Gavin Putland

Six Months to Full Employment

SECOND DRAFT
November 10, 1998

To Bill Gates,
who made me do it his way.

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Preface

No party politician could have written this book. Party politicians do not so much shape public opinion as pander to it. They do not so much educate the electorate as exploit its ignorance—while paying lip service to its intelligence and discernment. They devise policies so as to minimize the scope for misrepresentation by their opponents, and then misrepresent their opponents' policies in every possible way. For a party member, the consistent promotion of good policy simply because it is good policy is a recipe for disendorsement. For a party, it is a recipe for defeat.

What political party, for example, will promise to extend the dole to the employed as well as the unemployed, or to remove income tests on child allowances, or to remove assets tests on pensions? Everybody knows that the means-testing of benefits leads to lower taxation. What party will promise to flatten the income tax rates? Everybody knows that high income earners rightly pay higher marginal rates than low income earners. What party will make promises concerning the structure of the tax system but not commit itself to specific rates of tax? Everybody knows that the true measure of the tax burden is the total amount of tax collected, which in turn depends on the rates. What party will propose a variable tax rate as the price of maintaining low interest rates? Everybody knows that "variable" taxes vary in only one direction. What party will promise to abolish tariffs? Everybody knows that tariffs are good for jobs.

Unfortunately all those statements beginning with "Everybody knows . . ." are false. They are "political truths"—lies that politicians must pretend to believe if they want to win elections. "Political truths" are widely believed because the arguments that purport to prove them are simpler, and hence more easily reduced to slogans and soundbites, than the arguments that disprove them. No party will stake its electoral future on its ability to defeat emotive sloganeering with unemotive logic. The logic must come from outside the party system.

Disclaimer

The opinions expressed in this book, unless otherwise attributed, are those of the author and are not necessarily shared by the publisher, or the University of Queensland, or the Greek Orthodox Archdiocese of Australia, or any other organization with which the author is currently or formerly associated. The author is not and has never been a member of any political party, does not always vote for the same party or ticket, and does not believe that any existing party would tolerate him as a member. *The contents of this book are not to be interpreted as legal advice, financial advice, tax advice, academic advice or any other kind of advice*, or as anything other than the author's exercise of his (non-Constitutional) right of free speech. The author has made, and will continue to make, every reasonable effort to ensure that factual statements in this book are accurate; nevertheless, in view of the size and complexity of the work and the pace of change in the relevant policies and laws, no warranty of accuracy can be given.

When referring to hypothetical persons, the author sometimes uses the masculine pronoun, sometimes uses the feminine, and sometimes distinguishes between two persons by using different genders. In no case is any gratuitous significance to be attached to the choice of gender. The author has not counted the number of occurrences of each gender, and advises anyone contemplating such an exercise to get a life.

The "mug Australian voter" is the author's general-purpose Devil's Advocate. He has not read this book and has no intention of doing so. In the author's opinion, the average voter is less intelligent than most politicians *claim* to believe, but more intelligent than most politicians actually believe.

Gavin R. Putland
November 10, 1998.

Acknowledgments

For useful discussions during the preparation of this book, I wish to thank the following persons, none of whom necessarily agrees with what I have written: Anthony Cassimatis (School of Law, University of Queensland), Eleni Demitriou, Yiota Marendy (Feros Wee), Frank Putland (Kip McGrath Education Centres), Ralph Waters (Lochhead Research & Development).

An earlier version of my tax reform package is described in the paper "Fourteen Steps to Full Employment" [21], submitted in March 1998 to the Tax Reform Challenge Competition conducted by the Land Values Research Group. The main subject of the paper, namely reform of land tax, is not considered in this book. Inaccuracies in the paper concerning GST compliance costs are corrected in the book. The details of the Direct Expenditure Tax, including its extension to companies and its treatment of inheritances and capital gains, were not properly worked out in the paper and are corrected in the book. The corrections were influenced by Mark Latham [15], although I have rejected other aspects of Latham's package (see Section B.5).

