Taxes – our payment for civilization

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Introduction

Oliver Wendell Holmes was an American devoted to public service. He served as an officer in the Civil War, held an academic position at the Harvard Law School, became a judge in the Commonwealth of Massachusetts, and in 1902 was appointed as a justice on the US Supreme court. His public service extended beyond the grave: on his death in 1932 he bequeathed his residual estate to the US Government.

In recognition of his service the Roosevelt Government had his words chiseled on the plinth of Washington's Internal Revenue Service building:

> *Taxes are the price we pay for a civilized society*

The economics of taxation is a huge field. In this paper I do no more than to touch on some of the issues most relevant to those advocating greater expenditure on public services. This paper does not go into the question of the economic justification for public services – another huge field in itself. The case for restoring government to its rightful role in doing what we cannot do in our individual capacities, or cannot do so well, is strong. It suffices to say that wee won't make any sustained progress on restoring public revenue until we come to see taxes not as an unfair burden, but as a way of funding what we want to share, or to use the term that has been excised from our language in this age of right-wing political correctness, to contribute to our common wealth.

The first part of this paper outlines where Australia now stands, pushing aside two popular misconceptions reinforced by those who stand to gain from an enfeebled public sector. One myth is that Australian taxes, by comparison with other countries, are high. The other is that high taxes come at a cost to economic performance. Australia does have an emerging problem of growing government debt, particularly at the Commonwealth level, but contrary to some partisan perceptions, such as those conveyed in the terms of reference of the recently announced Commission of Audit,[1] Australia's budgetary problem stems from an inadequate taxation base, rather than excess government spending.

The second part takes us into the public attitude to taxes, which has been well-researched here and in other countries. The general finding is that if we can see that our taxes are spent in

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* This paper draws on many sources. Where I draw on specific publications, statistics or research findings, there is acknowledgement in the endnotes. I also want to acknowledge the contributions to my knowledge and understanding from Miriam Lyons and the researchers at the Centre for Policy Development (www.cpd.org.au), Richard Denniss and the researchers at the Australia Institute (www.tai.org.au), the regular tax surveys conducted by Per Capita (www.percapita.org.au), the numerous contributions by contributors to Taxwatch (www.taxwatch.org.au) and the contributions of academic colleagues at the University of Canberra and other universities in Australia and abroad.

accordance with our wishes, and that they are spent responsibly, we don't mind paying taxes. For many important government programs however, particularly at the federal level, we don't see those connections between what we spend and what we get in return. In part this is because we have been conditioned to believe that government is intrinsically inefficient, wasteful and untrustworthy. And in part it is because governments themselves have been inept at what most corporations would call 'public relations'. Governments generally do a good job in providing public services, but those services often remain unseen, or invisible. Governments don't make it easy for us to connect taxes to public services.

In the third part I want to refer to some principles that advocates could adopt in their quest to improve public revenue, which has been falling sharply since the Global Financial Crisis hit in 2007. The obvious quick fixes are to retain the mining and carbon taxes, and while these are good taxes by economic criteria, their revenue benefits are not necessarily ongoing. We need to look, once again, at the recommendations of the 2010 Henry Review,[2] which had a strong emphasis on what are known as 'tax expenditures' – $120 billion of tax revenue forgone every year as a result of tax deductions and rebates, such as those applying to superannuation. Unfortunately, the recommendations of the Henry Review about strengthening our long-term revenue base were largely put aside in the 'too hard' basket. I also want to touch on what for many may be a sensitive issue, the possibility of a higher GST, which, in view of some of our political and institutional constraints, may be a way of improving our public services in an equitable way.

Although there are some strong cases for particular tax measures, such as retaining the Minerals Resource Rent Tax and abolishing many superannuation concessions, I am not presenting a definitive list of recommendations for new or increased taxes. That's because a general movement to increase taxes would probably be less successful than specific campaigns to fund particular public services with means of raising the necessary tax revenues linked clearly to those services.

1. Australia, a low-tax country

Our $55 billion tax collapse

It's strange that when Labor was in office Australia had a debt crisis, but now, with the Coalition in office, and a less ambitious path to a balanced budget ("a surplus of 1 per cent of GDP prior to 2023"[3]) the crisis has gone away.

Let's get the lies out of the way. Australia did not experience a debt crisis under the Rudd-Gillard Government. Australian Government debt peaked at about 130 percent of GDP in 1945, when we had borrowed to pay for the Pacific War and were still carrying debt for the European War of 1914-18. Strong economic growth saw public debt fall to about 10 percent of GDP over the next thirty years, and it has stayed low since.[4] Both our gross public debt and our net public debt (that is, after deducting the value of public assets) are low by world standards and our own historical standards.

If, however, the newly-elected Government pursues a path of 'Reaganomics' – a policy of contained public spending and even lower taxes in the hope that the private sector may be boosted by the confidence engendered by a 'business-friendly' government – then a debt problem may emerge.

Similarly, the present Government has not inherited a budget crisis. The Commonwealth Government deficit peaked at 4.2 percent of GDP in 2009-10 in the wake of the GFC, and has been reducing since – this year it is budgeted to be 1.1 percent of GDP.[5] This compares with deficits this year of 4.0 percent of GDP in the USA and 7.2 percent in the UK. In those countries they were even higher just after the GFC – in the USA the Federal Government deficit peaked at 10.1 percent of GDP.[6] Australia has a number of economic problems (including private sector debt) but government deficit isn't one of them – at least not yet.

But we do have a public revenue problem.

When we refer to 'public revenue' in Australia we are really talking about taxes. Some countries with large nationalized sectors get a significant proportion of their revenue from dividends of public business enterprises, but at the Commonwealth level at least, Australia's non-tax revenue is small – around 1.5 percent of GDP and it does not vary greatly from year to year.

Taxation revenue generally follows the business cycle. In an economic downturn taxation receipts fall. Because personal income taxes are progressive, income tax falls faster than incomes, and because GST is not collected on certain essentials, GST falls faster than consumer spending. Tax revenue picks up after a downturn, but this pickup is usually slow.

This has been the pattern over the last 20 years, which have included the recession of 1991-92 ("the recession we had to have") and the more recent GFC. Commonwealth receipts and outlays covering this period are shown in Figure 1 on the next page, which displays, on the blue line, the rapid falls and slow recoveries in receipts.

The Howard Government, elected in 1996, had the good fortune to come to office during the upswing of the revenue cycle, which, thanks to the developing minerals boom, and a low exchange rate, turned out to be Australia's longest period without a recession or severe business downturn.

