Tax Myths and the Tax Revolt

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The level of taxes and the size of government in Australia are subjects of constant criticism and comment in the media and in our political life. Unfortunately, much of this comment is not only biased, but is also based on incorrect assumptions about Australia's tax burden. This paper briefly reviews some of the misconceptions about high taxes and big government in Australia and the ways in which the misconceptions have twisted the debate about public policy. The aim of the paper is not primarily to explain the underlying economic and social forces which maintain the strength of the campaign against higher taxes and "big government",[1] but to examine some of the arguments that are put forward as the intellectual underpinning of this campaign.

AUSTRALIA'S LEVEL OF TAXES

The first step in this campaign is the assertion that Australians pay exceptionally high levels of tax and that the public sector is, comparatively, very large in Australia. The fact is, however, that <u>Australians, far from being heavily taxed are, by international standards, one of the least taxed peoples among industrialised countries.</u> The share of the country's resources claimed by government is less than in most other comparable countries. If we accept the definition put forward by the American Supreme Court judge, Oliver Wendell Holmes, that taxes are the price we pay for a civilised society, we in Australia are not very civilised today.

What do the statistics tell us? Total taxes imposed by all levels of government account for about 29.7% of gross domestic product, i.e. roughly speaking, 29.7% of total incomes earned by Australians. How do we compare with other countries? The following table[2] sets out the latest available comparative statistics:

<u>Total Tax Revenue as Percentage of GDP (1977)</u>:

Sweden	53.38	Ireland	35.22
Luxembourg	49.97	New Zealand	34.45
Norway	47.52	Canada	31.98
Netherlands	46.32	Switzerland	31.51
Belgium	42.89	United States	30.30
Denmark	41.95	Australia	29.68
Finland	41.23	Greece	28.07
France	39.57	Portugal	27.15
Austria	39.31	Turkey	24.77
Germany	38.17	Spain	22.52
Italy	37.55	Japan	22.22
United Kingdom	36.60		

It is evident from the table that among the relatively industrialised countries, only the four poorest plus Japan, where many of the welfare services are provided by private firms, rate behind Australia. Furthermore, our percentage devoted to taxes at 29.7% is not just marginally below, but well below, the

O.E.C.D. average of 36.2%. This average itself is brought down by the U.S. figure which is comparable with our own, and the European Economic Community average at 40.9% must make one cautious in transposing European arguments about the effect of taxation to Australia.

The favourable tax position of Australian higher income earners is discussed below, but at this stage it should be emphasised that even "typical" Australian workers take home in their pay packets a higher percentage of their gross earning than the majority of their counterparts in other industrialised countries.[3] They have to spend less of that take-home pay on indirect taxes. Australians are comparatively lightly taxed at all levels of income.

Nor is it true that Australian taxes have grown exceptionally quickly over the past few years (though it is correct that there was a spurt somewhat above the international trend line in 1972-76). In a period of slower or negative economic growth, taxes as a percentage of incomes have grown rapidly throughout the world. Taking a starting date before the Whitlam government, the figures for the last available six year period 1972-77 (using a moving three year average to dampen out chance fluctuations) show that Australian tax revenue as a percentage of GDP rose by almost four percentage points (from 25.95% in 1971 to 29.75% in 1977) almost identical to the average O.E.C.D. increase (from 31.28% to 35.19%).[4]