Sources

References to newspaper articles and WWW documents are given in footnotes. Authors are usually not shown for newspaper articles written by staff reporters, but external contributors are acknowledged by name. References to books and journal articles are listed in the Bibliography if I have read the documents from start to finish; otherwise they are given in footnotes.

Biblical quotations, unless otherwise attributed, are from the King James Version (1611). "RSV" refers to the Revised Standard Version, 2nd Ed. (1971).

"*Concise Oxford Dictionary*" means the *Australian Concise Oxford Dictionary* (Melbourne: Oxford University Press, 1987), based on the 7th UK edition (1982).

Software

This book was typeset by the author using LaTeX 2ε, which was developed by Donald Knuth, Leslie Lamport et al. and ported to Windows 95/NT under the name `MiKTeX` by Christian Schenk. Draft printouts were made from Russell Lang's `GSview`, a menu-driven front end for Aladdin Ghostscript. The text was edited using `emacs`, which was developed by Richard Stallman et al. and ported to Windows 95/NT by Geoff Voelker et al. `MiKTeX`, `GSview`, Ghostscript and `emacs` are freeware packages distributed under various free public licenses. All product names appearing in this paragraph are assumed to be trademarks.

Abbreviations

Before perusing the huge number of taxes on the following list, the reader should note that the only taxes endorsed in this book are FDET, GST, excises, mining royalties, State land taxes, local government rates and (maybe) an RST on luxury cars, yachts and private aircraft.

A$	Australian dollar(s)
ABS	Australian Bureau of Statistics
ACCI	Australian Chamber of Commerce and Industry
ACOSS	Australian Council Of Social Service
AGPS	Australian Government Publishing Service (Ausinfo)
ASX	Australian Stock Exchange
ATO	Australian Taxation Office
BAD	Bank Account Debit
CAD	Current Account Deficit
CGT	Capital Gains Tax
CPI	Consumer Price Index
DET	Direct Expenditure Tax (see also FDET, PET)
DSS	Department of Social Security (Centrelink)
EITC	Earned-Income Tax Credit
EMTR	Effective Marginal Tax Rate
FBT	Fringe Benefits Tax
FDET	Flat Direct Expenditure Tax
FID	Financial Institutions Duty
GDP	Gross Domestic Product
GR	General Rebate
GST	Goods and Services Tax (see also VAT)
HECS	Higher Education Contribution Scheme
ISA	Income Security Account
MHR	Member of the House of Representatives

MP	Member of Parliament
NAIRU	Non-Accelerating-Inflation Rate of Unemployment
OECD	Organization for Economic Cooperation and Development
PAYE	pay-as-you-earn
PCT	Patent Cooperation Treaty
PET	Progressive Expenditure Tax (Kaldor Tax)
PIT	Personal Income Tax
PPS	Prescribed Payments System
pf	per fortnight
R&D	Research & Development
RBA	Reserve Bank of Australia
RRT	Resource Rent Tax (excess profits tax)
RST	Retail Sales Tax
TCF	Textiles, Clothing and Footwear
VAT	Value-Added Tax (see also GST)
WN	*The Wealth of Nations* (Adam Smith, 1776)
WST	Wholesale Sales Tax

Chapter 1

Overview

1.1 Twenty-one steps

When representatives of any minority religious sect knock on your door, they first try to win your confidence by expressing opinions that you already share, based on arguments that you cannot fault. Only after many such meetings, during which you have invested considerable time and hope, and during which they have built up their stock of credibility in the form of a long series of apparent agreements between reason and dogma, do they cash in their advantage and introduce you to their more bizarre and onerous beliefs.

Not wishing to be compared with such operators, I begin this book by listing the steps by which, in my opinion, the Federal Government can restore full employment without widening the gap between rich and poor. The steps are as follows:

1. **A negative poll tax:** Introduce a universal transfer payment called the General Rebate (GR), payable to every adult regardless of employment or income or marital status, to replace the dole, dependent spouse payments, rent assistance, the low-income rebate, most of the old-age pension, the living expenses component of study allowances, the tax-free threshold (Step 6), and almost all other forms of industry assistance (Steps 4 and 19). In Budget statements, classify the GR as a tax refund, so that it does not appear in the social security budget or in overall tax receipts.

