-war period, and appear to reinforce recent trends for declining tax progressivity. Chapters 8–13 are important because they signal the new political

economy of taxation in Australia. An important insight arising from these studies is that taxation and social policy in the twenty-first century will be shaped by the services and finance industries in the same way that manufacturing and primary industries supported the general tax financing of social security and child endowment in their own interests earlier this century. On this interpretation, the greater influence on public policy exerted by the gambling industry, the finance industry and private health funds during the 1990s symbolises a broader trend associated with Australia's changing industry and demographic structure, with rising incomes and with constraints on public revenue raising in a 'global economy'. Industry deregulation by State governments chasing gambling revenues made taxation more regressive (Chapter 10); expanded tax subsidies to private health insurance weakened the redistributive effect of public health expenditures (Chapter 11); and, visible tax avoidance of one kind or another (Chapters 12 and 13) undermined tax progressivity and public support for taxation.

A casual inspection of the data for Australia shows that taxation ratchets up after both World Wars, apparently supporting the idea that war causes increased taxation and social spending due to 'inspection' and 'displacement' effects (Peacock and Wiseman 1967). However, the question remains whether this is a causal relationship or not. A third important finding of this thesis is that war was the occasion rather than the cause of increased taxation in Australia. This finding is in line with that of Musgrave and Musgrave (1989) that wars interrupted a long term rising trend in public (civilian) spending over the century, and that higher taxes followed higher spending rather than the other way round (Borcheding 1977).

- Chapters 4 and 5 show that by 1939 in Australia, there was a backlog of demands for social programs that had not been funded due to rigid federal institutional barriers. The large additional revenue requirements of war required removal of these barriers, clearing the way for financing of such social spending out of Commonwealth taxation revenues after the war. In the same way, as became evident in Chapter 7, the introduction of age pensions was constrained before Federation by State political and financial barriers but these barriers were no longer decisive after new political and public finance institutions were created from 1901.
- Also consistent with this story, emphasising the interaction of economic change, political demands and institutional constraints in shaping tax systems rather than a single dominating factor such as war, a significant shift in the role of income taxation in Australia from the mid–late 1950s is revealed in Chapter 3. From this time the redistributional effect of income taxation came to depend increasingly on the incidence of the public spending it funded rather than on narrowing the dispersion of after-tax incomes. When, during the 1970s and 1980s governments cut income taxes, the reduced average level of income tax unambiguously reduced its redistributive effect. This shift is consistent with the changing political economy of taxation and with a 'taxation by political inertia' explanation for the evolution of the level and structure of taxation (Rose and Karran 1987).

Although the experience of other countries has been that reduced inequality (due to a booming post-war economy with low unemployment) helped weaken political pressures for fiscal redistribution, support for progressive taxation and redistribution does not appear to have been strengthened by the rise in unemployment and inequality since the 1970s. This appears to be because of reduced public confidence that the income tax was 'fair' due to increasingly visible tax avoidance from the late 1970s and because of rising wage earner concerns at substantial and more 'targetted' redistributions to 'non-earners' during the period of slow real wages growth during the 1980s. It may be that a lack of citizens' identification of tax payments with fiscal benefits — 'fiscal benefit confusion' — contributed to taxpayer resistance and especially the reduced progressivity of Commonwealth taxation from the 1980s. This identification or 'earmarking' problem is also related to problems with Australia's federal finance system.

Federal fiscal institutions

The fourth major finding of this thesis is the important role of federal institutions in shaping fiscal redistribution in Australia. Historians have neglected the role of the tariff as a tax in the public policy debates around Federation: Chapter 7 has shown that the debate on federal finance during the Constitutional Conventions of the 1890s was fundamentally about the future allocation and level of income taxation, and had profound long-term consequences for how the expanded role of government during the twentieth century would be financed in this country.