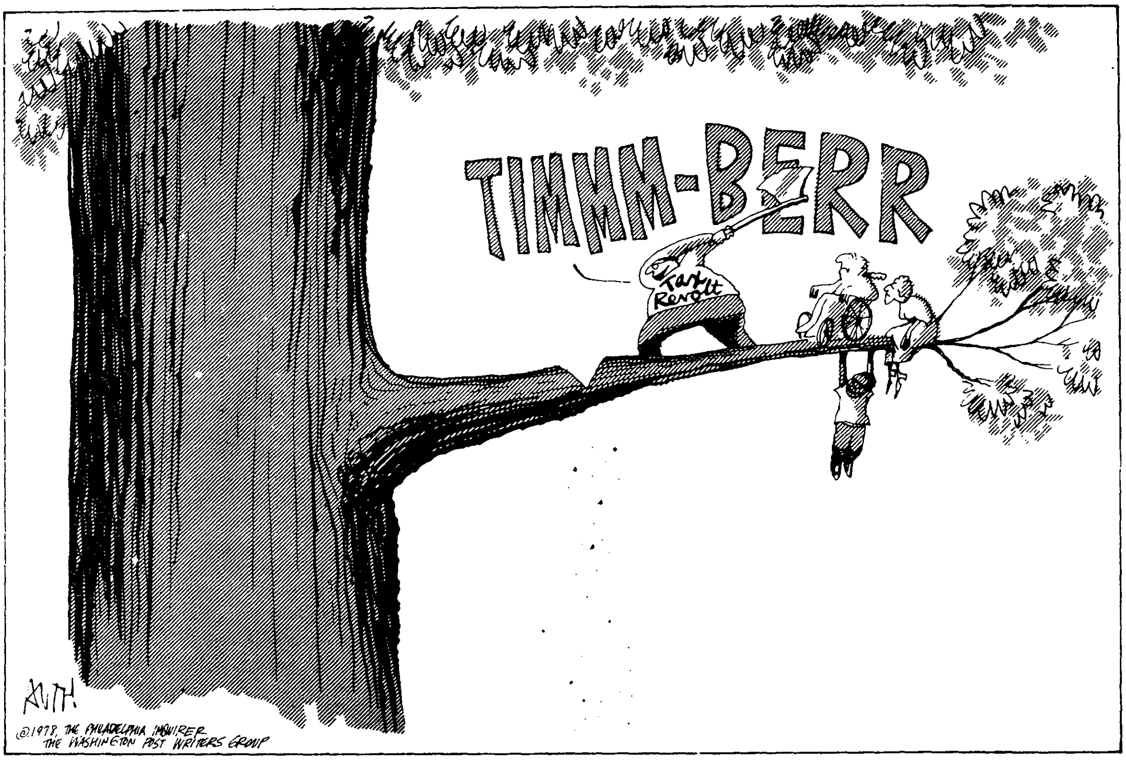
The statistics for government expenditure, of course, reflect the statistics for taxation (though the precise ratio between the two fluctuates from year to year). The size of total government in Australia, adding up all levels, is relatively small. The public sector expenditure share of gross domestic product at 32.8% is well below the O.E.C.D. average of 41.4%.[5] What this means is that Australian governments provide less in terms of essential facilities, services, and payments in the form of benefits than other similar countries.

THE "TAX REVOLT"

The Murdoch press would, of course, have us believe that other countries are in the grip of a tax revolt on a large scale, and that Australia should follow this alleged world-wide trend by reducing its own taxes. The facts about this so- called tax revolt, however, provide a very different picture of its extent and nature, from that presented in this section of the press.

There has been evidence in some European countries of increased resistance by some sections of the community against taxes - in particular income taxes - and of support for anti-tax political parties. The most dramatic example was the rise in Denmark of the Progress Party, an anti-tax party formed by a tax lawyer, Morgens Glistrup. The Progress Party at its peak in 1973 captured 16% of the vote as part of a general swing to the right. A somewhat similar party (the Anders Lange's Party) captured about 5% of the vote in Norway in the same year. (The loss of government by the Social Democrats in Sweden in 1976 has also been cited as evidence of this movement, but it involved a shift of public opinion of less than 1% and the "bourgeois" parties elected to government have not reduced public expenditure).

On the other hand, socialist and other left-wing parties usually associated with "big" government were maintaining or increasing their support in other countries such as France and Germany. Public opinion polls, for what they are worth, also showed very mixed results. For example, in Sweden 60% of respondents



in 1976 agreed that "social reforms have gone so far in this country that in the future the state should reduce rather than increase social benefits and support for its citizens", while in Germany only 16% of respondents in 1974 regarded "a cut in taxes and social security contributions and consequently fewer social benefits" as an important issue.[6]

Publicity about the tax revolt does not, however, centre on the high tax European countries but on the U.S.A. It began with the spectacular campaign by Howard Jarvis for the passage of Proposition 13 in California. The unique circumstances in which Proposition 13 was passed are worth noting: explosive property tax growth for single family homes; a potentially large state surplus; and a state government which because of divisions in the legislature would not deal with the problem. As one observer has noted: "It appears that California voters were primarily concerned with high and rapidly increasing property taxes ... Shortly after the election ... Howard Jarvis described the vote as an attack against inflation, large and arrogant government, and taxes of all kinds. This interpretation was soon adopted by the media, but existing evidence suggests it is hyperbolic."[7]