2. **Simplifying welfare:** Express other welfare payments, including child

allowances, study/training allowances, sickness/maternity benefits, carers' benefits and age/disability pensions, as supplements to the GR. Remove all means-testing and taxation of benefits. In Budget statements, classify all transfers other than the GR as social security payments funded by taxation.

3. Allow wages under Federal awards to fall so as to compensate for the GR, effectively turning the GR into a wage subsidy. Require future wage increases to be strictly enterprise-based. Allow the GR to take over the "safety net" function of awards. (The States would promptly do the same with State awards, or hand over responsibility for industrial relations to the Commonwealth—as Victoria has already done—in anticipation of Step 16.)

4. Abolish all other forms of "industry welfare", including tariffs.

5. Abolish Fringe Benefits Tax (FBT), Capital Gains Tax (CGT) including provisions on inheritances and gifts, and superannuation taxes.

6. **A flat direct expenditure tax (FDET):** Turn the Personal Income Tax (PIT) into a flat-rate PAYE tax with no threshold, with deductions for savings/investments and outgoing cash gifts and cash bequests, and applicable to all income including dissavings, sales of investments, and incoming cash gifts and cash inheritances, but not social security payments (see Step 2). (Inherited non-cash assets, such as real estate, businesses, farms and associated machinery, would not be taxable unless they were sold, in which case the sale proceeds could still be rolled over into new investments.)

7. **Extending the FDET to companies:** Turn the company tax into a tax on corporate consumption (not "profit") at the standard FDET rate, with deductions for wages and salaries, dividends, rents and investments, but *not* fringe benefits or other consumption expenses.

8. Retain excises on tobacco, liquor and fossil fuels, provided that the liquor excise is levied on *alcohol* content and the fossil fuel excise on *carbon* content. Replace Federal Resource Rent Taxes (RRTs) with *ad valorem* Federal mining royalties, with a uniform rate for each mineral. Subject new mines within each State to the same Federal royalties, and return the revenue to the State. (Fossil fuels, being subject to the carbon tax, should be exempt from mining royalties.)

9. Amend the Referendum (Machinery Provisions) Act to introduce voluntary voting in referenda that are not held simultaneously with general elections.

10. **Entrenching the welfare reforms:** Submit the following proposal to a referendum:

    > If a pension or like benefit funded by the Commonwealth is subjected to a means test, the amount withheld in consequence of the means test shall be counted as taxation, and the full value of the benefit shall be counted as expenditure, even in cases where the means test causes the full value to be withheld.

    If the referendum fails, incorporate the provision into the Charter of Budget Honesty legislation.

11. **Vertical fiscal balance:** Having set Commonwealth FDET at a sufficiently low rate, cease all grants to the States except matching grants and fiscal equalisation grants, and invite the States to introduce surcharges on personal and corporate FDET.

12. **Rationalising State taxes:** *After* the States have imposed the surcharges, submit the following proposals to a referendum as a single question:

    (a) that the States cannot impose any taxes except land taxes, mining royalties on existing mines, and surcharges on personal and corporate FDET, and

    (b) that each State may determine the rate of its FDET surcharge, but must impose the same rate on personal and corporate FDET, and must impose the surcharge on the same range of transactions as are subject to the corresponding Federal tax.

    These constitutional amendments would abolish payroll tax, financial institutions duty (FID), bank account debit (BAD) tax, stamp duties and gambling taxes. If pigs fly and the referendum is defeated, attach the above conditions to the continuation of matching grants and fiscal equalisation grants.

13. Abolish Wholesale Sales Tax (WST).

14. Introduce a GST with

(a) zero rating for government and exports,

(b) exemptions (on *efficiency* grounds) for health and nursing services, education and childcare services, financial services and residential rents, and

(c) a single rate for all other goods and services, including food and clothing.

