

The ELECTION issue that WASN'T

Commentators of all persuasions agree that Australia will probably get a consumption tax before long. Both major parties are thought privately to endorse the idea, though they publicly disowned it in the campaign. Peter Groenewegen is a longtime left advocate of the consumption tax road. Here he argues that it's time the Left made up its mind on the issue.

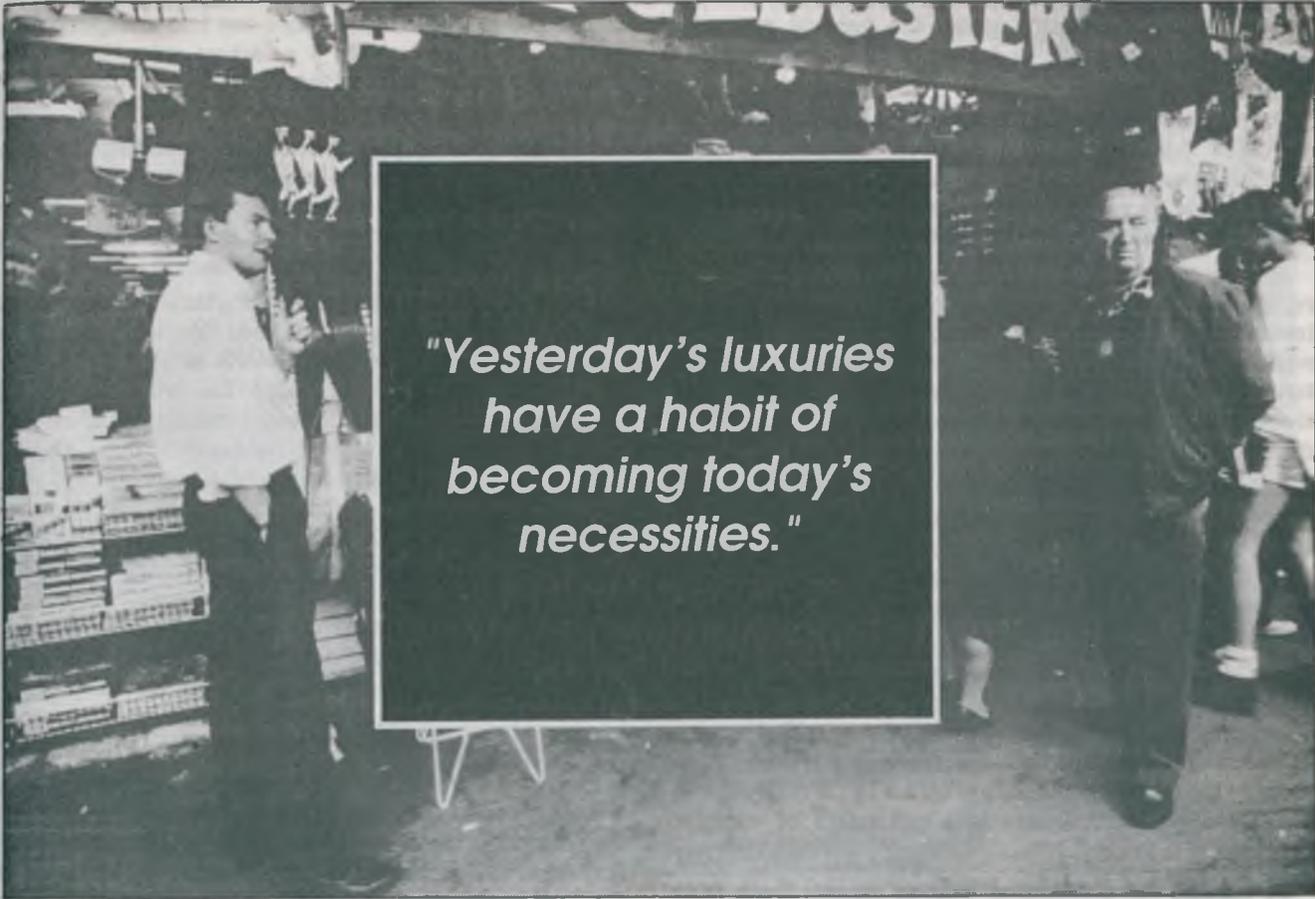
Despite its massive defeat at the National Taxation Summit in 1985 the issue of broad-based consumption taxation continues to resurface in Australian economic policy debate. Many of its former opponents at the Tax Summit now support the notion of broad-based consumption taxation, reflecting the changing economic circumstances of the intervening five years.

