

# Consuming PASSION

*Since ALR published Peter Groenewegen's article in April, the consumption tax debate has exploded. And passions are running high. Here are four responses to that article, and the debate.*

## Siege

# MENTALITY

**P**eter Groenewegen's article (ALR 116, April) is a welcome addition to the debate which has recently resurfaced on the introduction of a broad based consumption tax (BBCT) in Australia. It signifies that the Left is moving away from the perception of the consumption tax as an issue on which we will "go to the wall".

That is not to say that the victory achieved at the Tax Summit in 1985 should be ignored. The Left and the trade union movement as a whole (including the ACTU) was, and remains, correct in their rejection of the proposal to replace progressive income taxes with a BBCT. In this respect, it is useful to recall that Peter Groenewegen's proposal is broadly similar to that proposed by a significant section of the trade union movement in 1989.

The Australian Public Service Federation (APSF), the national body of the state public service unions, commissioned the H V Evatt Research Centre to undertake the first ever comparative study of the six state public services. The result of that study (*State of Siege: Renewal or Privatisation for the Australian State Public Services?*), canvassed the idea of a State Goods and Services Levy, basically a BBCT.

The State Goods and Services Levy (SGSL) would be used to replace a plethora of state taxes, and the federal wholesale sales tax. It was proposed as a means of ensuring the continued financial viability of the state in an era of a continuing need for services the states already provide, and emerging new demands for state services. The recent experience of each of the states over the last few months - as stamp duty revenue has been significantly below projections due to the collapse of the property market - shows how urgent is the need for the states to develop a secure revenue source. Continued reliance on stamp duties on property transfers would be similar to a household which

won the lottery, planning on that basis, that next year's income will match this year's!

The proposal for a SGSL was made in the knowledge that, as *State of Siege* reported, "Australia's problem is that it collects the same ratio of indirect to total taxes as the OECD, generally from a base of four commodity groups (tobacco, alcohol, petroleum and motor vehicles). There would be large gains from rationalising the maze of state indirect taxes..."

Reliance on such a narrow taxation base has significant economic effects which Groenewegen has outlined, and which do not need to be repeated here.

The SGSL proposal would replace certain state taxes with the SGSL which would be a BBCT. *State of Siege* canvassed in particular the replacement of the states' reliance on payroll tax.

It is important to explain why this tax was particularly targeted, given that payroll taxes are the most important contributor to states' own tax revenue (the largest contribution to states' total revenue remains federal grants). *State of Siege* pointed out that it is necessary to distinguish between the statutory incidence and the actual incidence of a tax.

The fact is that, while payroll taxes are statutorily levied on employers, the burden of the tax can be, in the last instance, shifted forward (to prices) or shifted backwards (to wage rates). Alternatively, it can create an incentive to replace labour with capital which does not incur the same tax liability.

The negative impacts of the SGSL were also recognised in *State of Siege*, and proposals for their minimisation were put forward. These proposals were also canvassed by Groenewegen's article. Basically, they fall into the category of transfer payments to low-income earners.



Photo: John Fairfax & Sons

## JOHN HEWSON

Set the ball rolling with his no-compensation consumption tax proposal, to "boost savings".

Photo: News Ltd



The inflationary impact of a BBCT has been the subject of much debate. It is important not to exaggerate this and to realise that what inflationary impact it may have would be one-off. The allocative advantages which would result easily outweigh the inflationary impact - particularly for the manufacturing sector.

But the APSF did not limit its proposals to the introduction of the SGSL. Additional proposals included the serious consideration of a wealth tax; the targeting of franchises from alcohol and tobacco sales to health expenditure; and urging all state premiers to work actively towards harmonisation of state taxes.

On this last point, it is significant that the Premier of New South Wales has already expressed the view, in the context of environmental policy, that the old conservative view of states' rights is passé. It may be possible for the Left to urge - at least - the Labor premiers to adopt the same attitude on state taxation.