15. **A tax/interest trade-off:** Thereafter, control demand and underlying inflation by adjusting the GST rate at the beginning of each accounting period. In the enabling legislation, include the following provisions:

    - The GST rate shall be adjusted by the Treasurer on the recommendation of the Reserve Bank of Australia (RBA);
    - The RBA's recommendation shall be published simultaneously with the Treasurer's announcement;
    - The RBA's recommendation shall be designed to maintain low inflation, avoid deflation, and minimise interest rates;
    - Each adjustment of the GST rate shall be accompanied by a preemptive CPI-linked adjustment of the GR and supplementary benefits.

16. **Socialising sick leave:** Allow payment of benefits for sickness or other incapacity to commence immediately at the onset of the incapacity.

    Under Federal awards, require all existing paid leave entitlements, including sick leave and leave loadings, to be absorbed into the basic pay rate, and extend the availability of unpaid leave and flexible hours.

17. **Removing the cause of discrimination:** Enact legislation whereby employers can claim compensation from the Commonwealth for expenses incurred in employing disadvantaged persons.

18. **Protecting investment in training:** Enact legislation to the effect that

    (a) an employer who invests in the training of a current or prospective employee is deemed to recover the investment over a certain period, and

    (b) if the employee resigns before the end of the period, the employer can claim the unrecovered portion of the investment from the new employer (if any), but *cannot* claim it from the employee unless the claim against the new employer is legally unenforceable.

19. **Protecting investment in R&D:** Waive all Patent Office fees for Australian inventors. Provide merit-tested (*not* means-tested) legal aid to individual Australian inventors applying for patents. Provide legal aid to any individual or corporate Australian inventor who is compelled to defend a patent in an Australian or foreign court. Require all applications for Australian patents to be submitted on international forms as provided under the Patent Cooperation Treaty (PCT), so that Australian inventors are forced to give timely consideration to their international options. Abolish existing tax concessions for R&D.

20. **Civilising politics:** Put the following proposal to a referendum:

    > All Federal MPs, whether they are Ministers or not, shall receive the same remuneration, which shall be entirely in the form of salary, with no "allowances" or superannuation; and any change in the salary of Federal MPs shall not take effect until after the next general election for the House of Representatives.

21. **Fixing election dates:** Put the following proposals to a referendum as a single question:

    (a) General elections for the House of Representatives and half of the Senate, for all houses of State Parliaments and for all local councils shall be held simultaneously, on the 4th Saturday in November every 4th year (elections held on this date are called "scheduled elections" below);

    (b) Any unscheduled elections shall be held in addition to, not instead of, the scheduled elections;

    (c) New members of the House of Representatives, the Senate, State legislatures and local councils shall commence their terms 44 days after each general election (for scheduled elections, this means the first Monday after the first Thursday of the new year).

    If the referendum is defeated, replace the words "half of the Senate" with "all of the Senate" and immediately submit the amended question to a new referendum.

Steps 1 to 8 simplify the direct tax system and eliminate destructive interaction between tax and welfare. Steps 9 and 10 consolidate the reforms. Steps 11 to 15 simplify Commonwealth-State financial relations, State taxes and Federal indirect taxes. Steps 16 and 17 shift some social security costs from employers to the Commonwealth. Steps 18 and 19 encourage investment in public goods. Steps 20 and 21 reduce the risk of backsliding.

The title of this book refers to Steps 1 to 8, which must come into effect simultaneously, and which can restore full employment within six months of implementation, allowing time for the advertising and filling of vacancies. The remaining steps can be spread over a longer period, and are intended in part to prevent renewed inflation after the clearing of the labour market.

1.2 Preview of remaining chapters

Chapter 2: Government-induced market failure

If the provision of a service creates a benefit for which the provider is not rewarded, classical economic theory predicts that the service will be in short supply. The unrewarded benefit is a *positive externality*. The resulting undersupply is an example of *market failure*. At present, the creation of a job causes a positive externality, namely a reduction in welfare expenditure. Therefore jobs are in short supply. The externality would be removed if the employer were not required to pay the full income of the employee, but only required to pay the *difference* between the full income and the dole. This result can be achieved by replacing the dole with a universal benefit, which I call the General Rebate (GR), payable to the employed and the unemployed alike.