Its importance as a source of revenue for financing public expenditure growth is increasingly being appreciated in the post-Summit era by those who do not think that a small public sector is a good public sector. The revenue potential of a value-added tax for financing much-

needed expansion in some social welfare spending is well understood by those, such as ACOSS, whose requests for such additional spending have been rebuffed on the ground that income tax rates need to fall.

The recent changes of mind on the issue on the part of some on the Left in part reflect the major error in the Draft White Paper on Tax Reform which the government issued on the subject back in 1985, and which then helped rob the idea of support. In short, the White Paper planned to introduce broad-based consumption taxation by a hybrid retail tax which was unable effectively to eliminate producer goods from the tax base, instead of going the generally preferred value added tax route.

If we do require a consumption tax to expand social spending, then a value-added tax rather than a retail sales tax should be supported by the Left, since the latter cannot



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Photo: Patrick Riviera/Sydney Freelance

easily generate substantial revenue. A retail sales tax is, therefore, generally supported by those wishing to seek restraints on public sector growth.

Since 1985 the documentation in support of the superiority of value added tax has increased substantially. In addition, New Zealand's introduction of value added tax under the more neutral title, Goods and Services Tax, has greatly allayed the fears of many observers about its supposed detrimental consequences - fears largely derived from the often fictitious accounts of the horrors of the British experience in the early 1970s.

Changed perceptions of the relevance of broad-based consumption tax reform, together with greater appreciation of the importance of choosing the right instrument by which to effect it, make a re-examination of its advantages and disadvantages timely in the present straitened fiscal circumstances. Such a re-examination is particularly important on the Left, since myths have tended to predominate over realism in left debate on tax issues - though of course the Right is by no means immune to such mythologies. For those unable to cast their minds back to Joh's infatuation with the Laffer Curve then being pushed by leading sections of the stockbroker fraternity, aspects of the Coalition's election campaign tax policy will provide plenty of examples of wishful and inaccurate thinking on the tax front.

It is also worthy of note that neither the Coalition nor the Labor government in Canberra is currently willing to nail the consumption tax flag to their policy mast, irrespective

of the many advantages which are said to flow from such an initiative by tax analysts across the political spectrum. This, in itself, is a salutary warning that the consumption tax debate is too complex politically and economically to be dismissed simply as a conservative sleight of hand.

Many of the arguments in favour, as well as the disadvantages, of broad-based consumption taxes were discussed in the Draft White Paper released by the federal government at the time of the Tax Summit. It may be useful to reiterate those official arguments as a starting point for discussion.

Firstly, a broad-based consumption tax would enable some rationalisation of Australia's existing indirect taxes on goods and services. In the context of the economic and political difficulties associated with the personal income tax and the high marginal tax rates which were then in force, a broad-based consumption tax would, it was argued, ensure that income which avoided or evaded income tax would bear some tax liability when spent.

At the same time, the reduction in marginal income tax rates allowed by the revenue from such a broad-based consumption tax would, in turn, reduce incentives to avoid or evade income tax. Furthermore, because a consumption tax does not affect interest income and therefore has a neutral effect on present consumption and saving (unlike the double impact on savings associated with the personal income tax) a consumption tax regime is conducive to increased personal income tax levels and hence more favourable to economic growth. This last point has become

more important recently, given the general personal savings crisis identified in Australia by many commentators.

Further, a broad-based tax covering all consumption at a uniform rate is more administratively efficient in that it requires fewer resources for the Australian Tax Office to assess and collect, and its operations are less costly for the firms which collect it on behalf of the government.

Such an approach to implementing the tax likewise creates less distortion on the consumption decisions of individuals and households because it does not interfere with the relative prices of consumption goods - a characteristic which, in addition, increases horizontal equity or the equality of treatment to taxpayers in equal circumstances.