- In particular, Chapters 4, 5 and 7 demonstrated how the financial clauses of the Constitution represented a significant institutional barrier to higher taxation and government spending until World War II, failing to provide adequately for State governments' financial future in an increasingly integrated national economy in which the public sector played an expanding redistributive role but in which State income taxation was restrained by tax competition and rising factor mobility. As Musgrave has commented, the progressive income tax by its very nature is better suited for national administration (Musgrave 1986b). As illustrated by the examples of State income taxes and the financing of child endowment in Chapters 4 and 5, Australia's decentralised federal political institutions channelled rising public demand for social protection against economic shocks to State governments, which were unable to respond from the late 1920s because of their inability to extract sufficient income tax revenues. A related finding is that the transition to the epoch of the wage earner financing the Australian welfare state did not occur through uniform income taxation and the National Welfare Fund during World War II, but at the State government level during the 1920s and 1930s. This provides some support for the argument (Hackl, Schneider and Withers 1993) that the 1929–32 Depression, rather than World War II, marked the watershed in trends in public expenditures in Australia.
- This finding of institutional incongruence up until 1942 may also explain the arrested growth of Australia's uniquely pragmatic brand of social protection after World War I. This is evident in the comparatively falling share of Australian government spending in gross domestic product during the interwar period including compared with New Zealand, which has a unitary system of government and similar cultural values and institutions but by contrast expanded its spending during the same period (Tanzi 1998b). It suggests that although an expansion of redistributive government was financed initially by higher Commonwealth tariff revenues and then State income taxes, by the 1930s both sources of revenue had reached their political and economic limits.
- Chapters 3, 4 and 7 illustrate a rising incongruence between federal political institutions and the demands for the public funding of social protection measures until 1942. The Uniform Income Taxation Plan of that year was one adaptation to this problem. The other was establishment in 1933 of a unique federal fiscal institution, the Commonwealth Grants Commission (CGC). Together these financial arrangements facilitated the funding of social protection, directly through provision of new social security benefits in the case of uniform income taxation, and indirectly through 'horizontal equalisation' enabling at least in principle more equitable, more comparable standards of social services by Australian State Governments from 1933.

An important remaining question is how Australia's federal institutions and the centralization and heavy use of income tax powers especially after 1942 influenced the economic efficiency cost of redistribution. Such pervasive institutions of federal finance as the 'vertical fiscal imbalance' are likely to carry significant implications for the economic costs and efficacy of redistribution by Australia's governments. The relative ease with which the Commonwealth could acquire revenues reminds us of R.R. Garran's 1897 prophesy of 'reckless remission of taxation' and 'extravagant expenditures' by the Commonwealth (Garran 1897, p. 164). The findings of Chapters 7, 8 and 9 would suggest two main possibilities: firstly the way

in which taxation revenues were used and, secondly, through the effects on community perceptions of net fiscal benefit.

- Firstly, the imbalance in Commonwealth–State tax 'handles' has led since the mid 1980s to what Garran might have labeled Commonwealth 'extravagance' and States' 'demoralisation' and generous Commonwealth income tax cuts and income tax expenditures funded in effect by increases in the States' economically inefficient and highly regressive taxes. The imbalance in taxation powers also resulted in a constrained role for public investment in the post-war era, including, for example, investments with long-term redistributive effects such as schools, hospitals and other community infrastructure generating local economic and social opportunities. As shown in Chapters 8 and 9, States' fiscal dependence on the Commonwealth reduced the level and, perhaps, the return on Australia's public investments, and propelled State Goverments into socially harmful pursuit of gambling revenues.
- Secondly, although conventional approaches suggest 'fiscal illusion' and vertical fiscal imbalance supports 'big government', the Australian case suggests that 'fiscal illusion' or more specifically, 'fiscal benefit confusion', may have instead constrained growth of taxation and public spending during the post-war period. The reason for this is that any increases in the Commonwealth income tax in recent decades did not flow through into State government areas of spending responsibility which have been identified as public funding priorities: instead they have gone into less valued Commonwealth activities including assistance for industry and welfare spending (Withers and Edwards 2001). The lack of clear responsibility and accountability for governments' taxing and spending decisions due to Australia's Commonwealth–State finance arrangements has probably diminished, not increased public tolerance of taxation.

