A TALE OF
Two Taxcuts

Paul Keating’s One Nation package helped rescue the
government’s fortunes. The cost, however, was meeting
the Coalition’s tax cut promises. Peter Groenewegen
argues it’s time to call a halt to the tax-cut bidding war.
Tax cuts have their uses, but the evidence points to the
need for raising taxes, not lowering them.

The Tax Gunfight’ was the Sydney
Telegraph-Mirror’s response to Paul
Keating’s One Nation package in late
February. PM and would-be-PM
were suitably adorned with stetsons and gun-
belts, flanking commentary depicting the One
Nation/Fightback! confrontation as a saga in the
spirit of the Gunfight at the OK Corral. Following
the battle of the taxcuts was as gripping, we
were told, as a Fenech world title fight, an
Australian victory in the World Cup, or the latest
episode in the battle of the sexes in Chances.

Yet, while there are many differences of great import be-
tween Fightback! and One Nation, there is also much that is
similar. In particular, it is sadly true that both packages
pander to the populist disease currently afflicting
politicians of all hues for appealing to the public’s appetite
for bigger and better tax cuts. Nor is this disease confined
to Australian politicians: the Economist of 29 February
implored British politicians ‘Don’t Cut Taxes’, in the runup
to this month’s elections. The tax-cut fixation is all the more
relevant when two decades of this mindset have driven
Australia from the top of the bottom third in the OECD tax
league to as close to the bottom as a self-respecting
developed nation can get.
The political attractions of tax cuts are too well-known to require much comment. Inflation and 'bracket creep' (the erosion of the real thresholds of tax rates by inflation) are still of great importance, even with our drastically simplified rate scale and lower recent inflation rates. And tax cuts are always on call to redistribute an inflation-induced tax yield bonanza to whichever group of deserving 'middle income earners' have been drawn to the party pollsters' attention. Inaugurated by one of Gorton's one-year treasurers, Leslie Bury, the political tax cut was assiduously practised by subsequent Treasurers Billy Snedden, Frank Crean, Bill Hayden, Phil Lynch, John Howard and, most recently, Paul Keating himself—probably the most notorious instance being Malcolm Fraser's 'fistful of dollars' election campaign in 1977.

The common thread through these instances is that the grandiosity of their announcement ('the biggest tax reform since federation') is equalled only by the rapidity of their retreat from memory. Malcolm Fraser's one-year excursus into income tax rate indexation, hailed on its introduction as the greatest fiscal reform ever, was five years later described by his then-treasurer John Howard as a luxury no realistic politician could afford. The vague promises about automatic tax indexation in *Fightback!* ring particularly hollow when it is remembered that its architect was an unelected member of the gang which cobbled together Fraser's fiscal Xanadus during the early 1980s.

What is the case for tax cuts? And, more specifically, what is the case for further personal income tax cuts? To sort out the rhetoric from the analysis, it is not really necessary to wade through the catch-cries about the merits of a 'leaner' public sector—catch-cries which in any case can only be muted given the massive relative reduction in the size of the public sector over the last half-decade or so. Focus instead on the more important issue of the tax policy context in which the tax cuts are made.

For example, in the change in the tax mix from taxing income to taxing consumption advocated in *Fightback!*, income tax cuts can in certain circumstances play a legitimate role in compensating for a new broad-based consumption tax (GST). Such a policy has merit to the extent that it rationalises the tax system by replacing Australia's antiquated and indefensible wholesale sales tax (an objective, however, which it is perfectly possible to pursue without massive income tax cuts of the *Fightback!* variety).

Nevertheless, in many respects a change in the tax base has less merit today than it would have had in the early 1980s. Income tax administration has become much more efficient in the last few years, thanks to tax file numbers, selective audits, improved substantiation requirements and more common deduction of tax instalments at source—and this has been assisted by some adventurous, though still limited, base-broadening (the capital gains and fringe benefit taxes). Tax compliance has in consequence vastly improved from the days of the 1970s and early 1980s—a time when it could have been said with justice that income tax was voluntary for non-PAYE earners.
What other justifiable reasons are there for cutting income tax? Restructuring tax rates by adjusting the thresholds at which those rates come into operation can be a useful corrective to the ravages of inflation. Of course, an even more effective corrective would be simply to index income tax thresholds for inflation—though policymakers have traditionally rejected this for what may well be quite sound fiscal reasons.