Figure 1: Commonwealth receipts and payments as percentage of GDP - 1988-89 to 2013-14

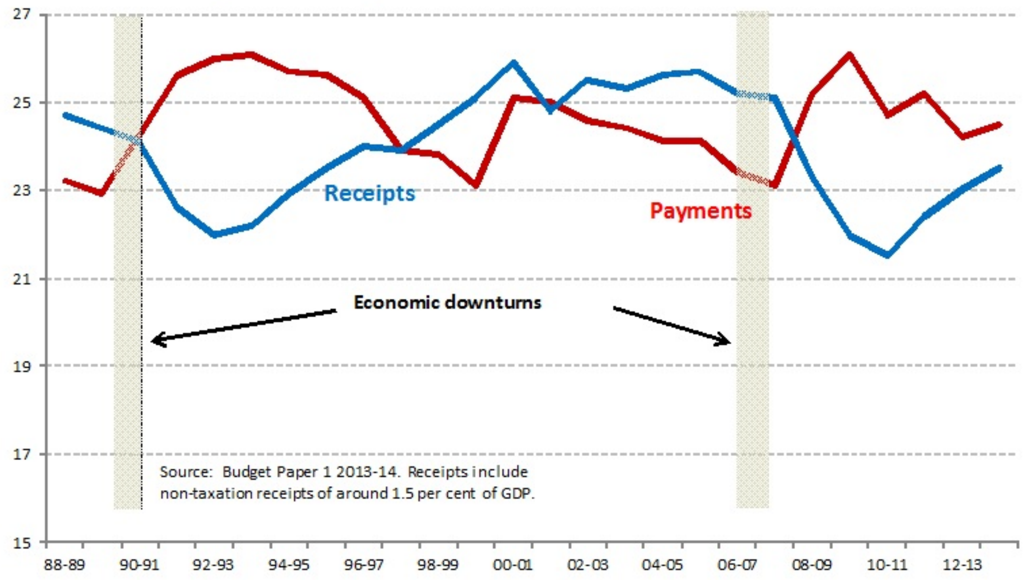
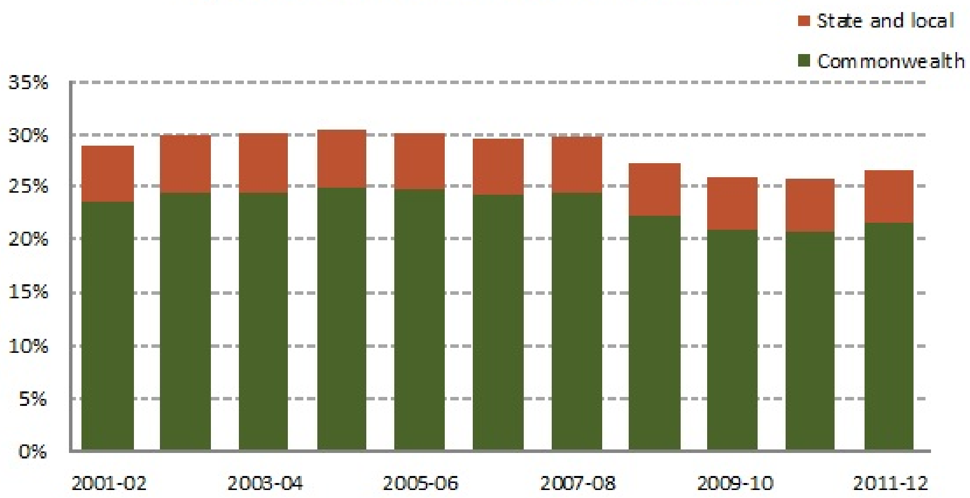


Figure 1 covers only Commonwealth Government receipts, but state and local governments have been through a similar fall in revenue.

Figure 2 shows taxation so far this century, separating Commonwealth from state and local taxes. (I haven't gone back further because of the statistical complications associated with the GST, collected by the Commonwealth, and shown as a Commonwealth tax, but passed through to the states.)

Figure 2: Australian taxes as % of GDP



To get an idea of the extent of the recent shortfall in public revenue, imagine that tax collections had stayed at their 2004-05 level, when total taxes were 30.3 percent of GDP. Our GDP in 2011-12 was $1.463 trillion. Applying 30.3 percent to that $1.463 trillion, we would have collected $446 billion in taxes in 2011-12. As it was, we collected only $391 billion (26.5 percent of GDP), a shortfall of $55 billion compared with what we would have collected had our tax to GDP ratio been what it was in 2004-05. Table 1 shows this shortfall.

Table 1: Australian tax revenue, $billion 2011-12

	Based on 2004-05 Tax to GDP ratio	Actual	Shortfall
Commonwealth total	366 691	317 888	48 803
of which GST	57 035	48 849	8 186
State and local own taxes	79 690	72 796	6 894
Total state and local incl GST	136 725	121 645	15 080
Total taxes	446 380	390 684	55 696

Source: Taxes from ABS 5506.0 *Taxation Revenue, Australia* (various years), GDP from ABS 5204.0 *National Accounts*.

As US Senator Everett Dirksen would have said, $55 billion a year is "starting to look like real money". It's ten years of the additional school funding recommended by Gonski, more than the capital cost of the much-maligned National Broadband Network, enough to fund over two years a high-speed rail connecting the capitals from Adelaide to Brisbane, with a $50 weekly boost to the Newstart Allowance paid for from the small change.

An optimist, particularly if he or she is a newly-elected backbencher in a government that has made a suite of fiscal assurances in the election campaign, such as a promise not to increase the GST, and to cut three significant taxes (the carbon tax, the mining tax and corporate tax), may hope that history will repeat itself with a steady revenue recovery as enjoyed by the Howard Government.

Commonwealth Budget figures predict a rise in taxes from 21.0 percent of GDP in 2011-12 to 23.2 percent of GDP in 2016-17, but these estimates, prepared before the change in government, include the Minerals Resource Rent Tax and the Carbon Tax, which account for 0.5 per cent of GDP, and the benefits of planned but not legislated tightening of fringe benefits taxes on motor vehicles and tax on high superannuation earnings. The Coalition's plans are to abandon all these taxes. Almost all the rest of the growth in the Commonwealth's estimates comes from personal and corporate income taxes.

Some growth will come from 'fiscal drag', particularly if, as the exchange rate falls, inflation picks up. If personal income tax brackets are unchanged in nominal terms, inflationary increases in income result in disproportionately higher increases in income tax. For example, if a taxpayer with an income of $60 000 received a $3 000 nominal pay rise as a result of 5.0 percent inflation, his or her tax would actually rise by 8.6 percent, a real rise of 3.6 percent.

(This effect is even stronger for low-income earners: someone with a $30 000 income rising by a nominal 5.0 percent would pay an additional 11.4 percent in income tax.) The Appendix models this effect over a range of incomes.

While fiscal drag may hurt taxpayers on low incomes, it wouldn't contribute much of a boost to revenue: personal income taxes are only part of the tax mix, and even a four percent real rise in income tax would contribute only around 0.4 per cent to tax as a proportion of GDP. Otherwise the budget projections seem to be based on optimism about economic growth.

The Budget revenue forecasts are reasonably bullish, but in my judgement recovery in tax revenue is unlikely to be as strong as it was in the last business cycle upswing. The Budget was prepared in May. The present Government, in its secrecy on fiscal matters, has refused to release the Mid-Year Economic and Fiscal Outlook, but we do have the Reserve Bank's November downward revision to economic growth forecasts.[7] There are seven reasons tax receipts will probably be well below the trend of previous post-downturn recoveries , the last two suppressing GST receipts:

(1) The crisis initially known as the 'Global financial crisis' has become 'the Great recession'. Its recovery path, while not from so great a depth, is turning out to be as slow as the recovery from the 1930s Depression. Australia is benefiting from strong Chinese growth, but there is no guarantees that China's model of capitalism exempts it from the workings of the business cycle.

(2) Even once 'developed' countries get their public finances back in order, most such countries, including Australia, have significant foreign debt, which many economists believe to be unsustainable.

(3) The mining boom has been so far an investment boom, and mineral prices until recently have been rising. The next phase will see prices easing and production volumes rising, thus sustaining gross revenue, but competitive pressure could suppress profits, many profits will be shifted overseas through transfer pricing, and there will be less construction activity.