The APSF took what can only be described as a far-sighted and courageous step in advocating the introduction of the SGSL. The problems that would arise from the introduction of such a tax have been recognised, but proposals have been put forward to minimise the equity disadvantages of such a tax.

But it is clear that all the issues involved could not be canvassed. That will require ongoing and open debate. Peter Groenewegen and *ALR* are to be congratulated for providing a forum for the Left to debate the issue rationally.

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## JOHN BUTTON

Suggested a consumption tax could eliminate a "tax bias" against manufacturing.

# DIVERSIONS

## from the STRUGGLE

**O**ne of the Left's few major victories in the 1980s was the defeat of Paul Keating's proposal for a consumption tax. Now the proposal has been reactivated by corporate capital in conjunction with the Liberal Party and sundry other supporters. Even *ALR* has seen fit to run an article extolling the advantages of a consumption tax. Still, after giving space in the February issue to a reactionary polemic by PP McGuinness on "the death of communism", one should not be surprised at that. No doubt *ALR* justifies this policy in terms of contributing to public debate, but these views get a good airing in the mainstream media.

So the Left has to gird its loins to do battle against the consumption tax again. One is reminded of Marx's comment that we live history once as tragedy, but to live it twice is farce! Contrary to Peter Groenewegen's claim in his pro-consumption tax article, the situation has not changed fundamentally since the national Tax Summit of 1985. The main issue is still the same - how to finance a good range of government expenditures by a tax system which is geared to people's ability to pay.

The basic problem is still the same - tax minimisation by companies and the wealthy (now resurfacing in 'out-of-the-harbour' rather than 'bottom-of-the-harbour' schemes, as recently reported in the press) which throws an excessive burden of tax on low and middle income earners. The basic solution remains largely untried - to simplify and widen the definition of income for taxation purposes so as effectively to eliminate tax avoidance and ensure that the nominally progressive tax scales are actually progressive in practice.

Against all this, the alleged inadequacies of the system of indirect taxation pale into insignificance. Indeed, there has been reform of sales taxation since the Tax Summit, leading to some simplification of the scales. The intention has been to gear the rates of sales tax more closely to whether goods are necessities or luxuries. Any such differentiated system necessarily embodies particular judgments. Yes, it does mean that consumers of crystallised fruit suffer higher taxation (and worse teeth) than consumers of fresh fruit. Yes, those people preferring to read books for relaxation are not sales-taxed, whereas those whose hobby is photography are taxed at the maximum rate.

These sorts of discriminations reflect an attempt, albeit imperfect, to tax more highly the sort of goods typically, but not invariably, purchased by upper income groups. What alternative does a consumption tax provide? It taxes the lot at a uniform rate. That is certainly one way of eliminating potential anomalies; but at the expense of the overall equity of the tax system. The poor pay more and the rich pay less. Dearer bread, cheaper BMWs.

So the blow has to be softened by "a comprehensive compensation package" comprising income-tax cuts for low income earners and improved social security benefits, plus a new wealth tax. But this is a sleight of hand, since those changes have no necessary link with the introduction of a consumption tax. If the income-tax and expenditure system can be reconstructed to help the poor, let's have those changes anyway. If a wealth tax would increase the equity of the tax system, and raise substantial revenue without massive offsetting costs of assessment and collection, let's have it anyway.

But why link these progressive proposals to a patently regressive consumption tax? More realistically, why give this sort of conditional support to a consumption tax when the conditions - particularly a wealth tax - are unlikely to materialise in practice? In fact, Groenewegen's article in *ALR* acknowledges most of the problems that a consumption tax raises. It would be inflationary, adding a possible 6-7% to the consumer price index in the year of introduction. It could fuel unemployment, particularly in the housing sector where it would add many thousands of dollars to the price of a new house. The article claims that unemployment need not occur, but the introduction of a consumption tax in current economic conditions, with the prospect of resurgent inflation and the possibility of a recession, would be a 'courageous act' (to use Sir Humphrey Appleby's famous phrase). Moreover, the claimed advantage of consumption tax as a stimulant to savings is, at best, a statement of faith. Proponents claim that a consumption tax would encourage savings since it effectively favours saving over consumption spending. However, savings for most people are a residual after they have met their consumption needs. A consumption tax would reduce that residual, so the overall effect is just as likely to be a reduction in savings.