This claim to fairness on the part of a broad-based consumption tax has been much misunderstood. It needs to be understood that selective sales taxes of the type currently used in Australia fail to treat people with similar incomes equally because of differences in their consumption patterns.

Leaving aside the deliberate discrimination introduced by extra heavy taxation of tobacco products, alcoholic beverages and motor fuels - a situation not likely to be abandoned when a broad-based consumption tax is introduced - the current wholesale sales tax by its rates and its exemptions discriminates between users of various products.

A passion for crystallised fruit as against fresh fruit incurs a sales tax liability in Australia. Ending a meal with cheese rather than with after-dinner mints escapes such tax liability, while those preferring artificial flowers to natural flowers have to pay sales tax for indulging this taste. More generally, those preferring to read books for relaxation are not sales-taxed on their leisure requirements, while those whose hobby is photography are taxed at the maximum rate.

Apart from the penalties imposed on taste by selective as against broad-based consumption taxation, selective taxes like Australia's wholesale sales tax impose penalties on activities, a form of discrimination which broad-based consumption taxes avoid.

By concentrating on commodities sold at wholesale and exempting most services, the existing consumption tax regime discriminates against the manufacturing sector. Supporters of a strong manufacturing sector for Australia should therefore push for a broad-based tax on consumption which can effectively tax services.

The current sales tax regime likewise favours imported over domestically-produced goods, since the valuation procedures tend to understate the value of imports relative to equivalent goods produced domestically. This is despite the 20% valuation surcharge imposed on imports to prevent this tax preference to importers. Exporters, on the other hand, although not required to pay sales tax on the value of goods exported, may pay sales tax on inputs used in the production of those goods, for which they obtain no exemption. Hence costs are higher than they

would be, and goods therefore are less competitive in overseas markets under a selective sales tax of the Australian variety than with a broad-based consumption tax like value-added tax.

Another advantage of broad-based consumption taxation is the simplification of the existing tax structure, particularly if this tax reform is implemented with the co-operation of state governments, and leads to replacing a number of so-called 'nuisance' taxes.