(4) Generally, firms will be facing a more competitive environment. In the 1990s national competition policy was in its infancy. The economy is now open to more domestic and international competition. Corporate profits will not be as high as in previous times.

(5) Tariffs are now lower than they were twenty years ago. Therefore revenue from customs duty will not recover so quickly.

(6) At some time housing prices will stop rising, and if they fall there will be a fall in consumer confidence. Rationally there should be no connection between consumer confidence and house prices, but empirically there is a strong connection.

(7) When the exchange eventually falls significantly inflation will almost certainly rise, and therefore nominal interest rates will rise, reducing disposable income.

International comparisons – we're near the bottom of the pack

In their 2012 survey on public attitudes to taxation, the think tank Per Capita asked Australians how they think our tax levels compare with those in other countries.[8] As shown in Table 2 very few Australians believe our taxes are low.

Table 2: Beliefs about Australia's taxes

"When compared with other developed countries, do you believe Australia is…"	
A high-taxing, big government country.	57%
A mid-range taxing country with a mid-sized government.	31%
A low-taxing, small government country.	4%
Don't know/not sure.	8%

Source: Per Capita 2012

That same survey found that this belief about Australia as a high-taxing country was fairly much independent of income.

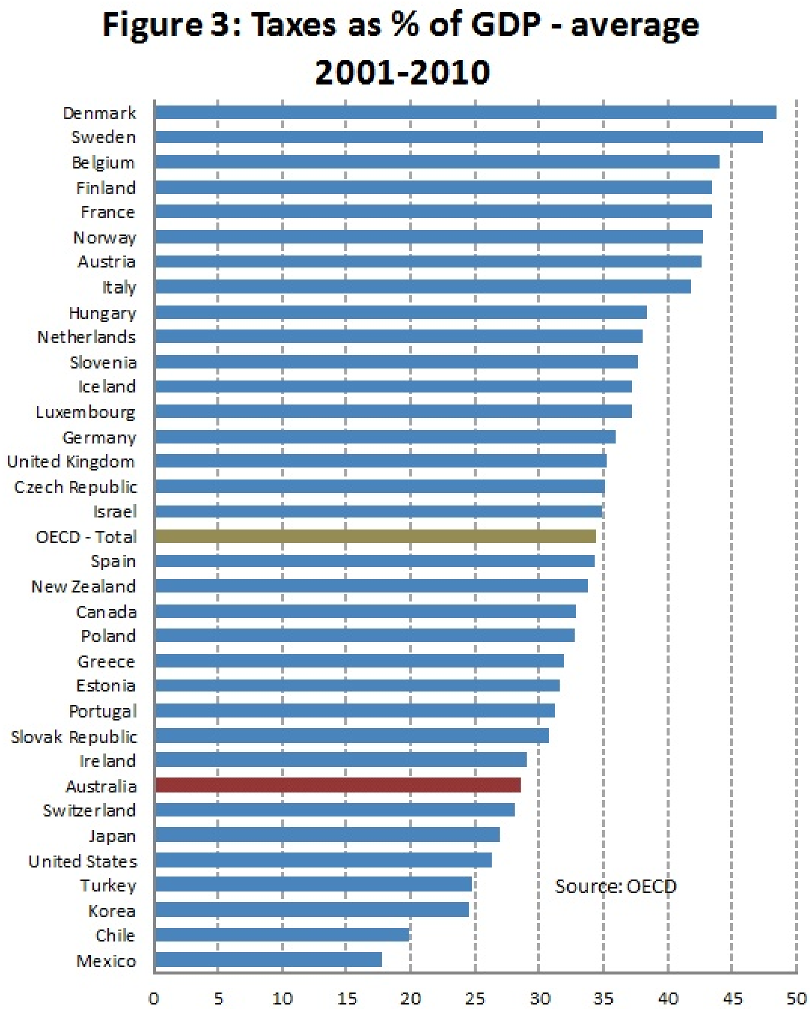
A survey by the Australia Institute also in 2012, with a slightly different question, found that around two-thirds of Australians believe ours to be a high-tax country.[9]

The reality is shown in Figure 3 on the next page, which shows OECD figures on average tax to GDP ratios over the period 2001-2010.[10] We are among the low-tax countries, and well below the OECD average. (If our taxes were at the OECD average of 34.9 percent of GDP, we would have had another $123 billion in public revenue in 2011-12.) In fact to return to the Per Capita question, which asked about 'developed' countries, we would find that among developed countries only Japan, Korea and the USA have lower taxes. What is true, however, is that in our tax mix personal income tax is a reasonably high proportion of taxes. European countries are generally more dependent on consumption taxes (the VAT) and on gasoline taxes.

It is common to compare Australia with the USA, another 'new world' country with many similar characteristics. Their tax-to-GDP ratio over that same period is 26.4 percent, while ours is 28.7 percent, but over that period their Federal budget deficit has averaged 3.7 percent of GDP,[11] while ours on average has been a small surplus of 0.3 percent of GDP. In other words, in order to sustain their public expenditure, America would have to raise taxes from 26.4 percent of GDP to 30.1 percent of GDP. By running a high deficit all they are doing is deferring their tax liability to the future.

Comparisons with other countries are also influenced by the presence of 'privatized taxes'. These are compulsory or near-compulsory imposts paid to private entities to provide certain collective goods.[12] America's health insurance system is essentially a privatized tax. Until the Affordable Care Act (Obamacare) became operational this year health insurance was built into many corporate labour agreements, and with the Affordable Care Act it will be even more akin to a tax, because, by definition, 'taxes' are compulsory and provide collective rather than individual benefits. With health care costing around 18 percent of GDP in the

USA[13], and almost half of that passing through compulsory private insurance,[14] that equates to a privatized tax of around 8 percent of GDP.



In other words, the common idea that in comparison with America we're a high-tax country is wrong – an illusion resulting from accounting practices. Our taxes are lower than America's – a lot lower when we consider their burden of compulsory private health insurance. Anyone who has holidayed, worked or studied in the USA would be well aware of their crumbling infrastructure, their mean welfare system, their poor education standards and their high-cost health care system (which will still be high-cost after Obamacare.) Only in defense does the US Government significantly outspend Australia's Government, but that fiscal largesse is enjoyed by armaments firms, not by soldiers, whose pay and veterans' benefits are miserable by Australian standards.