However, there is a broader framework to consider here. Tax cuts can have a role to play in wider macroeconomic policy-making, enhancing the capacity of the government to bolster demand in time of recession, attack the distribution of wealth in our society, and enable resources to be allocated more efficiently between sectors. Addressing the issue of tax cuts in these terms helps us understand the pros and cons of the two tax cuts currently on offer. It also enables us to pierce that dark veil called 'fiscal illusion', which masks some of the real dangers inherent in tax-cutting for political purposes.

First, tax cuts can have a significant role to play in stabilisation policy—in other words, in circumstances when the government needs to use macroeconomic policy to remedy a general deficiency in demand and rising unemployment. Across-the-board income tax cuts have been a longstanding means of lifting the overall level of demand in a recession such as the present one. One advantage is speed: the pay-as-you-earn system, since it docks wages at source, can also bolster pay packets and thus spending power quickly. The effectiveness of tax cuts in stimulating demand is all the greater if they are skewed towards lower income levels, since low-income earners spend more of what they earn, and spend a greater percentage of it on domestically-produced goods, than the well-to-do.

Another useful tax cut policy tool for recessions is a selective cut in sales tax, which can help stimulate demand in specific industries. Paul Keating's sales tax cut on imported cars in One Nation clearly falls into this category. Nevertheless, its effect will probably be short-lived, since its main effect will be to bring forward car sales rather than increase their total. The same stimulus to demand can also be achieved in other ways (and potentially more effectivel)—such as by carefully-designed spending packages aimed at infrastructure to boost employment in the right place at the right time. Yet counter-cyclical public investment planning, on which great hopes were built in the 1930s, has rarely been seriously attempted. It appears that politicians and bureaucrats find it easier to face political-arbitrariness. All the same, it has to be said that in their economic credibility both Fightback! and One Nation are miles in front of the flat-tax phantasies of a few years ago, whose castles in the air, built on growth and productivity supposedly generated through 'incentivation', even mesmerised ex-Treasury luminaries like John Stone.

There are a few distributional principles that potential tax-cutters would do well to keep in mind. For instance, raising the tax-free threshold raises the relative importance of the tax cut for the lower paid (its progressivity), but may also benefit the undeserving (some income-splitters, for example), and affects the tax burden of all, including the highest paid. Cutting marginal tax rates at the lower end of the scale assists those immediately affected, but because it likewise affects all taxpayers in higher brackets, it is exceedingly costly. Reducing maximum tax rates to bring them into equality with those overseas (such as the US or the 'Asian Tigers') may lay claim to recognising the potential of international tax competition, but it also wreaks havoc with the progressivity of the system. In short, some tax cuts are distributionally preferable to others, but most would be vastly improved if combined with increases in the tax base. Superannuation and housing are two instances of such base-widening—and in the first of these Fightback! is clearly ahead of the government.

The third issue of importance in considering tax cuts is their potential impact on the efficient allocation of resources between different sectors of the economy. Fightback's claims are particularly ambitious on this score. John Hewson's stated intention to secure zero inflation is well-known. In Fightback!, the known inflationary consequences of a 15% GST (in isolation from other policy measures) are supposedly offset by concomitant tax cuts in fuel excise, sales tax and payroll tax—the intention being to reduce the total inflationary impact to just 4.4%. Yet this is probably optimistic. If the GST creates the 'fiscal illusion' of falling wages, a wage push aimed at offsetting the increased prices of goods under a GST could shatter those inflationary expectations. Likewise, financial market reac-
tions to a GST-induced one-off change in the value of the Australian dollar may have a further inflationary effect.