Puzzles and policy implications

One of the useful functions of research into policy history is to reveal 'lost alternatives', that is, viable policy alternatives that once succeeded (Zelizer 2000). While the conditions surrounding past policy responses to problems may have changed too much for them to be presently viable, in some other cases, key conditions or circumstances are still in place.

The problem of taxation in a global economy

A key issue of taxation policy is how governments can raise sufficient revenue to finance necessary social protections and redistribution and to respond to the pressing needs for public spending associated with rapid economic integration. As this thesis has shown, these are not new problems. Below some parallels are drawn for tax policy between Australian economic history and the current experience of globalisation, and some possible principles and solutions are outlined. From this thesis, two main policy conclusions emerge, pointing to several economic historical research challenges.

It has been shown in Chapters 4 and 5 of this thesis that economic integration during the 1930s undermined the capacity of the Australian States to respond to demands for social protection precisely at a time when economic integration produced a greater exposure to external economic shocks and required a greater capacity of governments to provide such social protection. Chapter 13 highlighted comparable problems for Australia's national tax system from the mid 1990s, with greater demands on tax revenues to meet social and environmental goals, at the same time that capital mobility was increasing the problems of tax avoidance and international tax competition. More generally, it has recently been shown that globalisation is leading to growing impotency of the nation state (Tanzi 1998b) as fiscal termites erode national taxation system (Tanzi 2000a). Increasing tax competition and tax avoidance are undermining the fiscal structures of nation states at the same time that growing economic integration creates

new 'spillover' effects, economic vulnerabilities and social inequalities and therefore new needs for social protection and international coordination (Tanzi 2000b).

Just as there are parallels regarding economic forces for centralisation of taxation, there are parallels with conflicting economic and political trends of centralisation and decentralization. During the 1920s the CGC drew attention to the conflicting tendencies in a federation for regional specialisation and the centralisation of economic power alongside rising democratic pressures for decentralisation of political power. A similar issue arises from the unequal national and regional distribution of the benefits of international trade liberalization and economic specialisation. Tanzi (2000a) has recently argued that the importance of adequately resourced local governments increases due to globalisation. This suggests nations need to adapt to globalisation by exploring new national and international equalization mechanisms for local, sub-national and, eventually, national governments.

Lost alternatives: principles and lessons for tax policy

The tax-transfer system is but one component of a system of social protection, and its efficacy and economic efficiency in achieving a given reduction in inequality must be compared with alternative means of achieving the same ends, for example, through labour market regulation or public enterprise pricing policies. Nevertheless, it is suggested here that this modern tax problem presents parallels with the tax history of federation such as Australia, where, for example, a growing incongruence between decentralized political institutions and increasingly integrated State economies was a key factor drastically reshaping income taxes and the fiscal system as a whole. The parallels suggest the urgency of addressing the problem of 'fiscal termites' (Tanzi 2000b), as well as some principles and future directions for international tax cooperation proposals.

For example, the proposal for a World Tax Organisation (Tanzi 1999) aims to address problems of harmful tax competition, 'fiscal termites' and the problem of financing social protection by

- Coordination and harmonization of tax policies;
- Surveillance and monitoring and moral suasion, and, ultimately;
- Centralized tax collection and disbursement.

It envisages an international institution clearly modeled on the World Trade Organisation which is a body originating in the international collaborative vision of planners during World War II. Along with the Bretton Woods twins, the International Monetary Fund and the World Bank, the World Trade Organisation was to address problems of harmful international economic spillovers experienced during the Depression, notably the proliferation of trade and tariff barriers, competitive devaluations, and the international transmission of domestic economic imbalances including deflation. It was part of a system of international economic cooperation that rested on principles such as multilateral negotiations, international fiscal transfers, and moral suasion as a means of encouraging harmonious international economic and political relations.

Australian tax history as presented in Chapter 4, 5 and 7 of this thesis illustrates a historical process of dealing with comparable problems of taxation through a process of tax centralization alongside creation of a new fiscal institution for horizontal equalisation.