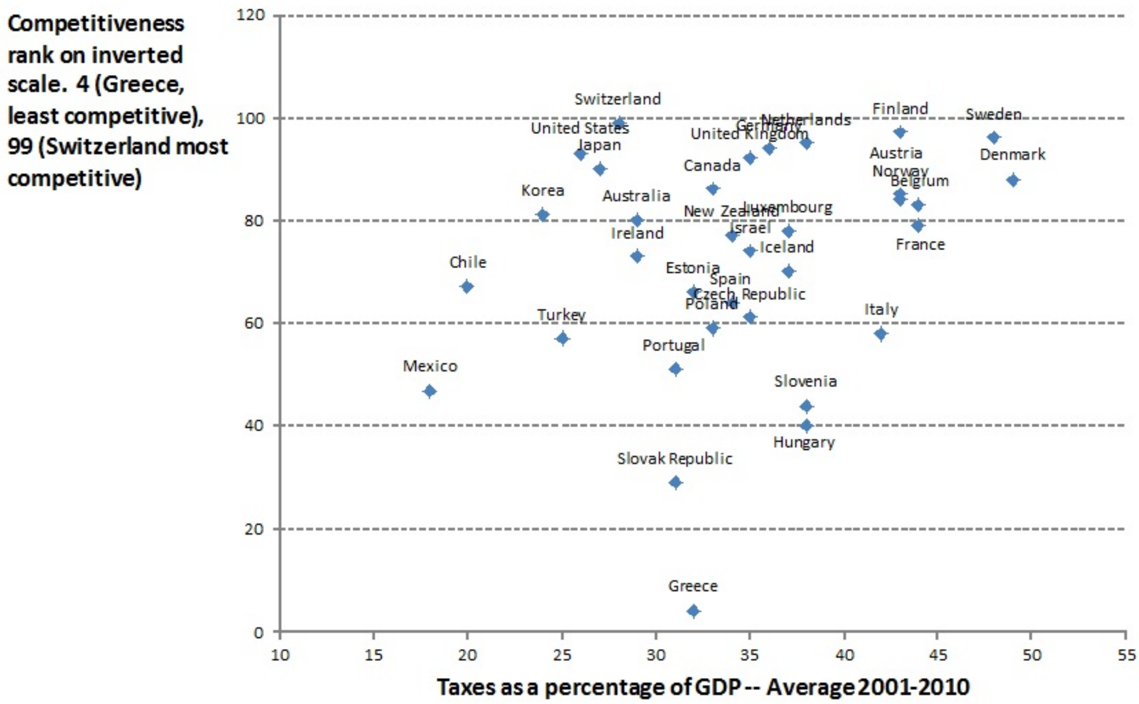
But does the fact that other countries have higher taxes justify our raising taxes? Advocates of lower taxes say we should not follow the crowd, and commonly argue that high taxes are bad for economic growth.

When we plot taxes against economic growth, it is apparent that, if anything, countries with higher taxes have enjoyed higher economic growth, but that doesn't necessarily mean there is a causal relationship. It is quite possible, and consistent with economic theory, that as people become more prosperous they properly demand more public goods, That is, higher taxes are a sign of prosperity. Economic historian Avner Offer of Oxford University points out that over recent times incomes in prosperous countries have risen strongly, and many consumer goods – cars, foreign travel, communication, entertainment – have become much cheaper. In terms of private consumer goods there are diminishing returns, and in relative terms we get more value from more public goods.[15]

In relation to the causal argument about high taxes retarding economic growth, rather than relying on historical data, we can use the World Economic Forum's competitiveness index[16] as an indicator of a country's prospective economic growth. If the argument about taxes impeding growth is correct we would surely find that countries with higher taxes are less competitive.

Yet when we plot countries' competitiveness (as shown on an inverted scale in Figure 4) the impression is of a slight positive relationship – higher taxes seem to result in better competitiveness. That would be a cheeky conclusion, for the coefficient correlation is low ($r^2 = .065$), and there are many factors contributing to or detracting from competitiveness. But there is no evidence to support the idea that high taxes impede economic growth. It's an article of faith – or perhaps a downright lie – rather than a statement of fact.

Figure 4: Taxes and Global Competitiveness OECD countries



In terms of public finance what counts for economic competitiveness is the pattern of public spending and the quality of public services. If spending is wasteful, on an over-generous welfare system (Greece) or on a hungry military establishment (USA), then economic performance does suffer. If there is inadequate spending on essential services which the market cannot supply or cannot supply efficiently because of market failure, then the economy will be under-performing. There will be costs if public services are run inefficiently, but that is an argument for improving efficiency, not cutting public services. (Governments on the ‘right’ are adept at mismanaging public services, thus confirming their prejudice that inefficiency is intrinsic to public administration.)

If a country has an inadequate tax base to support its public spending then there arise economic problems, as has been the case in Britain, the USA and the Mediterranean countries. Some on the ‘right’ see the problems in these countries in terms of public expenditure, but it is no less valid to see the problem as a public revenue crisis, particularly in countries like Greece and Italy where personal and corporate tax evasion and avoidance have become so widespread that governments have had to rely on inefficient taxes. Europe’s problem, manifest in high budget deficits and accumulating government debt, is portrayed by the ‘right’ as a spending problem, but it is no less valid to see it as a revenue problem.

In sum, there is no evidence to support the generalization that taxes impede economic activity. There are types of taxes that discourage productive investment, for example, but if taxes provide the public goods necessary for business expansion – education, infrastructure, a safety net to absorb worker and investor risk – competitiveness is improved.

2. Attitudes to taxation – from revulsion to true love

A taxpayer in distress

In June 2012 an ABC *Q & A* program was devoted to the Prime Minister, Julia Gillard, answering questions from the studio audience in Sydney.

The second questioner was upset about taxes. She said "We slide into the middle-class band whereby we don't get any subsidies whatsoever. We feel we're constantly paying out."

She complained about the means testing of the private health insurance rebate – a means test applied to families with incomes above $168 000 a year. That means her household was probably in the highest six percent of household incomes. In fact, if she really meant her family was getting no explicit subsidies, her family income would be above $260 000 a year – in the top three percent of household incomes.

The Twitter responses were hardly complimentary to the questioner. Yet she was doing no more than articulating a commonly-held view that she was "constantly paying out" – with the implication that her family is getting nothing in return.

Of course her household would be paying a reasonable amount of tax, but they would still be getting the benefit of heavily-subsidised education and health care, protective services such as defense, policing, search and rescue and firefighting, public assets such as roads and a range of other public assets and services.

With reflection she may have come to think about these benefits, but they don't immediately come to mind. If she and her family were in good health she may have little cause to think about Medicare and other parts of the health care system, and if she had experienced a period of hospitalization she may not have realized that even if she had top level private insurance, governments would probably have paid most of the bill. If her children were at private schools she may not have realized that the fees she pays are net of the government contribution, and that the teachers at that school got their degrees at a publicly-funded university, as her children would in time. When she paid her family's private health insurance she may not have realized that, even though the 30 percent rebate had been abolished, the premium was still subsidised by at least $3 900 (1.5 percent of $260 000), because of her exemption from the Medicare Levy Surcharge.

Perhaps she did think about the roads, the ferries, the council libraries and parks, and the police forces, considering these all to be state and local government services, unaware of the way much public revenue, collected by the Commonwealth, flows to state and local governments.

And it would have been even harder for her to be conscious of the way in which governments in countries like Australia have made our lives so much better over the years. For example, over the twentieth century, thanks largely to government investments in public health, life expectancy at birth has risen by around 30 years in Australia, and annual death rates from infectious diseases have fallen from 300 to less than 10 per 100 000.[17] Contrary to the drivel about crime in the tabloid press our cities have become much cleaner and safer. Over the last 40 years road fatalities have been on a steady downward trend, falling from around 25 to 6 per 100 000 people, thanks to both private technologies in vehicle design and to public contributions through roads, research and regulation.[18]

Cornell University political scientist Suzanne Mettler in her book *The Submerged State: How Invisible Government Policies Undermine American Democracy*[19] writes about government as an unseen and unacknowledged presence for many. She cites research showing that when Americans were asked if they had “ever used a government social program”, 57 percent said that they had not, but when reminded of 19 programs, such as home mortgage interest rate reductions, student loans and Medicare, 92 percent of respondents said they had.