More important, however, are the claims Fightback! makes for its ability to rebuild and reward Australia. The key to this achievement, we are told, are the incentives generated from reduced tax rates, and the improved competitive advantage derived from the reduced costs to business. Yet the extravagant hopes raised in other countries and at other times for this sort of supply-side economics have rarely borne fruit. Reducing the marginal tax rates may lead to some added incentive to work, save, invest and take risks—but the precise amount of this effect is highly speculative, and much overrated by those on the conservative side of politics who in any case have a predisposition towards lower income tax rates. Here tax cuts can feed the dangerous conservative delusions of ‘something for nothing’ exemplified by the now-notorious Laffer Curve, so successfully peddled in the presidency of Ronald Reagan.

A less publicised allocational effect of tax cuts is their impact on the public sector and the desirable flow of publicly-provided goods and services. It is upon this neglected factor that I want to concentrate in my final comments. The ability of government and opposition to offer tax cuts is in one sense a product of the relative decline of the public sector over the last few years. Australia’s public sector has been shrinking since 1985-6, with only a minor reversal recently owing merely to the disproportionate effects of the recession on the private sector. On average, the size of the public sector fell from 41.3% of Gross Domestic Product (GDP) in the early 1980s to 39% in the second half—a record not matched by many other OECD countries.

This trend has been accentuated by a statistical illusion in conventional measures of the growth of the public sector which tends to overestimate the size of the public sector, and hence to underestimate the effect of reductions in the size of the sector relative to GDP. The key to this illusion is the difficulty of measuring productivity and productivity gains in the public sector. By way of analogy, take the performance of a musical composition. The scope for productivity improvement in such cases becomes very restricted. A Schubert Trio cannot be performed by two people. Nor, if it was scored by the composer to take half an hour, can its performance be effectively reduced from the 1.5 person (performer) hours it takes to perform satisfactorily to one person hour by reducing its performance to twenty minutes.

Schubert Trios are admittedly a boundary case. They illustrate, however, that where the quality of output is tied to fairly specific inputs of labour, the ability to measure productivity gains in conventional terms is very restricted. Personal and community services embody many of the characteristics of the Schubert Syndrome; quality is substantially reduced if the required numbers or the requisite time is altered (eg larger class sizes or fewer counter staff)—though not always with the same dramatic consequences as in the case of the Schubert Trio.

A number of more general conclusions can be drawn from the Schubert Syndrome (known in academic circles as the Baumol effect). The first is that some sectors of the economy have unrestricted capacity for productivity growth (such as primary industry, mining, manufacturing and some services), but there are other services where a certain labour content is an essential feature of the quality of the output. Over time, as the productivity of the former category of industries and services grows, they will appear to be using relatively fewer resources (in labour). At the same time, the latter category will appear when measured in the conventional ways to be rising over time as a share of national output and employment—a measurement which then appears in the data for the Gross Domestic Product, but which in some ways is quite spurious. To put the same point in another way, there are some goods and services from which increasing satisfaction can be obtained even when the relative resources (in labour) devoted to their production is falling; on the other hand, there are other outputs (Schubert-type ones), where the satisfaction derived from their output may be falling even when the relative resources devoted to them may appear to be rising.

The Schubert Syndrome has crucial implications for interpreting the conventional measures of public sector growth. It seems plausible that Schubert Trio-type goods are of greater importance in public provision than private provision. Given current views on what should be publicly provided, then, one would expect the share of the public sector in national resources to rise over time, not fall. When this is not the case, as is patently true for Australia for the last five years or so, the quality of the provision of those types of services will tend to decline continually.

The Schubert Syndrome also has a nice corollary for relative tax burdens and the ease with which they can be borne. A declining share of income going to private provision is perfectly sustainable, provided that, as a result of productivity growth, these declining resources produce an equal or greater satisfaction of wants. Hence, we could easily live in a 99% tax regime if the remaining one percent of disposable income enabled the purchase of equivalent privately-produced goods and services. The moral is that rather than preaching the merits of further tax cuts, as politicians are all too prone to do, they should be selling tax rises as an essential price for maintaining the quality of those services provided by the government which resemble that of the Schubert Trio.

It also suggests that balanced growth makes it appropriate for private sector market activities to enjoy a declining, not a rising, share of national resources. Sadly, however, neither One Nation nor Fightback! mention any of these concerns. Packages in praise of tax cuts do not always tell the full story.

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