Property taxes in the U.S.A. are a more important component of personal taxation than in Australia. They are usually levied on the value of the house and land, not on the "unimproved capital value", and collected at the State and local level. While rates are sometimes high, assessors have had considerable flexibility in assessing the value on which such rates are struck. As local assessors are usually elected officials their survival instinct ensured taxes did not rise too quickly. Three factors changed this situation and brought property taxes into political prominence. The first was a rapid increase in house prices. The second was a series of Court decisions and legislative amendments declaring illegal the discretion previously exercised by local assessors. The third was the fall in property taxes paid on commercial property so that to maintain revenue local government required the income from domestic property tax. Thus Kuttner at Harvard's Institute of Politics notes:

> Business conservatives muttering about government spending and ending up as the biggest beneficiaries of Proposition 13 and its clones, have managed to convince people that taxpayers were rebelling against growth in public outlays. But the real problem, it turns out, was that businesses were already getting too big a tax break, that property taxes increasingly were being shifted away from them and onto homeowners. The tax revolt of 1978 was created largely by business tax relief at the expense of homeowners.[8]

Middle-income and low-income earners with their wealth increasingly concentrated in their homes thus faced staggering increases in their rates (while other forms of wealth largely escaped taxation) and began to pay a growing share of total state and local tax. Californians faced by an inept state legislature were the first to force this growth to a halt.

A number of other states have now followed California in limiting property taxes or setting general limits on expenditure (though these are normally limits on the rate of growth and many contain large loopholes). It is interesting to note that whether such referenda are passed or defeated bears little relationship to the actual level of taxes (i.e. referenda in some high tax states have been defeated, those in some low tax states have passed). Evidence from public opinion polls suggests that one factor which influences voting is the public perception of the effectiveness of government expenditure (a point to which this paper returns below). It is true, however, that proponents of limitation on taxation have succeeded in focussing their campaign on the total tax load, rather than on who should be paying it. Assertions about balanced budgets and the effects of taxes on business property have been a prominent part of the debate.

The revolt, however, in so far as there is one, has succeeded in limiting only a small percentage of total taxes. Furthermore three factors suggest that it may be shortlived. First, there has been a considerable change in the financial position of the states and local government. In early 1978 just before the passage of Proposition 13, state and local governments had a cumulative surplus of $8.4 billion; a little over a year later, as a result of recession and reductions in federal aid, there was a cumulative $6.1 billion deficit. Second, public opinion polls in late 1979 were showing lower proportions of voters concerned about taxes. Third, these polls were also showing increased public concern about the fairness of the tax system - not surprisingly as the major beneficiaries of tax cuts apart from homeowners have been the wealthy and corporations. Many states now have sharply regressive tax systems.[9] The Proposition 13 movement has thus been a complex phenomenon; and its significance for Australia is far from clear.

If there had been the sort of large-scale revolt against taxation which some of our newspapers and politicians claim to have found, then we might have expected that reported widespread tax evasion and political protest would have led to a reduction in taxes and public sector expenditure in a number of countries. In fact, however, taxes have risen on average by about a percentage point of GDP each year through the mid-seventies in the industrialised countries. Even Mrs Thatcher's much heralded income tax cuts (compensated for by indirect tax increases) have not stopped the real increase in public expenditure in Britain. After a slight decline under Labor, public expenditure both in real terms and as a percentage of GDP has risen each year since 1977-78. Although a slight fall is planned in the next year, this would still mean that realised public expenditure would be higher in real terms than in 1978-79.[10]