Similarly for tax cuts. A year after the Obama Government introduced tax cuts for 95 percent of all working Americans, only 12 percent of people surveyed said that taxes had decreased. Per Capita found something similar in Australia: 49 percent of respondents believed that they had received no government compensation for the carbon tax, even though the new tax scales introduced in July 2012, along with the Clean Energy Program, gave cuts to 90 percent of households.[20]

Tax cuts, as Mettler points out, are soon forgotten. After one payday the new net pay becomes part of the normal background. That means a tax cut of $500 a year, for someone paid every two weeks, probably has a recognition value of only $20. And worse, as confirmed by behavioural economics research, a small reduction in what is already a significant outlay goes largely unnoticed. If each pay packet is already contributing $350 to tax, and we get a $15 reduction, that $15 has much less subjective value than a specific $15 payment.

Mettler’s specific findings are in a US context, but her general findings have relevance for Australia. She finds that programs funded by ‘tax expenditures’, which are rebates or deductions for specific purposes, are less recognized than those funded with direct cash appropriations. The USA and Australia are both significant users of tax expenditures, although for different programs. Both countries privilege housing, but in different ways, and one of our biggest tax expenditures is for superannuation. (More on tax expenditures is in Part 3.)

She also found that those programs which benefit the well-off are more likely to be funded by tax expenditures than those which favor people with lesser means. That resonates with Australian experience, particularly in relation to superannuation, while age pensions and unemployment assistance are clearly identified as outlays.

When programs were delivered under contract by private agencies, Mettler observed, people are less likely to identify them as government programs. In Australia, as mentioned above, subsidies to private health care and private schooling don’t appear on people’s accounts, and similarly programs delivered through non-government agencies do not bear a government trademark.

In all, for organizations that do so much good, governments are very poor at selling themselves. And it is quite understandable that so many people whose prosperity has been supported by government programs really believe they are self-reliant and believe that their taxes go to pay for others.

When we like taxes

If you go out doorknocking to ask people “what would you think about paying more tax?”, you will get much the same rate of positive responses as you would if you asked “what would you think if a motorcycle gang set up a methamphetamine lab next door?” The 2012 Per Capita survey found that only 1.2 percent of people believed they were paying “not enough tax”.

But there are circumstances in which people can be amenable to higher taxes, and the contrast between two taxes introduced by the Rudd-Gillard Government illustrates some of the findings on our attitudes to taxes.

Although there is a strong economic case for putting a price on greenhouse gas pollution (based on negative ‘externalities’), and a carbon tax ranks alongside a cap-and-trade process as a responsible market mechanism, the carbon tax was not accepted well, even though its net financial impact on households was minor. Even in late 2013, after more confirmation of anthropogenic climate change from the Intergovernmental Panel on Climate Change, and some worrying local and regional weather events, only 44 per cent of Australians support carbon pricing.[21]

Its poor reception can be traced in part to its representation as a ‘broken promise’ by the Opposition, and its deceitful campaign which dramatically over-stated its costs and impacts with the image of a “wrecking ball through the economy”. Also it came on top of other pressures which had nearly doubled real electricity prices over the previous ten years. But the government also carries some responsibility for the poor reception of carbon pricing, because in its concern for equity, it kept emphasizing that households would be ‘compensated’ for its impact. In common usage, and by dictionary definitions ‘compensating’ is about making amends for harm: the unintended inference was that the carbon tax was something bad, rather than something which pays for our small contribution to holding back destructive climate change, or, to use earlier language “the greatest moral challenge of our time”.

By contrast the 0.5 percent increase in the Medicare Levy to provide partial funding for the National Disability Insurance Scheme – a levy which will cost households around the same amount as a carbon tax but without any ‘compensation’ – has met with very little protest.[22] One could attribute this to the Opposition’s support, but that support was more likely a result, rather than a cause, of the policy’s popularity.

In part this was because the program was based on a Productivity Commission study commissioned by the Government to examine the specific issue.[23] The Productivity Commission process allows for voices in support of and in opposition to reforms to be heard and considered. Opponents get their day in court, even if the outcome does not align with their immediate interests. Also, national disability insurance does not have as many concentrated losers as carbon pricing. Another factor was a strong awareness of the need for reform. Gary Banks, former chair of the Productivity Commission, explaining the success of the difficult reforms of the Hawke-Keating Government said:

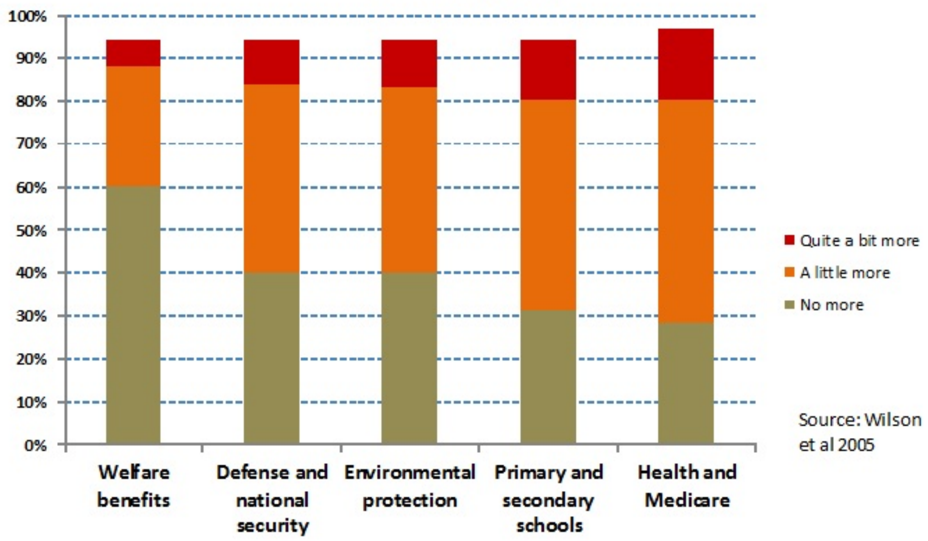
> Acceptance that reform was needed did not come about overnight. It emerged over time, with mounting awareness of the costs of the status quo and the potential gains from doing something about them. This in turn resulted from research and evidence on the deficiencies of existing policies, and deliberate efforts to communicate that information to the community.[24]

The main political point from Banks's advice and from the NDIS success is that if we are to pursue reforms which require raising taxes, then even if the opposition is politically opportunist and is ideologically on the 'right', if the problem to be addressed is acknowledged and its costs are well-established through research and awareness raising, opposition politicians find little option other than going along with the tide. Both CO_2 abatement and the NDIS have widespread benefits, both, in their ways being insurance schemes. But in the case of CO_2 abatement those benefits are not so self-evident, and therefore they need to be made more explicit.

Australian surveys on attitudes to tax and public spending reveal what is at first sight a contradictory preference: we are unenthusiastic about paying more taxes but we want more public goods.[25] This contradiction is explained in part by the belief that others (high income earners, corporations) should pay more tax, but not the survey respondents, even if they are in high income brackets.

Those same surveys, however, find that when people see a link between taxes and benefits, particularly if those benefits are high on their list of priorities, resistance to higher taxes softens. When survey questions are framed as "would you support a tax increase to fund X", where X is a specific program, responses are more positive. A survey conducted in 2003, for example, found strong support for increased taxes for health and education.[26] The results are illustrated in Figure 5.