- With income tax problems initially resolved through bilaterally negotiated tax treaties between States, tax negotiations during the interwar period proceeded through multilateral discussions on tax harmonization and joint collection arrangements with the Commonwealth government in some States, then to discussions on tax allocation leading to the central assessment and collection of income taxes on companies and of personal income taxpayers with assessable income from more than one State. Two decades later, in 1936 tax negotiations produced uniform income tax legislation which was passed by both State and Commonwealth Governments, until superceded by income tax unification in 1942

when the Commonwealth used its constitutional powers to impose uniform income taxation and unilaterally exclude the States from this tax field.

- As seen in Chapter 7, accompanying the above process of income tax centralisation was a process of change in the basis for allocating centrally imposed and collected tax revenues, with a gradual shift from an 'unfederal' principle of reimbursement according to the location of collections or the derivation of revenues, towards a federal principle of *per capita* grants. Alongside these broad provisions for distribution of central government grants evolved ad hoc adjustments to the *per capita* basis to meet the needs of particular States with lesser fiscal capacity. Although these grants were originally necessary to achieve agreement to federate, they became necessary during the Depression to keep the Federation together. Such special assistance for financially weaker States evolved through the institution of the CGC into full horizontal equalization of Commonwealth general revenue grants from the 1980s, a process aided by the political imperatives for transparency and principle in the allocation of revenue as well as equity between States.

This thesis also identified flaws and problems arising from Australia's federal finance arrangements, which warn of future pitfalls for any international enterprise in the same direction, including:

- An excessive centralization of revenue powers, resulting in central government 'extravagance' and States' 'demoralisation'.
- Unsatisfactory provision for prioritizing particular forms of State expenditure against particular forms of Commonwealth expenditure, which has favored expansion of transfers and public consumption spending, at the expense of public infrastructure and spending on human capital.
- Interaction of a central fiscal surplus with existing economic and political power structures, creating the potential for capture of the central fiscal authority and its tax policies, and for excessive avoidance of tax by privileged categories of entities or taxpayers.
- The importance of earmarking taxation visibly to the benefit of popular social spending priorities in order to enhance taxpayer trust and compliance

An important difference between the current problem of taxation in a global economy is that the Australian States were operating on a 'federal' principle, having ceded some sovereign powers to a central government in return for the obvious benefits of mutual trust and common protection. Despite this auspicious beginning, safeguards for States' financial viability proved insufficient. Based on Australian States' experience, 'if the total level of federal grants is inadequate to enable the States to carry out their constitutional responsibilities, the equalisation process will bring all States to a comparable level of poverty' (Mathews 1994b, p. 5). This history implies that the proposal for a World Tax Organisation might develop along the following lines in the longer term:

- Establishment of international tax institutions, a) to encourage tax harmonization, and reduce tax competition and avoidance, through multilateral tax negotiations centred on taxation of corporations and high personal incomes; and b) to establish principles and processes for allocating income tax revenues between nation states (initially on a reimbursement basis but later by a more equalising formula).
- Institutional design which a) guards against excessive imbalance of fiscal power between international and national institutions; b) prevents distortion of spending and taxing priorities; c) counters the risk of capture by dominant economic or political interests; and d) hypothecates tax revenues to decentrally and democratically identified social protection priorities.

Future research

This study suggests several remaining gaps in our knowledge that still hinder our understanding of the problem of tax policy in Australia.

Firstly, this thesis suggests that rising income inequality generates demands for social security and new tax revenues. However, historical studies of income inequality in Australia are few, being limited by available data. None examine empirically or directly the historical relationship between income inequality and taxation or social security reform.

Secondly, this study has only touched on the evolution of social security, its centralization, and the relation to economic change and to the institutional constraints of a federal system. Social security in Australia was financed by taxation, and Commonwealth grants to States were adjusted accordingly where provision moved to the central government, but there has been no exploration of the forces or motivations behind this process. Existing political or social histories and interpretations of Australian social security would usefully supplemented by a study of its evolution within an economic and institutionalist framework.

Thirdly, the contention developed in this thesis has been that centralized fiscal authority in Australia led to 'a gradual retreat from public capital formation' (Butlin 1980 [1954], p. 472).