Fundamentally, it seems that the case for a consumption tax rests on two themes - the desirability of a "non-distorting" tax system and a pessimism about the capacity to create an equitable tax structure. The former aspect rests squarely on the abstract formulations of neoclassical economics. As the *ALR* article puts it, the tax "creates less

distortion on the consumption decisions of individuals and households because it does not interfere with the relative prices of consumption goods". However, such "distortions" pervade all aspects of the economy because of the effects of monopoly, imperfect information, trade barriers, regulations and "externalities". What does a "level playing field" for taxation mean when there are so many other bumps? Indeed, as every good mainstream economist knows, the theory of second best states that there is no reason to suppose that the removal of some but not all imperfections from the market will improve the society's economic well-being. So we are left with the defeatist case that a consumption tax at least squeezes some revenue out of the wealthy, whereas other forms of taxation are seemingly incapable of doing so. This position seems more particularly to underlie the views of Russell Mathews ever since his observation that "the essential problem is not to make the rich pay high rates of tax or even to pay more tax: it is to make the rich pay any tax at all".

Yes, it would also be nice to get some more taxes from the tourist dollar and from the services sector; but the main task remains that of enforcing a tax system based on ability

**PAUL KEATING**

Claimed he'd already fixed the tax system, and that the tax would cost \$2 billion.



Photo: Brendan Smith/SMH

to pay. The task is to correct the situation noted by Mathews, though subjecting income from whatever source to an effective and progressive tax system. That would also have the effect of simplifying the tax system and enhancing its legitimacy. The debate on consumption tax is a diversion from this political priority.

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# Taxing REASON

**T**he entry of ALR to the revived consumption tax debate - by publishing Peter Groenewegen's contribution (ALR 116) - is welcome. It is particularly welcome evidence of political and intellectual maturity on the Left that such matters - until recently widely regarded as anathema - are openly and sensibly discussed.

Others who would prefer to wish the debate out of existence are, unwittingly or otherwise, furthering the 'ghetto-isation' of the Left. And even if - at the end of the day - some remain unconvinced concerning "the tax that dare not speak its name", this doesn't justify throwing into question the integrity of those on the Left who support it.

But it is important to be clear about precisely what is being proposed.

Virtually all consumption tax (CT) proposals have been couched in terms of 'revenue neutrality': new revenues raised by CT are to be offset by other tax reductions, so that total tax revenues as a proportion of national income remain unchanged. This is not because the current tax share of national income is regarded as ideal but simply to separate the issue of desirable tax level from the issue of desirable tax structure. It is the latter which is really at issue with regard to CT. There appear to be two quite distinct proposals being floated in public debate, involving three different major rationales:

1. Apply a CT to reduce income tax and, in particular, marginal income tax rates. Rationale: reduce disincentive to the supply of saving and increase the proportion of national income which is saved ("the saving ratio") - a so-called 'supply-side' argument.
2. Apply a CT to reduce income tax and, in particular, marginal income tax rates. Rationale: reduce disincentive to work and labour supply - another supply-side argument.
3. Apply a CT to reduce other indirect tax and rationalise the indirect tax system as a whole. I will come to the rationale for this in a moment because it is the proposal I regard as worthy of support.

Proposals 1 and 2 are obviously closely related, the distinction being that the first emphasises the potential for a change in the direct/indirect tax mix to increase the saving ratio and thereby reduce the current account deficit as a proportion of GDP.