Figure 5: Willingness to pay increased tax for public services (2003)



Preferences for increased spending tend to shift. Health and education consistently get top ranking, with environmental protection, defense, transport (roads and public transport) also getting high support. Results vary by region and in accordance with the salience of particular issues (e.g. defense ranks highly after terrorist attacks). Framing counts: 'welfare', for example, evokes a much less positive response than 'pensions' or 'family assistance'. Surveys almost always find strong support for visible services, but when people are asked about their support for "government administration" – that is, the public service – the response is negative. (There's a message in these findings for public service unions who protest about staff cuts. Their protests probably work against their cause. They would be far better advised to protest against cuts in public services.)

Surveys also find a trend towards more support for public services. In the mid 1980s, when the cult of neoliberalism was at its ideological peak, there was an overwhelming view that taxes should be reduced in preference to increased social spending. But those views crossed over in this century with the preference shifting to social spending. In 2010, however, according to one survey, the preference for cutting tax slightly pipped the preference for increased spending.[27] That is possibly a result of the successful but deceitful campaign by the Opposition at the time to depict the Government as incompetent and high-taxing.

Surveys on willingness to pay are somewhat abstract. Economists always like to look at how people react when there are real costs at stake – what they refer to as 'revealed preferences', rather than an opinion with no consequences. The world offers the occasional natural experiment in those few campaigns when a party in a democracy goes to the polls promising to tax more than its rivals.

In 1989 Bob Carr was NSW Opposition Leader when Premier Greiner introduced a levy of three cents a liter on gasoline to fund roads, which were in even worse condition than they are now. The program was originally intended to last three years: hence it was known as the "3 x 3" levy. In Sydney, and around the state, signs appeared at roadworks announcing "3 x 3, your levy at work". A few stand to this day.

In the 1991 state election campaign the 3 x 3 levy came under questioning, and some in Greiner's Liberal Party canvassed the idea of abolishing it, but the Party backed off once its internal polling found the levy to be quite popular, and Greiner went on to be elected. The levy lasted quite a lot longer than three years, and funded a significant improvement in the state's roads.

Further afield, in the UK the BBC is funded in large part by an annual television licence fee. The conventional texts on tax policy would say it is a dreadful way to fund public broadcasting – as a virtual poll tax it's highly regressive, and it's expensive to collect. But it's popular, for it quarantines the BBC against calls for its privatisation.

Another example comes from the USA, which we generally regard as having an entrenched opposition to taxes, but in November last year Californians voted in a referendum to support a specific proposition to raise state sales and income taxes with the funds earmarked for school funding. The measures they supported raise state sales tax by 0.25 percent, and they raise state income taxes for those three per cent of Californians with annual incomes above $250 000. The proceeds will be around $8 billion a year. Scaled back to Australia's population (23 million compared with 38 million in California) a similar tax would equate to about $5 billion a year – enough to fund the Gonski reforms.

Then there are voluntary contributions to government agencies. Oliver Wendell Holmes's bequest of his personal estate is at one end of the spectrum, but there are many other examples, such as gifts of land to national parks, down to more modest contributions, such as the honesty boxes in recreation reserves. In the past, states have conducted lotteries to fund particular projects of services: the Sydney Opera House was partially funded by a lottery, and until Medicare was introduced Queensland's public hospitals were funded by a lottery. Older Australians say that buying a ticket in these lotteries was similar to buying a ticket in the local scout group raffle – a civic contribution rather than a bet. (There is no known instance of anyone putting money through poker machines because it's an opportunity to pay gambling tax.)

Both survey data and these real-life examples tell us that when there is a clear link to benefits people can support increased taxes. People don't like the established 'consolidated revenue' idea of government – that their taxes are to go into a pool to be appropriated in accordance with political and bureaucratic processes. We want public goods, but we don't trust governments to spend our taxes in accordance with our wishes.

A more general message for those who seek higher taxes to fund particular programs is to establish the case for the programs first. Advocates of higher taxes to support government programs should think of successful retailing. Only for absolute essentials like milk and gasoline do retailers emphasize price at the first point of promotion; for most products they promote the product itself, and if people are sufficiently convinced price is almost an afterthought.

Advocates should always think of language and framing, not only of the programs, but also about taxes. Those who want to denigrate public services use terms like 'pain' and 'burden'. Terms such as 'levy' and 'price' ('carbon price') carry a useful message of connection of outlays to benefits. Words signifying connection help – possessives such as 'our' or 'my' ('our taxes') imply a consensual transaction rather than an imposition.[28]

3. Increasing public revenue

It is not my intention to make a list of possible areas for increasing taxes. Rather, I want to outline some principles which may guide those advocating tax reforms. The obvious and conventional principles have to do with equity, economic efficiency (that is, not to distort resource allocation), and administrative simplicity. These are well covered in a short ACOSS policy paper "Tax reform: purpose, principles and process".[29] The not-so-obvious ones are about:

- keeping an eye on tax expenditures
- ensuring taxes are sustainable;
- ensuring that the tax and revenue system is trusted;
- linking taxes to expenditure;
- the choices between user-pay systems and taxes;
- remembering wealth as well as income.

First, a brief look at how we raise taxes at present.

Present sources

We entrust the Commonwealth with the biggest share of revenue collection. Although there is sometimes talk about putting responsibility back to states, in a federation with mobility of labour and firms, extreme devolution of taxation responsibility down to state and local government results in a race to the bottom as governments compete with one another to offer tax breaks. The history of Australian taxation has been for the Commonwealth to take more responsibility for collecting taxes, as illustrated by the Commonwealth takeover of income tax from the states during the Pacific War, and the Howard Government's takeover of certain indirect taxes. Sources of taxation revenue in 2011-12 are shown in Table 3 on the next page.

Australia has instituted the idea of 'horizontal fiscal equalization' through distributing revenue grants to the states, upon receipt of advice from the Commonwealth Grants Commission. In plain English, that translates to Karl Marx's maxim "From each according to his ability, to each according to his needs". That principle sees taxpayers in New South Wales, Victoria and Western Australia subsidizing taxpayers in the other states and territories. In addition to these general revenue grants (the GST), there are also specific grants for health, education and infrastructure.

Whatever mechanism of intergovernmental balancing is used, federations such as the Australia and USA have particular political problems in tax collection. The federal government is seen as remote. People identify more closely with their state and local governments. Surveys on trust in government generally find trust to be highest for local government and lowest for central government. In federations the biggest part of the tax effort is up to the least-trusted tier of government – the tier that for most people provides few visible benefits.

Table 3: Taxation Revenue 2011-12 $bn

Commonwealth	
Personal income tax	150
Company tax	68
Taxes on super funds	8
GST	49
Excise (alcohol, gasoline)	26
Tariffs	7
Other	10
Total	318
State & Territory	
Payroll taxes	20
Land taxes	6
Conveyancing taxes	12
Taxes on insurance	5
Gambling taxes	5
Motor vehicle taxes	8
Other	4
Total	60
Local	13
Total	391

Source: ABS 5204.0 *Taxation Revenue*

Tax expenditures

With a focus on tax collected, it is easy to overlook tax revenue forgone, through tax expenditures, which came to $112 billion in 2011-12 and are expected to be $126 billion this year. These are shown in Table 4.