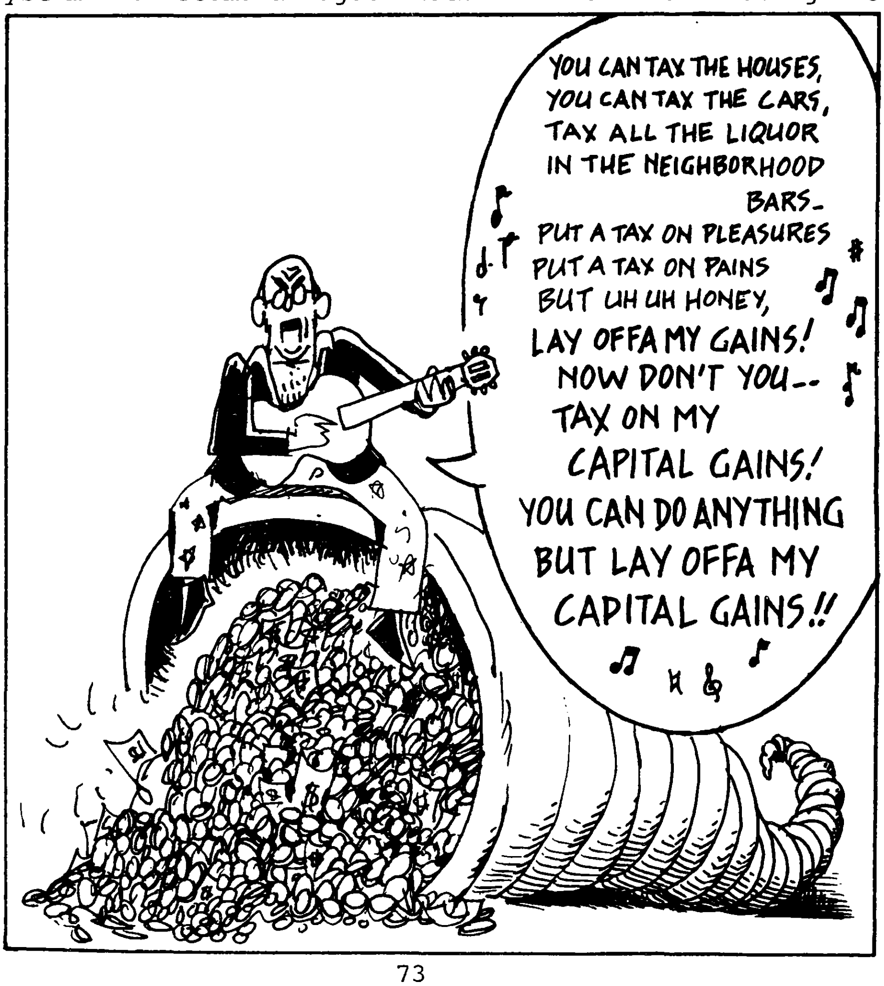
How is all the publicity about worldwide increased resistance to, and avoidance-evasion of, payment of taxes, and dissatisfaction with the welfare state, to be reconciled with the reality of increasing taxes and public expenditure? The answer is that dissatisfaction has been concentrated among professionals, businessmen and other high income earners - articulate groups with access to the media and influence with politicians. In a number of countries such as U.S. and Australia this has resulted in an alteration in the incidence of taxation, meaning that the better off will pay less and the worse off will pay more.

Indeed if there is a tax revolt, it is a tax revolt of the rich who have successfully used their political muscle to shift some of the burden of public spending onto the poor.

The shift in the burden of Australian taxes has already been the subject of widespread political comment. Not only has the tax scale become less progressive, but also tax avoidance and evasion have shifted the burden to wage and salary earners on P.A.Y.E. The proportion of personal income tax paid by wage and salary earners has risen steadily while their share of household income has remained roughly constant. At the same time reliance on revenue from indirect taxes of a regressive nature (which had been falling relative to personal income tax revenue for many years), has once again risen with the introduction of import parity pricing for petrol.

As Australia's foremost academic authority on taxation, Professor Russell Mathews, has noted of the Australian tax system,

> the potential for interpersonal redistribution has not been realised. Indeed it is plausible to argue that the taxation system has become a major instrument for distributing incomes



> and wealth in favour of the rich ... tax authorities, government and the courts have allowed tax avoidance to flourish on such a scale as to make personal income tax a voluntary tax for the rich non-salary earner ... the essential problem is not to make the richest pay higher rates of tax, or even more tax, than the poor; it is to make the rich pay any income tax at all.[11]

That such a shift has occurred is not surprising. It is to be explained not only in terms of the self-interest of powerful groups but also as a necessary mechanism (at least in the short-term) if a capitalist economy is to undergo a return to economic growth on the basis of a private sector recovery. As O'Connor has noted:

> Put briefly, the incentive rationale asserts that if profits are taxed too heavily, the accumulation of capital, and thus the growth of production and employment will diminish, and that if the incentives of wealthy families and investors and their financial institutions ... are impaired, the supply of investable funds will dry up. In other words the offical ideology of taxation asserts that taxes must not reduce incentives both to supply and to invest money capital.[12]

While this may be the logic of the system in the short-term, in the longer term a wide range of levels of taxation has been shown to be consistent with economic growth and prosperity, as a glance at the table at the start of this paper will verify. Indeed the richest countries, with the exception of the U.S.A., are grouped towards the top half of the table. This leads on to an examination of a further assertion about high taxes: their alleged deleterious effect on work output.