An income-tested benefit, withdrawn over a certain range of income, is equivalent to a non-income-tested benefit combined with an *income tax surcharge* on the same range of income. Hence the abolition of the income test on the dole does not require a *real* increase in taxation.

Conventional industry assistance takes the form of protective tariffs, subsidies and tax concessions, all of which come at the expense of individual taxpayers, and all of which reduce overall employment by diverting investment from profitable industries to unprofitable ones. In contrast, the GR delivers industry assistance *through* the individual, so that a corporation cannot obtain the assistance except by employing the individual.

Other examples of government-induced market failure include the lack of protection for corporate investment in education and R&D.

Chapter 3: The cost of red tape

Creating jobs is not a matter of creating work. On the contrary, the creation of unnecessary work—red tape—diverts resources from productive work to unproductive work, reducing the revenue of employers and consequently reducing their overall capacity to employ. Thus the creation of a number of administrative jobs is necessarily accompanied by the destruction of a *greater* number of jobs elsewhere: *making work destroys jobs*. This is a recurring theme throughout the book.

Red tape is implicated in numerous other social evils. Some of these are caused directly by red tape, while others are caused directly by unemployment and hence indirectly by red tape.

Chapter 4: The employer's burden

While employers are not legally obliged to employ, they are financially obliged to make a profit, and legally obliged to perform a long list of social and administrative functions which are logically the responsibility of governments and which, when dumped on employers, make it harder for them to employ people while still making a profit. Employers relieve the pressure in the only possible way—by not employing.

Chapter 5: The tax burden

The true cost of taxation is the *deadweight cost*—the reduction in national income caused by the tax system—and has little to do with the actual amount of tax collected. Similarly, the true cost of welfare is the deadweight cost—the reduction in national income caused by the welfare system and its interaction with the tax system—and has little to do with the actual amount of welfare handed out. Means-testing of welfare payments is a hidden form of taxation with a narrow base and a correspondingly high rate. The notion that means-testing reduces the tax burden is the greatest lie in Australian politics and the greatest single contributor to the deadweight cost of welfare. A means test cannot reduce the tax burden because, for all practical purposes, it is a tax!

Chapter 6: FDET: a simplified direct tax

The Flat Direct Expenditure Tax (FDET) is a single tax that replaces income tax, company tax, fringe benefits tax, capital gains tax, death duties, gift duties and superannuation taxes. It replaces not only the actual or potential *revenue* of those seven taxes, but also their logical functions. It is a direct consumption tax, where *consumption* is defined as income minus net savings. The deduction for net savings avoids double taxation of capital, which is a fundamental flaw of income tax and a major impediment to the creation of employment.

Chapter 7: GST: a simplified indirect tax

As a means of controlling demand, and hence of controlling inflation and the flow of imports, a variable GST is more effective, more equitable, more fiscally responsible and less damaging to employment than variable interest rates. To promise that the GST rate will remain constant is to throw away greatest benefit of a GST. That is the main point of the chapter. But, for the sake of completeness, the advantages of a GST over other indirect taxes are enumerated, and numerous objections to a GST are refuted.

Chapter 8: Constitutional reform

The general dishonesty of political debate indicates that the current system of parliamentary remuneration offers too many rewards for winning elections and not enough rewards for good policy. The problem is compounded by perpetual election fever, caused by the high frequency of Federal and State elections and by the ability of Prime Ministers and Premiers to call elections at opportune times. With the appropriate constitutional amendments, it is possible to moderate the rewards for winning elections and confine election fever to predictable times. After the election season, the best re-election strategy for a new government would be to adopt responsible long-term policies, so that it can go to the (distant) next election with the best possible record.

Chapter 9: Political considerations

It is futile to propose reforms which cannot survive the electoral process, or which will be amended beyond recognition by minor parties in the Senate, or which will be repealed by future governments in pursuit of short-term political gains. The proposals in this book are shown to be politically robust.