Table 4: Tax expenditures 2011-12 $bn

Exemption of main residence from capital gains taxation	36
Superannuation concessions	30
Food exemption in GST	6
Health and education exemptions in GST	6
Capital gains tax discount for individuals and trusts	5
Other (deductions for charitable giving, other GST exceptions etc)	29
	112

Source: Budget Paper #1 2013-14

There are other areas of revenue forgone, not covered in regular official documents, although the Henry Review did make specific recommendations about bequest taxes and land taxes.

One significant area of tax revenue forgone, for example, is exemption from the Medicare Levy Surcharge for those high income earners holding private health insurance.

What stands out in our tax expenditures is that they disproportionately favor the well-off, who are likely to have higher superannuation balances, to own more expensive houses and to hold private health insurance. Although our specific areas of tax expenditures are not the same as in the USA, their incidence is roughly the same. Mettler's finding that tax expenditures favoring the well-off are submerged from view holds here as well as in the USA. A useful and low-cost tax reform initiative therefore would be to shift as many tax expenditures as possible to specific outlays, and for the remaining ones to require specific identification of public expenditure, such as on receipts for private school fees.

Sustainability

Among professional economists and others concerned with efficient resource allocation, there is strong support for the Mineral Resource Rent Tax and for the Carbon Tax (or its replacement by auctioned tradable permits).

In the short term (2013-14) the Carbon Tax will bring in $9 billion in annual revenue – a useful contribution, and at around 0.5 percent of GDP, hardly a significant cost to those who pay it. The MRRT, watered down badly from the original proposal in the Henry Review, will raise around $3 billion a year. Both are good taxes by most economic criteria.

But they should not be relied on for our permanent revenue base, any more than we should rely on the $5 billion annual tobacco excise, for the carbon tax is designed to discourage certain harmful behaviors, and the MRRT applies only to abnormal profits, which tend to occur in boom times. Taxes with a short life span are best applied to specific capital projects, or to paying down public debt when the business cycle is at its peak. Similarly, short-term revenue gains should not be applied to permanent tax cuts. The Howard Government's use of proceeds of the mining boom to pay for tax cuts is one reason our tax base is now so weak.

The Henry Review was concerned with our long-term public revenue base, but for the most part the Government's responses to the Henry Review were timid. It is well worth re-visiting.

Keeping public trust

Even once people accept the need to pay taxes to fund public goods, the question of compliance arises. Unless people believe that the public revenue system is fair, they will do everything to avoid or evade tax. (The distinction between avoidance and evasion is a fine one: avoidance is legal while evasion is illegal, but there are many avoidance schemes that go against the spirit of the law.)

If you or I believe that tax evasion is widespread, then it is quite logical that we should also evade tax if we can. Our personal preference may be for public goods to be funded from our taxes, but if those public goods are not forthcoming because others are not paying their taxes, then we would be suckers not to join them. That's a statement of the 'prisoners' dilemma' of provision of public goods rather than a statement about morality. While there are images of tax-inspectors and stories about tax audits, the Australian Taxation Office would be overwhelmed with compliance work if they could not rely on people assuming that the system is fair. A fair and trusted public revenue system is a valuable part of our social capital.

In this regard the newly-elected Coalition Government has gotten off to a bad start. The previous Government had announced, but not legislated for, closure of two loopholes – both allowing people to claim private expenses as work-related expenses. One relates to cars provided as part of salary packaging, where, because of the way the Fringe Benefits Tax is structured, all private use can be claimed as a deduction in the same way as a business expense. The other relates to self-education expenses, which is easily rorted, for example by those who include a conference as part of their expensive foreign travel and claim the whole holiday as a tax deduction.

In not proceeding with these measures the Government is legitimizing the idea that it's quite OK to claim non-business expenses as a tax deduction. Cars and self education may be considered as special circumstances, but it is hard to quarantine the principle of allowing deductions for non-business expenses. Those who do not have corporate employers to provide cars, and those who do not travel to conferences will feel cheated, as will those who have had these rorts available but have not used them.

Similarly the intention not to proceed with the tax on pension incomes above $100 000 (at the same time as deleting the superannuation contribution for low-income earners) carries a strong message of unfairness.

The political message in these reversals of policies – policies designed to preserve the integrity of the tax system – is that taxes are unfair burdens placed on low-and middle-income earners, and that may be precisely the message those on the far right want to convey. The ultimate cost of legitimizing car and self-education rorts, now that the Government intends to give them legal sanction, is that they undermine the trust we have in the tax and public expenditure system. If that trust is lost, we can expect tax avoidance and evasion to become more widespread, and for governments to be forced to rely on unpopular and regressive taxes and charges which are hard to avoid.

Linking taxes to benefits

In Part 2 it was pointed out that when taxes are clearly linked to desired services, public acceptance is more likely.

Sometimes those linked taxes will be regressive in nature. A fixed levy on income, for example, is at best neutral – neither progressive nor regressive. But it is possible that the distributional benefits of the services funded by the tax or levy are such as to overcome the regressivity of the tax itself.

Economists and social advocates agree that consumption taxes are regressive. The higher our income. the lower is the proportion we spend on consumption and therefore the higher is the proportion of our income spent as taxes.

But what if an increase in GST is used to finance services which contribute strongly to the 'social wage' – those 'in kind' benefits we get from government services?

On average, 62 percent of state government outlays are for health, education, housing and 'in kind' welfare benefits (65 percent in South Australia).[30] Cash payments for welfare are handled by the Commonwealth, while many 'in kind' benefits are state-funded. In addition to these services specifically identified by the ABS as "transfers in kind" there are other state services with a strong redistribution component, such as public transport.

Table 5 shows the Gini coefficients for income distribution taking into account taxes, social security and public services identified as "transfers in kind". The Gini coefficient is a measure of inequality, with a range from 0 (perfect equality) to 1 (all income held by one person). Commonwealth social security benefits paid in cash, such as age pensions, yield a big improvement (0.051), as does our reasonably progressive income tax (0.027). "Transfers in kind" – services which dominate state government outlays – give another significant improvement in equality (0.031). The GST raises the Gini coefficient back towards inequality, but only by 0.010. The net result of an increase in GST linked to state services could well be progressive.

Table 7: Gini Coefficients of income 2009-10

		Change
Private income	0.401	
Gross income after social security benefits paid in cash (Commonwealth)	0.350	-0.051
Disposable income after income tax	0.323	-0.027
Disposable income after income tax and "transfers in kind"	0.292	-0.031
Disposable income after income tax, social transfers in kind, and GST	0.302	+0.010

Source: derived from ABS 6537.0 *Government Benefits, taxes and household income* 2009-10

This presentation is an illustration rather than a definitive analysis, but it suggests that those seeking an equitable way to fund public services should not rule out increasing the GST. There are problems in raising the GST from its present 10 percent, because it would make for a sharper distinction between GST-free and GST-charged goods, which would increase its distortionary impact and would raise the incentives for firms to evade GST through shifting overhead costs. But, given the rise in incomes since the GST was introduced, expenditure on some GST-free items may now be less significant than it was 13 years ago, thus allowing for some reclassification of exemptions. For example, between the ABS Household Expenditure Surveys of 2003-04 and 2009-10, expenditure on food has fallen from 12.5 percent to 11.4 percent of household expenditure for all households and from 15.8 percent to 14.8 percent for those in the lowest income 20 percent of households.[31]

With the deterioration in state revenues it is likely that premiers, regardless of political persuasion, will have some enthusiasm for raising the GST.