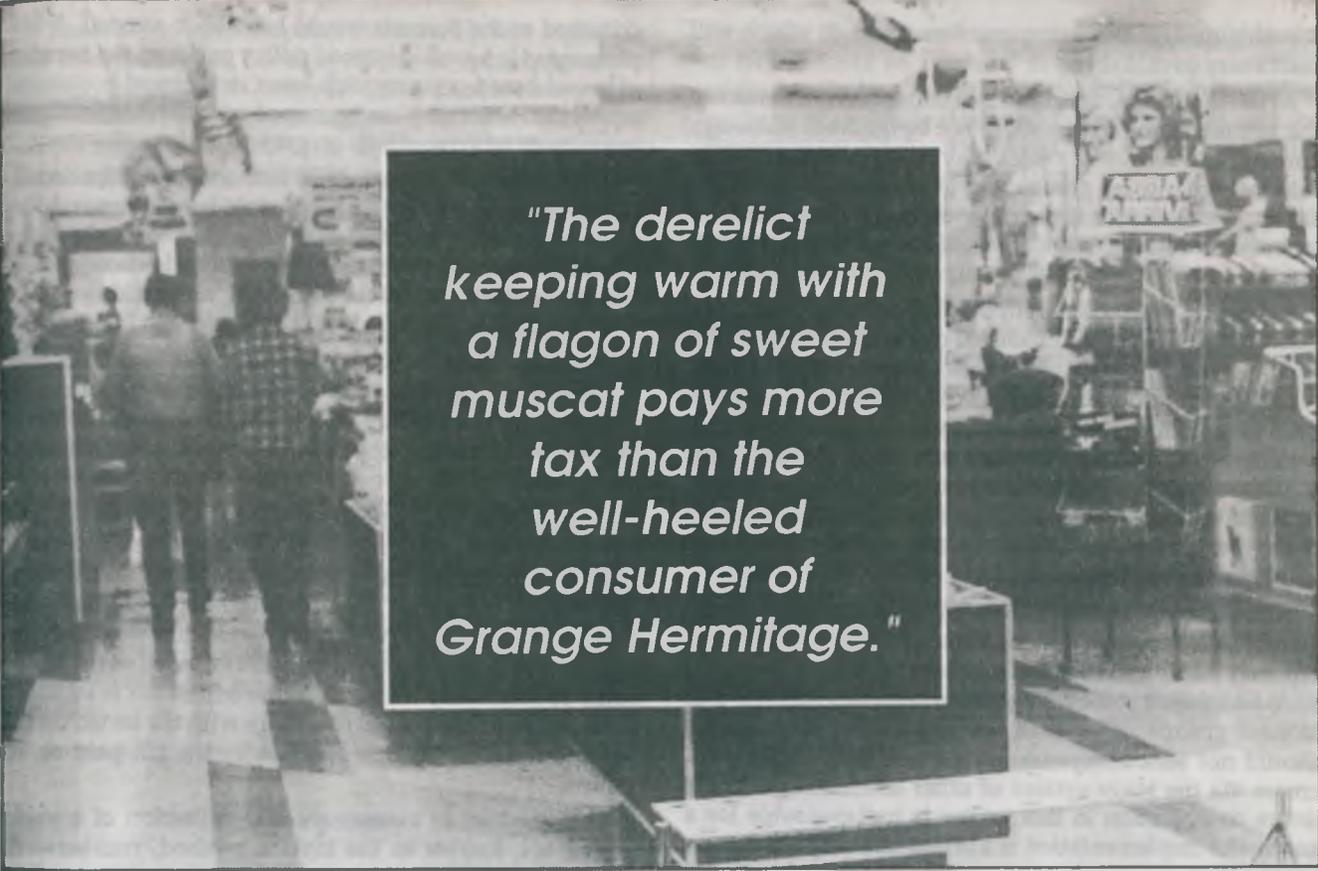
Last, but not least, as a partial substitute for income tax, a broad-based consumption tax can impose tax liability on non-residents on short-term visits to Australia who, generally speaking, are not liable to Australian income tax but whose personal consumption spending would be comprehensively taxed under a consumption tax regime. Given the growing importance of the tourist industry (despite the current problems created by the domestic airline dispute) broad-based consumption tax may help to spread the tax burden relative to the benefits of public services enjoyed. Australia's current sales tax, rebatable on items for export purchased by short-term visitors, does not often fall on general purchases by such visitors, like meals or other personal services and entertainment. In short, the advantages of moving to broad-based consumption taxation have expanded rather than diminished since 1985.

One major reason for the rejection of the broad-based consumption tax strategy at the Tax Summit in 1985 was the perception that it would tend to hit low income groups and other underprivileged people relatively harder than the well-to-do. The reason for this perception is quite straightforward. Consumption declines with levels of income so that a uniform rate on consumption spending falls proportionately relative to income as that income rises: a clear sign of a regressive tax.

A low to medium income family with dependent children which consumes all, if not more, than its regular income - by borrowing or by running down past savings - at best pays a rate on consumption in terms of income equivalent to an income tax rate. If the household temporarily consumes more than its income, its situation deteriorates. A high income family, even with many dependent children, consumes considerably less than its income: hence its consumption tax rate in terms of income falls considerably below the equivalent income tax rate.

This problem can be redressed in several ways. One suggestion which surfaced both before and during the Tax Summit was to target consumption taxation to luxury goods and exempt all necessary consumption items. European consumption tax experience, as well as Australian economic research, suggested that this would transform a regressive tax switch to something approximating proportionality in tax burdens if not progressivity.

The difficulty with this procedure is partly administrative. Exemptions and multiple rates impose substantial additional costs on tax administrations and taxpayers which are of no benefit to the community. More importantly, the task of classification which this type of tax regime imposes is endless, since yesterday's luxuries have a habit



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of becoming today's necessities as living standards rise over time and costs fall with the extension of production associated with a growing market.

Furthermore, and often irrespective of incomes, one household's luxury is another's necessity, hence the arbitrary selection of goods for one or the other category imposes penalties on consumption, preferences which often are only imprecisely related to taxable capacity differences.