Appendix A: Response to Latham's *Civilising Global Capital*

The FDET is a modification and extension of a proposal described in Latham's recent book [15]. While my policy prescriptions are more radical than

Latham's, they address some of the same problems: the conflict between industry welfare and social welfare, the underinvestment in education and R&D, gain sharing, regional concentrations of underdevelopment and unemployment, the lack of incentives to move from welfare to work, and the funding of education and welfare.

Appendix B: Flawed concepts

A survey of (possibly) well-intentioned but unworkable proposals.

Appendix C: Political stunts

Bad policies that win votes.

Appendix D: The Constitution in plain English

When Australians vote in referenda, they vote on the wording of a document which most of them have never read: the Constitution of the Commonwealth of Australia. While this apparent lack of interest in national affairs is appalling, one must concede that the reading of the Constitution is made unnecessarily tedious by the numerous transitional provisions that have been rendered void by the passage of time. Accordingly, for the reader's convenience, I include a plain English version of the Constitution and related Acts, with all obsolete provisions removed.

Chapter 2

Government-induced market failure

2.1 What is full employment?

Full employment cannot be defined as a zero unemployment rate. In any state of the labour market, there are two causes of temporary unemployment. First, some workers are temporarily unemployed because they are changing jobs. This is *frictional unemployment*. Second, job-seekers who have recently left full-time education take some time to find employment. Because graduations occur in bursts at particular times of the year, especially December, the resulting unemployment is called *seasonal unemployment*; hence unemployment figures must be *seasonally adjusted* to allow meaningful comparisons between figures collected at different times of the year. The boundary between frictional and seasonal unemployment is blurred. At the end of a fruit-picking season, for example, many employment contracts terminate. The resulting unemployment could be classified as frictional because it involves workers changing jobs, or as seasonal because it occurs at particular times of the year.

Hence we may define full employment as a situation in which the only unemployment is frictional and seasonal. But how much unemployment is that? We have had objectionable levels of unemployment for so many years, and the economy has diversified so much in that time, that no one can confidently calculate what level of official unemployment is purely frictional and seasonal. Furthermore, we have not fully defined frictional and seasonal unemployment. The difference between short-term and long-term unemployment is, after all, only a matter of degree. If you lose a job, how long must it take to find a new one before your unemployment ceases to be frictional? If you graduate from an educational institution, how long must it take to find a job before your unemployment ceases to be seasonal? Evidently the answers depend on what kind of employment you are seeking. The higher your expectations, and the narrower the range of employments that you are prepared to consider, the longer you must expect to wait. Even if your first application is successful, you will be unemployed until the completion of the selection process, the duration of which depends not only on the nature of the job, but also on the state of the labour market: when unemployment is high, employers have too many applications to consider, but must consider them carefully for fear of being sued for discrimination by disappointed applicants.

Perhaps the best we can say is that in times of full employment, a job-seeker who is not unduly demanding will find a job within a time frame determined by the selection process. In other words, full employment is an economic state in which you can pick up the weekend newspaper, find half a dozen advertised vacancies that match your qualifications and experience, submit applications, and be confident of getting at least one offer. Such a definition accords with the aspirations of job-seekers, who know perfectly well what full employment is, even if economists do not.

Employers also know perfectly well what full employment is. It is an economic state in which you can advertise a vacancy in half a dozen newspapers and *not* be confident of getting a suitable applicant, because too many other employers are competing for too few applicants. In short, full employment is an employee's market. But employers do not complain about this; their insatiable demand for labour indicates that business is brisk, and the small number of applicants makes it safe and easy to choose the best. Full employment does not necessarily mean that *every* employer faces a shortage of labour, because in any state of the labour market there will be prestigious professions and prestigious employers that can always fill their vacancies. Rather, full employment is an overall shortage of labour, affecting a sufficient range of professions and industries to ensure that any reasonable job-seeker can quickly find employment.