In considering any proposal to raise the GST, it should also be remembered that for many so-called 'self-funded' retirees, living off tax-free private pensions, GST is the only federally-collected tax they pay. An increased GST may be the only minor compensation for a tax incidence that has tipped very much in favor of older Australians.

The choices between user-pay systems and taxes

In general, services are funded by taxes when there is some degree of market failure. When governments impose user-pay systems without correcting for the market failure, some combination of inequity and inefficiency usually results. In general, when there are significant market failures, taxes do a better job in terms of equity and economic as a means of funding services.

While that is the general rule, there are a few occasions when the market failure can be rectified, and for user-pay systems to improve equity and efficiency.

One particular form of market failure is known as 'non-excludability'. This relates to services for which it is impossible to exclude non-payers. The textbook case, now dated, is the lighthouse. There is no way to find a way to allow the lighthouse to be seen only by ships which have paid for it.

Most roads in Australia are non-excludable. Only on some urban freeways and on some bridges is it practical to impose a toll, and when a toll is imposed, the freeway or bridge tends to be under-utilized, as drivers find rat runs to avoid the toll, thus leaving an expensive piece of infrastructure under-utilized. (Economists refer to such under-utilization as 'deadweight loss', because no one benefits.) Tolls are not a good way to fund roads when most of the road network is untolled. They have proliferated in our largest cities only because governments – both Labor and Coalition – have shied away from raising taxes.

Governments generally use proxy taxes to pay for roads. States impose vehicle registration fees, which are inequitable because they relate to ownership rather than to use, and they usually bear little relationship to the market value of the vehicle. The Commonwealth collects fuel taxes (which, in one of his less fiscally responsible moves, Prime Minister Howard froze at 38 cents a liter in 2001, removing indexation). But fuel taxes are only indirectly related to road use and to costs such as congestion and pollution.

By now it is becoming possible, using GPS technology, to charge for all road use, eliminating fuel taxes and registration fees altogether, for example charging heavier vehicles for road wear and charging for congestion. Those who use their vehicles less, or who travel for shiftwork when the roads are less congested, would pay less than they do at present. A transition to road user charges was one of the recommendations of the Henry Review. When it eventually gets raised again it will probably raise howls of protest from those with high road use who are presently subsidized by those whose vehicles are used less. Anticipating campaigns to block such reforms and heading them off early is essential if reform is not to be squashed.

Don't forget wealth

Most discussion about taxes and equity focuses on income. Income disparities, over time, lead to wealth disparities, and wealth disparities are much more enduring than income disparities. Wealth disparities have been widening significantly.

In 2003-04 there were 77 000 households with net wealth over $4 million; by 2011-12 there were 99 000 households with over $5 million in net wealth (the equivalent of $4 million in

2003-04). This widening is not only at the very top end: in 2003-04 households at the 90th percentile point of wealth distribution had 45 times the wealth of those at the 10th percentile point; by 2011-12 they had 54 times the wealth.[32]

When such figures are presented it common for those on the ‘right’ to refer to ‘class warfare’ – an emotive but meaningless term (unless there are rioting crowds in the streets of Toorak, Double Bay and Medindie setting fire to houses and overturning BMWs). A simple wealth tax is a crude measure, but there are ways of ensuring that wealth accumulation is kept within bounds. Well-designed capital gains taxes, progressive income taxes, elimination of income diversionary mechanisms such as family trusts, and gift and inheritance taxes, can protect against the emergence of a plutocracy and a class of idle rich living off inherited wealth.

Conclusion – they're 'our' taxes and it's 'our' government

There are many who stand to benefit from perpetrating the notion that our taxes are too high. Private profits are at stake, in the short term at least. In the long term the consequence is an imbalanced and under-performing economy, illustrated by J K Galbraith in his image of "public squalor" contrasting with "private affluence".[33] The patchwork of gated communities and slums in Mexico or Brazil give a reasonably good idea of the consequences of a low-tax path.

Capitalism as an economic system has succeeded because policymakers in the past have understood that economies need a mixture of private and public goods. Policymakers seeking to keep the economy balanced have been supported by a mature public, informed by free and independent media, who understand why some activities are best left to private markets while others are provided, funded, or regulated by governments.

This understanding rests on the public idea that government is the community's means to provide collective services. It entails a sense of 'common wealth', in the traditional sense of the term.

Those who seek to profit from the withdrawal of government have worked effectively to undermine that public idea. They have portrayed government as an agency separate from the people – a big kleptocracy which, through taxes and regulations, takes our hard-earned money and constrains our freedom.

In our university economic faculties established theories of market failure, which provide the philosophical underpinning for the traditional mixed economy, have given way to a theory known as 'public choice'. It's a model of government as an insatiable monster interested only in expanding its realm rather than in providing public services. In plainer language when campaigning to become Governor of California in 1965, in an uncharacteristically lucid moment, Ronald Reagan captured the emerging view of government saying "Government is like a baby. An alimentary canal with a big appetite at one end and no responsibility at the other".

The 'right' talk about taxes reducing our freedom to choose. The Institute for Public Affairs, for example, celebrates "tax freedom day" – the day in the calendar year "when Australians stop working for the government and begin working for themselves", calculated by apportioning taxes as a percentage of GDP to the 365 days in the year.[34] In Australia it falls much earlier in the year than in those prosperous democracies with a better standard of public goods. The clear inference from this sort of statement is that 'government' is a detached entity which does nothing for us of any value.

Those who seek to defend and expand public services need to take control of the language, particularly that notion of 'choice', for when a government tells us that it must cut public spending it is really saying, paternalistically "you say you want collectively-funded schools and hospitals, but we know better what's good for you". In other words, we are denied the freedom to make to enjoy our chosen mix of private and public services.

Once we restore a democratic view of government, as the agency *we* choose to provide our public goods, we need to carve that vision in stone, starting with the Commonwealth Treasury Building.

Appendix: Effect of fiscal drag of a 5.0 percent inflationary rise in income

This appendix is based on 2013-14 tax scales. It incorporates the Medicare Levy but does not include any offsets.

Annual income	Annual tax	Annual income after inflationary rise	Annual tax	Nominal tax increase	Real tax increase
10 000	150	10 500	158	5.0%	0.0%
20 000	642	21 000	847	31.9%	26.9%
30 000	2 692	31 500	3 000	11.4%	6.4%
40 000	5 147	42 000	5 827	13.2%	8.2%
50 000	8 547	52 500	9 397	9.9%	4.9%
60 000	11 947	63 000	12 967	8.5%	3.5%
70 000	15 347	73 500	16 537	7.8%	2.8%
80 000	18 747	84 000	20 287	8.2%	3.2%
90 000	22 597	94 500	24 330	7.7%	2.7%
100 000	26 447	105 000	28 372	7.3%	2.3%
110 000	30 297	115 500	32 415	7.0%	2.0%
120 000	34 147	126 000	36 457	6.8%	1.8%
130 000	37 997	136 500	40 500	6.6%	1.6%
140 000	41 847	147 000	44 542	6.4%	1.4%
150 000	45 697	157 500	48 585	6.3%	1.3%
160 000	49 547	168 000	52 627	6.2%	1.2%
170 000	53 397	178 500	56 670	6.1%	1.1%
180 000	57 247	189 000	61 432	7.3%	2.3%
190 000	61 897	199 500	66 315	7.1%	2.1%
200 000	66 547	210 000	71 197	7.0%	2.0%

Endnotes

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