Designing institutions that produce the best mix of policies in the present global context requires better understanding of the equity-efficiency tradeoff from different approaches to social protection. Because of the potential economic efficiency costs of high effective marginal tax rates this suggests the need for future economic research to empirically evaluate the 'excess burden' of pursuing social protection through progressive tax-transfers compared with achieving similar ends through, for example, wage regulation, investments in human capital or investment in public infrastructure.

Fourthly this study has excluded company taxation, and there is no comprehensive history of company taxation in Australia. To provide some insights for the present problem of corporate taxation in a global economy, a useful endeavour would be to identify key features of States' company tax systems at Federation, and explore the subsequent history of State and Commonwealth Government policy and official tax negotiations on tax harmonization and joint collection culminating in uniform income taxation in 1942.

Finally, the implications of the tax-transfer system for the reproductive work of households — creating and maintaining human capital has been put aside in this thesis because of the enormity of the task. However, this story has touched on the issue of how the costs of funding investment in human capital have been shared among parents, employers and the state. As the scope of the market economy has increased, and as the rewards of the paid labour market increasingly competes with economically and socially important household investments in human and social capital, a question is raised about the changing extent to which the tax, transfer and wages systems have shared the costs of human capital investment with households during the last century. The acknowledged historical importance of human capital investment in reducing inequality is reinforced by its rising significance to the future distribution of incomes with a shift in the pattern of economic growth to knowledge-based industries. This thesis thus points to the value of an historical study examining household and public investment in human capital from a perspective of such investment in children as a 'public good' (Folbre 1996).

Summing up

It has been argued that the most direct and powerful impact of globalisation on the welfare state will be through its effect on tax systems:

> While the fiscal house is still standing and looks solid, one can visualize many fiscal termites that are busily gnawing at its foundations. ... The conclusion must be that it would be prudent for many countries and especially for

> welfare states to begin preparing themselves for what could prove to be significant falls in tax levels in future years (Tanzi 2000b, pp. 15–19).

Public finance scholars have anticipated a 'tax crisis of the state' for over a century. For Goldscheid, writing in Europe during the late 1800s, the imperative for government to raise its revenues without harm to the health of the private economy meant the state could not levy any taxation affecting production or savings and investment incentives (Goldscheid 1958 [1925]). This forced the state into excessive borrowing and made the public sector over-dependent and vulnerable to exploitation by private financiers. For O'Connor, writing in the early 1970s, fiscal crisis arose from a structural gap emerging between rising public expenditure requirements and the limited ability of the state to raise revenues (O'Connor 1973); despite the increasing difficulty of raising revenue, the state must invest both to fund social consumption to reduce the employers' costs of providing for the reproduction of labour and to maintain the conditions for profitable investment.

This thesis has identified historical lessons of the tax policy problem from the experience of the Australian federation, and developed principles and proposals for dealing with the problems of tax policy in a global economy. Tanzi's analysis of the problem of globalisation and the future of social protection concludes thus:

> Whether adjustment of institutions [tax systems and systems of social protection, to globalisation] will be smooth or difficult remains to be seen. It will depend largely on the vision and on the technical and political skills of those who make policy decisions (Tanzi 2000a, p. 3).

The big questions arising from this thesis are whether those who make tax policy decisions can use the experience of history to distinguish situations where reduced sovereignty and greater supra-national authority (such as that arising from even more centralised revenue collection and disbursement) would be acceptable and sensible, from those spheres where the dominant influence of corporate or industry or other elite interests threaten diminished democracy and produce widespread and strong levels of citizen resistance.

In a sense, this is a question of whether a liberal democracy can develop appropriate institutions to respond to the political and social as well as the economic imperatives of a capitalist system, as anticipated by Schumpeter's 'tax crisis of the state' (Schumpeter 1954 [1918]). The alternative outcome is that foreshadowed by Tuchman's *March of Folly* (1984, p. 2), which concluded that

> A phenomenon noticeable throughout history regardless of place or period is the pursuit by governments of policies contrary to their own interests. Mankind it seems, makes a poorer performance of government than of almost any other human activity.

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