2.2 The invisible hand

> ... The annual revenue of every society is always precisely equal to the exchangeable value of the whole annual produce of its industry, or rather is precisely the same thing with that exchangeable value. As every individual, therefore, endeavours as much as he

> can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value, every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good. It is an affectation, indeed, not very common among merchants, and very few words need be employed in dissuading them from it.
>
> What is the species of domestic industry which his capital can employ, and of which the produce is likely to be of the greatest value, every individual ... can, in his local situation, judge much better than any statesman or lawgiver can do for him. The statesman who should attempt to direct private people in what manner they ought to employ their capitals would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it.
>
> — Adam Smith (1723–1790),
> *The Wealth of Nations* IV.ii.9–10 [23].

The genius of the free market is the conversion of a private vice into a public virtue: when individuals and corporations seek to maximise their own wealth, the collective result of their efforts is to maximise the wealth of society. Moreover, the public good is not merely an incidental effect of private profit, but a prerequisite thereto; as long as the rule of law prevails, individuals and corporations cannot profit except by serving the interests of others, at least to the extent of offering goods and services that others want to buy. The nervous system of the market is the price mechanism, which matches the supply of a good or service to the demand. If the supply outstrips the demand, competition between suppliers drives down the price, attracting more buyers and causing some suppliers to leave the market. If the demand outstrips the supply, competition between buyers drives up the price, discouraging some buyers and attracting more suppliers into the market. In either case, the price moves in such a direction as to restore the balance between supply and demand and establish a new equilibrium.

The ubiquitous effectiveness of the price mechanism is illustrated by the huge variety of goods and services on offer in any large town. With few exceptions, these products are offered not because any government has arranged for them to be offered, but because enterprising individuals and corporations have found that it is profitable to offer them. It would be quite beyond the organisational powers of any government to arrange for the supply of so many goods and services in quantities that so closely match the demand. The system works not because governments make it work, but because governments have not managed to stop it from working.

So what has gone wrong with the market for labour? In late 1998, the Australian labour market has been in a remarkably stable state for the last three years. We might therefore say that the price mechanism has produced equilibrium. But it is not an equilibrium in which the supply of labour is equal to the demand. Rather, the supply of labour exceeds the demand to such an extent that about 8% of available workers are officially unemployed, another 5% are underemployed, an unknown number of persons who are not eligible for benefits have given up looking for work, and job-seekers outnumber vacancies by more than ten to one. What we want, according to the above definition of full employment, is an equilibrium of the opposite kind, in which the demand for labour exceeds the supply. Why such an equilibrium is not achieved and how it might be achieved are explored in the remainder of this chapter.

2.3 Externalities (invisible handcuffs)

> According to the system of natural liberty, the sovereign has only three duties to attend to . . . : first, the duty of protecting the society from violence and invasion of other independent societies; secondly, . . . the duty of establishing an exact administration of justice; and, thirdly, the duty of erecting and maintaining certain public works and certain public institutions which it can never be for the interest of any individual, or small number of individuals, to erect and maintain; because the profit could never repay the ex-

> pense to any individual or small number of individuals, though it may frequently do much more than repay it to a great society.
>
> — Adam Smith,
> *The Wealth of Nations* IV.ix.51 [23].

In explaining how the price mechanism matches the supply of a good or service to the demand, two assumptions have been made:

- that the suppliers are rewarded in proportion to the full benefits that they confer on society, and
- that the suppliers bear the full cost of supply.

If the first assumption fails, society receives a benefit for which the suppliers are not rewarded. That benefit is called a *positive externality* (or *external economy*), and those who reap the benefit are called *free riders*. If the second assumption fails, society bears a cost for which the suppliers are not penalised. In that case, the cost is called a *negative externality* (or *external diseconomy*), and the suppliers themselves are the free riders.

If the supply of a product causes net positive externalities, the benefit to suppliers is less than commensurate with the benefit to society. In the absence of government intervention, this would cause the supply of the product to fall below the socially optimal level. If the supply of a product causes net negative externalities, the benefit to suppliers is more than commensurate with the benefit to society. In the absence of government intervention, this would cause the supply of the product to rise above the socially optimal level. In either case, the undersupply or oversupply is an example of *market failure*. The existence of market failure is the classical justification for government intervention in the economy.