I don't wish to go into technical detail on this matter and

therefore merely assert that both links in the argument are doubtful: I do not believe that such a change in the tax mix will systematically increase the saving ratio; and the notion that an increase in net saving will cause a reduction in the current account deficit is deeply problematic.

The notion that a shift in favour of indirect tax will increase labour supply and thereby economic and employment growth (also via increased saving) is entirely spurious.

In terms of income distribution such a shift tends to benefit savers in general and the wealthy in particular. Given the current level and structure of income taxation I do not believe such a shift to be desirable.

Nevertheless, the reflex reaction of some on the Left to defend the income tax status quo is absurd. This is so because, with given nominal income tax rates and persistent inflation, the real burden of income tax is rising continuously ('fiscal drag'). If the income tax system is 'just right' this year, distributionally speaking, it will presumably be wrong next year!

There remains the rationalisation rationale for a CT - which involves no shift in the direct/indirect tax mix - but, rather, a restructuring of indirect tax. This I think is a very worthy goal, partly because of the horizontal inequity of current federal and state indirect taxes; partly because the current state indirect tax system is such a ramshackle structure. I agree with Groenewegen that an expenditure tax is undesirable on pragmatic grounds and a value added tax is preferable to a retail sales tax. I also support a uniform rate for administrative and compliance reasons. So the logic of my view is that a uniform broad based CT be applied to abolition of the federal wholesale sales tax and a range of state indirect taxes plus any compensation for net price level effects of the reform. This conforms with the Evatt, *State of Siege*, view.

Two difficulties remain: the implications for vertical equity and for federalism.

With regard to equity, since my view does not involve a shift in the indirect/direct tax mix, compensation is not likely to be as considerable a problem as in the case of the 1985 Option C. The price level effects would depend on what state indirect taxes were abolished, and on the resulting downward pressure on prices.

With regard to federalism, the proposal requires a new compact between the states and Commonwealth with regard to tax policy. This is without doubt 'a big ask' but also offers big rewards, not least for the Left.

In summary, it must be understood, first, that in large part the current federal/state indirect tax system comprises de facto consumption taxes though set at quite arbitrary rates. Reform is easily justified.

Second, in the game of economic reform big prizes require big changes. State of Siege indicates that a 10-12% CT would put one within reach of abolishing all payroll taxes or all stamp duties, as well as the federal wholesale sales tax. Timidity in these matters results in proposals with benefits which hardly warrant the effort.

Third, the Left must not forget that the primary task of the tax system is to finance a healthy public sector which is capable of serving the interests of working people and the poor. Current state tax systems are not serving this function well.

The Treasurer is now as vociferously opposed to CT as he was in favour of it in 1985. He is right now to reject the arguments for proposals 1 and 2 above; but he is far from convincing when he broadly endorses the current indirect tax system as "reasonably efficient".

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## Poor LOGIC

**A**part from acknowledging that a broad based consumption tax cannot fail to be generally regressive, most commentators, including Peter Groenewegen (ALR 116) pay little real attention to the effect that its introduction would have on those with the lowest incomes. Furthermore, no argument seems able to be put forward as to the positive advantages that such a tax would have for that group. This is surely a question which must be

addressed by any commentator who pretends an interest in justice and equity as goals for reform in Australia's economic and financial systems.

Most supporters of the tax also argue for some sort of compensation, either through the social security system or the income tax system, for those who will inevitably be disadvantaged by its introduction. Groenewegen also falls into this trap. Comments such as "Compensate those disadvantaged...as long as their situation actually warrants it" (p33) seem reasonable enough at first glance. However, they imply tight targeting of benefits. This has a number of problems.

Although cost effective, targeting also can exacerbate welfare dependency through 'poverty traps' which means that those just above the threshold for benefits are sometimes worse off than those receiving them. Targetting also leads to a much more complex and, for the user, more cumbersome social security system. If the 'tidy government' brigade, being among the main supporters of the tax, wish to argue for simplified financial systems, an admirable aim in itself, then they must also argue for a simplified social security system.