The exemption of food items in general makes it difficult to differentiate, for tax purposes, King Island Brie from Kraft cheddar, imported pate from Vegemite. Likewise, blanket exemptions of clothing eliminates tax liability for an outfit from Best and Less or Fosseys as well as the finest in designer clothing purchases from the most exclusive boutique. Hence, blanket exemptions of items like food and clothing impose the same inequities which an excise on wine used to inflict on the derelict keeping warm with a flagon of sweet muscat, who paid more tax than the well-heeled consumer of Grange Hermitage.

The best response to the adverse distributional consequences of consumption taxation is to be found outside the tax system. This was first realised by Denmark when it introduced a single rate value added tax with few exemptions, and later by the Australian government in the broad-based consumption tax policy option put before the Tax Summit.

The answer? Compensate those disadvantaged by a move towards general or broad-based consumption tax-

tion for their loss of real income implied in this change, as long as their situation actually warrants it. Such compensation can either be provided by additional increases in social security benefits, automatic if these are indexed to changes in the official cost of living estimates, or by targeting concomitant income tax cuts in such a way that they proportionately benefit low income taxpayers.

A comprehensive compensation package was devised by Treasury in consultation with the Social Security Department at the time of the 1985 broad-based consumption tax proposal.

This was found wanting, however, on a number of counts. One criticism was that its concentration on compensation in terms of losses in current income reflected the fact that low income families with dependent children may finance high consumption levels during this stage of their lives by going into debt. Compensation arrangements which fail to account for this possibility leave such people and households worse off.

Data on consumption patterns of Australian households suggests that consumption spending often exceeds income in low income households with dependent children and among the aged, some of whom are not covered by social security payments.

Any package of compensation for a move towards broad-based consumption taxation should reflect this, and also take into account other criticism of the 1988 compensation package designed by the government. The fact has to be faced, however, that administrative complexity

prevents design of a compensation package which will meet every eventuality.

At the same time, distributional consequences at the top end of the income scale should not be ignored. Although a broad-based consumption tax may raise the amount of tax paid by high income groups who at present have substantial opportunities for tax avoidance, this by itself will not ensure overall progressivity of the tax structure after the change.

Achieving this requires supplementary wealth taxation either in the form of reintroduced death duties, or regular wealth ownership taxes of the type levied in various OECD countries, or a combination of both. Effective exemption from saving for many would otherwise generate too much wealth inequality. Apart from the adverse distributional consequences of a broad-based consumption tax policy, critics have raised the potentially adverse macro-economic consequences on inflation, economic activity levels and employment opportunities.

Some adverse consequences on the price level are inevitable if a consumption tax is indeed to be introduced, but they need not become long term if neutralised in a once-and-for-all price change. However, this requires that income groups other than social security beneficiaries should not seek compensation for this cost of living increase via the wage system or other mechanisms. Trade union co-operation in this matter is indispensable for a successful implementation of a broad-based consumption tax strategy.

Even then, a once-and-for-all inflation change can cause havoc in financial markets in an open economy like Australia with its unrestricted foreign exchange and capital transactions. The precise inflation effect of a broad-based consumption tax is not easy to estimate, depending as it does on the rate at which it is to be imposed and the taxes which it is going to replace. The 12.5% tax proposed in 1985, which was intended to replace completely the wholesale sales tax, was estimated to induce a jump in the price level of approximately 6-7%.

More important fears were expressed about the income effects of the policy as a result of its tendency to depress aggregate demand in the economy. A revenue neutral package which lowers income taxes and restores the lost revenue by a uniform consumption tax would, it was argued, lead to a reduction in demand. This in turn would lead to substantially lower levels of economic activity and thereby to significantly higher unemployment.

However, most of the modelling carried out on this before the Tax Summit exaggerated this effect. Analysis prepared by the National Institute of Economic and Social Research for the ACTU and the government at the time of the Summit showed that if the package proposed by the government was implemented as planned, it would have minimal adverse income and employment effects. This was because much of the impact on demand from the tax switch was offset by increased demand from the compensation package. In short, if adequate compensation for the real income losses imposed on disadvantaged groups had been provided, the adverse effects for which the policy was

criticised at the Summit would have been averted. If implemented in a well-designed policy package, the benefits of broad-based consumption taxes in terms of horizontal equity and neutrality can be reaped without distributional inequity or adverse effects on growth and employment.