TAXES AND INCENTIVES TO WORK

It is alleged that high rates of tax reduce effort as people decide it is not worth their while to work for the extra dollar if the government is to take away half of it or more. A reduction in taxes, it is said, will therefore increase effort, output and general prosperity. This is an especially important assertion for the critics of taxation as it permits them to translate what would otherwise be seen as special pleading in their own self-interest into disinterested advocacy in the public interest.

Indeed this is an argument that is probably true for the individual doctor or lawyer of our acquaintance. Others, however, may be motivated to work more to maintain their incomes. For the community as a whole, repeated studies - both sample surveys and econometric studies - have failed to provide support for the view that higher tax rates reduce incentives to work.

The alleged disincentive effect of taxes is not a new refrain. In 1756, David Hume wrote in Of Taxes:

> Exorbitant taxes, like extreme necessity, destroy industry by producing despair ... 'tis to be feared that taxes all over Europe are multiplying to such a degree as will eventually crush all art and industry.[13]

Theory does not predict the relative strength of the income and substitution effects of tax changes (greater work effort to maintain post-tax income and substitution of leisure for work respectively); and both effects will be reduced to the extent that non-pecuniary factors, such as status and job-satisfaction determine work incentives. Thus the effect of taxes remains an empirical matter.[14]

Empirical research on the effects of taxation on labour supply has been carried out principally in Canada, the U.K., and the U.S.A. A series of surveys were carried out by different workers on samples, principally of high income groups, in these three countries over a period of years from 1951 to 1973. There are certain methodological problems about such surveys but their findings are very similar. They are that the tax effects are very small and that the incentive and disincentive effects tend to cancel each other out. (There is also some evidence that increases in taxation tended to increase the age at which individuals retired).[15] Most of the econometric studies have been carried out in the U.S.A. and there has been a wide variation in results so that no firm conclusions can be drawn about the magnitudes of tax effects. There is, however, support for the conclusion that both income and substitution effects for male family heads are small, whereas the corresponding effects for married women are somewhat higher.[16]

In sum, a recent O.E.C.D. survey of all of the empirical work available suggests that "the net effect of taxation on labour supply is not large enough to be of great economic or sociological significance."[17]

The only other evidence that incentives among high income earners are changed in any significant way at all by taxes is that high rates of income tax may increase incentives to waste productive time and energy on tax avoidance schemes. It seems however that the wealthy need little incentive for tax avoidance in Australia and the reductions introduced for them by Mr Fraser in the marginal rate of tax on high incomes have not reduced the popularity of this pastime.

One body of research data does indicate a link between work effort and "effective rates" of tax at the other end of the income scale, where there is evidence that the structure of welfare payments tends to reduce work incentives.[18] People on welfare normally face very high effective rates of "taxation". Unemployment benefits, for example, are reduced dollar for dollar after the first $6 of earnings, an effective rate of income tax of 100%. For some beneficiaries loss of both pension and related benefits in the form of services plus the need to pay some tax can amount to an effective rate in excess of 100%. This is the so-called poverty trap. However this is not the end of the income scale that those who proclaim their concern with the effects of taxation on productivity are anxious to reform.

HIGHER TAXES, MACROECONOMIC POLICY AND UNEMPLOYMENT

If the facts about Australia's relatively low taxes were publicised, and if taxation were placed in its correct international and socio-economic context, perhaps Australians might decide that they can afford present taxes, though more equitably distributed. They might also decide that they cannot afford still worse facilities in the depressed areas of our cities, less human welfare benefits, and in general worse services in such areas as transport or recreation facilities where private enterprise has failed so lamentably. Of course, we would all want to see some of the existing expenditures managed more effectively but there is also in my view, room for gradual increases in taxation to be spent on important public purposes.

Over the course of time the additional revenues could then be spent on services commonly available in other parts of the world - child care, services for the aged in their own homes, a decent public transport system, subsidies to poorer families to permit their children to remain at school and improve their chances for better jobs, better facilities in cities, old-age pensions at reasonable levels, and so forth. Even non-Marxist critics of capitalist economies have suggested that as our society alters and becomes more inter-dependent, the pursuit of individual self-interest through the market will no longer deliver the goods. Only a collective approach will permit citizens to achieve many of the private goals they individually seek.[19] It is, however, beyond the scope of this paper to catalogue and discuss the merits of government programs (or levels of benefit) available in European countries but absent in Australia.