The current tax system is very simple for the poor. It is only the rich who find it complex and, indeed, who work hard to add to its complexities. Social security recipients are much less likely to be in a position to be able to negotiate difficult government systems than taxpayers. Their livelihood literally depends on them being able to find out what benefits they are entitled to, and to jump through all the hoops on the way to claiming. This is no mean feat as those who have dealt with the income support scheme well know. One has to ask why all the targetting and fine tuning should happen at the social security end of the system with its consequent disadvantages for welfare beneficiaries, rather than at the tax end. Tighter targetting creates an even more readily identifiable and stigmatised class of welfare recipients.

Rises in the CPI will push more people over the line beyond which they cannot manage on their incomes which, together with the increased costs of managing a more complex system provides a bigger and better target for those who want to hit out at welfare spending and welfare recipients. Women in particular will be disadvantaged. Not only do they form a large proportion of beneficiaries and low income earners but, as the family shoppers, they will be forced to make the family pay packet go further - breadwinners will not necessarily hand over significantly more because they are getting a few dollars more per week in income tax savings.

Much of the failure to address the real effects of a consumption tax on the poor comes from a failure to understand a central issue in the lives of poor people - their lack of choice. Comments such as the following hint at this failure. "The claim to fairness on the part of a broad based consumption tax has been much misunderstood. It needs to be understood that sales taxes of the type currently used in Australia fail to treat people with similar incomes equally because of differences in their consumption patterns." (ALR 116, p32.)

This statement is no doubt true. However, it begs the question of whether people on low incomes really have a great deal of choice in relation to their consumption patterns - that particular lack of fairness only affects those who have enough surplus once the basics have been taken care of to make any choice as to how disposable income will be spent.

The tax has appealed to certain sections of the Left on the basis that there would be more dollars for the "welfare basket". It would require a hefty consumption tax, say 20%, to cover the promised abolition of the current taxes which would disappear in the 'tidy up' accompanying its introduction and allow even a very small income tax reduction. It is also acknowledged that dry government would only introduce a consumption tax if it could be sold to the electorate on the basis that it would not raise the level of tax (and therefore of revenue) overall.

## JOHN HOWARD

Thought the tax was being given a rough time, and needed debate.



As argued above, there is no point in a bigger welfare basket if the introduction of the tax also creates a greater need. One of the main arguments is that evasion will be harder or impossible by those who should pay. The success of the fringe benefits tax and capital gains tax (minimal though the rate is) in raising revenue has shown that there are ways of collecting from the rich.

Most supporters of the tax now acknowledge that it will have minimum effect in achieving one of the main aims originally proposed for it, ie the increase in savings. Ross Gittins has pointed out (*Sydney Morning Herald*, 7.5.90) that other proposals have been made which are aimed at two of the other perceived benefits of the consumption tax - ending the bias against manufacturing and ending the tax on exports - which arguably will benefit the whole economy and low income earners along with it.

He claims that a VAT of approximately 7.5% would cover the cost of ending the wholesale tax and have a negligible effect on the CPI because it would be revenue neutral. It would therefore create no need for compensation but would be an unlikely measure for any government because it would bring no tangible benefits. As an incentive to savings he describes another option - an "expenditure tax" which simply gives people an income tax deduction for the increase in their savings via designated savings vehicles. However, any tax based on deductions and savings involves a regressive shift. Not only do the poor have less, if any, capacity to save, the value of deductions is less to them. Deductions are also notoriously prone to loopholes.

The foregoing answer to Peter Groenewegen will no doubt be criticised on the basis that it offers no positive alternatives to the consumption tax. It must be acknowledged that the debate requires more lateral thinking about alternative ways of redressing the inequities in the current system and raising more revenue from those who can afford to pay. At the same time, those who propose a consumption tax need to provide some better arguments as to precisely how the lowest income earners will benefit before the welfare sector should support it.

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