As the Draft White Paper also indicated in 1985, a broad-based consumption tax strategy could be implemented by a variety of tax instruments of which extending the wholesale sales tax, introducing a retail sales tax or using a value added tax were the three options considered.

A more extensive wholesale sales tax of the type currently in use in Australia is not a strong starter in this context. It cannot tax services, has administrative problems in determining sales values which favour certain sections of business over others, and is therefore technically inferior for the task.

On the other hand a retail sales tax which, in theory, can tax all consumption transactions at the retail level is theoretically equivalent to a value added tax which effectively does the same. The difference between these two instruments - and one with quite significant practical consequences - is that the retail sales tax is levied at the single stage of retail only while the value added tax is imposed at all stages of the productive chain with tax levied on the sales (output) of each firm offset by the tax paid on its inputs.

This method of assessment and collection of a value added tax, known as the invoice method, cumbersome though it seems at first sight, is in fact the source of its superiority over the retail sales tax. Rather than being collected in one go at the retail stage like a retail sales tax, the value added tax is gradually paid on the value added (sales less purchases) over all stages of production. Hence, small service providers at the retail level could be exempted but still pay tax on the inputs required for their industry which has already been collected at a previous stage of production.

Likewise, the fact that all producers and sellers feature twice in the tax transaction framework as purchasers (entitling them to tax credits) and sellers (making them liable to tax payments) provides a mechanism for keeping them honest since their tax liabilities, as tax credits for others, provide a useful opportunity for cross-checking. Thus a value added tax is more difficult to evade than a retail sales tax. Furthermore, value added tax can more easily provide rebates for tax paid on inputs which, after all, is a feature inherent in its method of collection and which is particularly useful for effective exemption of export industries from the tax.

A value added tax was not proposed in Australia in 1985 because it was believed it would take too long to introduce, was too complex for taxpayers, particularly in small business, relative to retail sales tax and, from British experience, would be too politically unpopular. Introduction of the Goods and Services Tax in New Zealand suggests that these beliefs rested on rather poor foundations. In short, a value added tax is now generally regarded as the best way for implementing a broad-based consumption tax.

There is one further option. With the current high interest in consumption tax as a vehicle to enhance personal saving, the Monash Centre for Policy Studies has revived the notion of a direct consumption tax. This simply exempts all income devoted to saving or investment from taxation, hence, by definition, taxing all outlays on consumption expenditure. To be consistent, all expenditures such as the running down of cash balances and bank deposits, is counted with consumption spending and hence liable for taxation. This form of expenditure taxation has the advantage that it can be applied at progressive rates, with rates for high consumption spenders capable, in principle, of exceeding 100%.

Although, at first sight, these are attractive features of this type of tax, its real administrative complexities have meant that no actual tax administration has been willing to implement it. In practice, it adds to all the complexities of income tax administration the difficulties of defining saving (or investment) spending which, if not carefully done, create all sorts of avoidance opportunities for the rich. Indirect consumption taxation is therefore the invariably preferred route by actual tax administrations from which to reap the benefits of broad-based consumption taxation.

A consumption tax is not a panacea for Australia's

economic ills, as some have portrayed it - if only because of its influence on personal savings. Nevertheless it can undoubtedly be a useful tax reform if implemented in a package of carefully designed income tax cuts and compensation for the disadvantaged, and if it is supplemented with appropriate wealth tax forms.

Most of its benefits in reality arise from eliminating distortions inherent in the current system of wholesale sales tax giving preference to services relative to manufactured goods, and to importers as against exporters. While there may be benefits for growth from the encouragement of savings, such benefits are easily overstated, particularly in the current panic about levels of savings in Australia.

Broad-based consumption taxation, in short, is a useful tax reform option for the rationalisation of Australia's current indirect taxes - taxes which are clearly less efficient and horizontally equitable. These benefits in themselves make the policy worth pursuing, and not one to be dismissed out of hand by the Left - even if some of its current and past advocates may have rather different reasons for pursuing it.

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