However, a specific policy one might consider is a change in macro-economic policy. Thus economic policy, even if it continued with the strategy of fighting inflation first, could, properly expounded, share the costs of that strategy more evenly across the community. With the maintenance of the budgetary deficit at more or less its present level and the restriction of the growth of money supply, increased taxes could finance increases in public expenditure. This would provide new employment opportunities in, say, capital works, and at the same time improve benefits for those still unable to get employment and living far below the poverty line.[20]

The economic strategy of cutbacks and "fighting inflation first" that maintains jobs and prosperity for some, deprives others of their livelihood. The government and the Murdoch press try to convince us that to support those who suffer from the strategy is an intolerable "burden" on those who benefit from it. Why should those fortunate enough to be in secure employment or in prosperous professions be able to grab an increasing share of the national income so as to maintain or increase their living standards, while others pay the cost of the economic downturn and government policies to meet it? Not surprisingly, the alternative strategy of higher taxes and higher expenditure with the same budget deficit, while spreading the burden more evenly over the whole community, is not attractive to either political party. Even the trade unions prefer to seek tax concessions for their employed members rather than increased opportunities and benefits for the unemployed, though this is hardly surprising in the light of the tax avoidance practised by the wealthy. The public stance of political parties and their refusal to contemplate these alternatives is a reflection either of the poverty of the debate on taxation issues, or of our lack of compassion as citizens, or perhaps both.

Any significant longer term increase in tax revenue, even if the system is made more progressive, will entail higher contributions not only from high income earners but also from the bulk of middle income earners. The nature and mix of taxes therefore needs to be carefully considered. Conventional wisdom on the structure of taxation and in particular the place of income tax is now under challenge. Income taxes provide in Australia 57.2% of tax revenues, the highest level of any O.E.C.D. country, the O.E.C.D. average being 38.6% (though all other countries also levy social security contributions based on income).[21] The attraction of an income tax lies in part in its progressive nature, but widespread avoidance and evasion of income tax in Australia has meant that its nominal and actual incidence have become quite different. Furthermore, it is now recognised that while "backlash" against taxation is not correlated with the level of tax, it is correlated with the level of "visible" tax. People seem relatively prepared to pay indirect tax, or to pay compulsory social security contributions which are apparently directly related to the benefit received. The greatest taxpayer resistance is to paying income tax and property tax.[20] An element of this reaction is tax-induced demands for increased wage to maintain take-home pay - regarded in some countries as part of the inflationary cycle. It seems reasonable to argue that such demands would be lessened if tax rises were more gradual, the tax system more equitable, and government expenditures clearly perceived to be alleviating unemployment and/or its effects.

This has led to the proposition that if there is to be a longer term substantial increase in tax revenues this will require the introduction of a widespread consumption or expenditure tax (with the possibility of income tax becoming proportional).[23] A consumption tax has the advantage of making avoidance difficult. As the vast majority of Australian taxpayers now pay proportional tax overall, then to the extent that higher income earners presently evade or avoid tax they will face a higher effective average tax rate, especially if the rate of consumption tax is higher on luxury goods. However, to ensure that there is equity in the system (and because general consumption taxes subsidise savings), a consumption tax should be accompanied at the top end of the income scale by an annual progressive wealth tax, and at the bottom end by increases in benefits and allowances.

"BIG GOVERNMENT"

Of course, the opponents of higher taxes and public spending have another string to their bow. They oppose big government because they say it leads to a loss of individual freedom. This is too large an issue to discuss comprehensively here but, as a postscript, two points might briefly be made.

First, even if the liberal private-enterprise framework in which this argument is couched is accepted, there are threats to individual freedom other than those that come from government, and government by regulating those threats may on balance increase our liberties. Many of the more important decisions that affect peoples' lives, e.g. the sorts of newspapers they are able to read, the industries and locations in which they are able to work, the sorts of cars they are able to drive, and so on, are determined not by government bureaucracies, but by business bureaucracies. In theory, of course, consumers still have control over them through the market mechanism, but often in practice the control by a small number of firms of Australian markets means that the consumer is no longer king (or queen!) It is not the faceless public bureaucrat, but the faceless private bureaucrat who limits our choices and that private bureaucrat may make his decisions in London or Detroit rather than in Canberra. Often it is only governments which can by legislation intervene in the market to try to ensure competition or protect the consumer. Indeed the critics of government often fail to see it in historical perspective; government has usually intervened either to enforce regulations or provide services only after the private sector has failed, and a manifest need has developed to relieve hardship or protect the safety of workers or consumers.

Secondly, much of the criticism is made not so much against government programs but against large impersonal bureaucracies lacking in accountability to the public. Here the critics have a point and one that is echoed in the fact that public attitudes towards big government are at least in part based on public perceptions of the effectiveness and benefits of government expenditure. With the increasing range and complexity of government functions and the decline of ministerial responsibility, power has become concentrated in bureaucracies and too many of their processes are aimed at internal maintenance rather than external impact.[24] A range of reforms is available which would result in a more responsible, representative, responsive and participatory bureaucracy.[25] Neither bureaucracies nor taxes will ever be popular but some reform of the bureaucracy may be a necessary step to more widespread acceptance of the benefits of public spending and a rejection of the myths about taxation.

FOOTNOTES

* This is an edited and expanded version of an ABC Guest of Honour Broadcast originally recorded in January 1980.

1 H.L. Wilensky, in The "New Corporation" Centralisation, and the Welfare State (Sage, 1976) suggests on the basis of empirical data that the states in which there is less discontent about taxes, social spending and bureaucracy are: (i) strong corporatist democracies which rely on invisible taxes (i.e. principally taxes other than income tax and property tax), (ii) countries with a young party system that provides several channels for party opposition and which, again, rely on invisible taxes. Australia meets neither of these conditions. For elements of a Marxist explanation, see Ian Gough, The Political Economy of the Welfare State, MacMillan, 1979.

2 O.E.C.D. Revenue Statistics of O.E.C.D. Member Countries 1965-1978, p.82

3 Ibid, p.263. 1977 figures for male married worker (with two children) on average weekly earnings.

4 Ibid, p.83.

5 Figures on 1974-76 average. Source: O.E.C.D. Public Expenditure Trends, June 1978, p.15.

6 Cited in Douglas A. Hibbs, Public Reactions to Growth of Taxation and Government Expenditure: A Preliminary Comparative Investigation. A.P.S.A. paper (mimeo).

7 F. Levy, "On Understanding Proposition 13", Public Interest, No. 56, Summer 1979.

8 B. Kuttner, "Behind the 'Tax Revolt': A Shift of the Burden from Business to Homeowners", Washington Post, September 9, 1979.

9 N.R. Pierce, "Tax Cuts Backfire as Recession Nears", Public Administration Times, October 1, 1979.

10 The Economist, March 29, 1980, p.35.

11 R. Mathews, "The Structure of Taxation" in The Politics of Taxation, Hodder and Stoughton for the A.I.P.S. - in press.

[12] J. O'Connor, The Fiscal Crisis of the State, St. Martin Press, New York, 1973, pp.204-5

[13] Quoted in J. Wanniski, "Taxes, Revenues and the 'Laffer Curve'", Public Interest No 50, Winter 1978.

[14] R.A. Musgrave, The Theory of Public Finance, New York, McGraw-Hill, 1959.

[15] O.E.C.D., Theoretical and Empirical Aspects of the Effect of Taxation on the Supply of Labour, 1975, pp.29-51.

[16] Ibid, pp.52-90.

[17] Ibid, p.126.

[18] M.G. Porter, "Taxation, Incentive and Productivity", in The Politics of Taxation, op.cit.

[19] See, for example, Fred Hirsch, Social Limits to Growth, Routledge and Kegan Paul, 1977.

[20] I believe that this strategy was first proposed in Australia by P.P. ,cGuiness in the Australian Financial Review.

[21] O.E.C.D., Revenue Statistics, op.cit.

[22] Wilensky, op.cit.

[23] See, for example, Mathews, op.cit., and P.D. Groenewegen, Taxation in Australia: Prospects and Options for the 1980s, (mimeo).

[24] P. Wilenski, "The Bureaucracy and Responsible Government", in Bureaucracies (University of N.S.W., Occasional Papers No. 3, 1978). See also R.S. Parker, "The Public Service Inquiries and Responsible Government" in R.F.I. Smith and P. Weller (eds) Public Service Inquiries in Australia, University of Queensland Press, 1978.

[25] P. Wilenski, "Has the Career Service a Future?", in R. Alley (ed) The New Zealand Public Service in the Eighties, NZIPA, 1980.