To the extent that a product gives rise to positive externalities, the product is called a *public good*. Some products, such as lighthouses and navigation beacons, are *intrinsically* public goods because there is no way to stop non-paying customers from using them. Others, such as defence forces and law and order, are public goods because their provision is a basic duty of governments or because only governments can raise sufficient revenue to pay for them. Still others are public goods because governments have seen fit to make them available free of charge. These are known as *merit goods*; examples include toll-free roads, public parks and gardens, free education and free health care. Some merit goods are publicly funded because they are intrinsically *partially* public goods. Education, for example, confers benefits not only on the students (the immediate consumers), but also on their future employers, who benefit from a more capable workforce, and on the country as a whole, which benefits from an educated electorate; hence, if tuition were provided only to paying students, the national investment in education would be unacceptably low. Other merit goods are publicly funded because some of the people who need them cannot afford to pay for them. Education belongs also to this category—some deserving students cannot afford to pay for tuition—but a better example is health care. The sick usually cannot pay for their care, not only because of the high cost, but also because their sickness reduces their earning capacity and hence their ability to pay. Voluntary insurance is an imperfect solution because of the *adverse selection* effect: the people who want insurance are the ones who are most likely to make claims, and their claims push up the premiums. Compulsory insurance imposes unacceptable burdens on low income earners unless the premiums are income-contingent, in which case, for all practical purposes, the “premiums” are taxes. Therefore the adequate provision of health care inevitably requires a measure of public funding.

2.4 Unemployment as market failure

2.4.1 Diagnosis and remedy

When a product gives rise to a positive externality, the link between the product and the externality is not always natural or inevitable; it can be created by government policy. The Newstart allowance, commonly called the dole, is paid in full to a completely unemployed person, but is rapidly reduced in response to earned income, so that a full-time worker, or even a half-time worker on a modest hourly rate, does not qualify for any Newstart. Now consider the wages of labour as a “product” offered by employers, for which employers receive “payment” in the form of labour. When a business creates a job, the new employee fails the income test for the dole, causing a saving in welfare expenditure. This saving is a positive externality. The free rider is the Federal Government. Hence the classical theory predicts that jobs will be in short supply. Unemployment is not a mystery; it is a straightforward case of market failure, albeit one in which the externality has been manufactured by the Federal Government.

The positive externality can be removed by paying to each employer an amount equal to the dole for each employee on its payroll—or, equivalently, by extending the dole to employed and unemployed persons alike, and allowing employers to cut wages and salaries by an amount equal to the dole (Steps 1 and 3). The result is that an employer does not pay the total income of an employee, but only pays the difference between the total income and the dole. Because the dole then becomes a universal benefit, it is renamed the General Rebate (GR).

The benefit of removing the externality is not just an academic abstraction. For employers, the GR functions as a wage subsidy, reducing the wage bill and making it more attractive to hire labour. Because the subsidy makes a higher fraction of income for low-income employees than for high-income employees, the increase in the demand for labour is concentrated at the low end of the income range—the entry level—where unemployment is currently highest, and where an increase in hiring is most beneficial in giving new workers a foothold in the workplace. Employers would be free to reduce present minimum wages by an amount equal to the GR. But, if the GR were sufficiently generous, a lesser reduction would be sufficient to restore full employment, whereupon competition between employers would prevent further reductions; as a result, the minimum take-home pay (*including* the GR) would be higher than it is now.

Extending the dole to the employed may appear to require an increase in taxation. But the appearance is illusory, because the current practice of withdrawing the dole in response to earned income is a *hidden tax* on that income. The fortnightly Newstart allowance, payable in December 1998 to a single person over 21 with no dependants, is $323.40, payable in full if (earned) income is less than $60, decreasing by 50 cents for every dollar of income over $60 up to $140, then decreasing at 70 cents for every dollar of income over $140, until the benefit cuts out at an income of $544.86 (all amounts are fortnightly). From the viewpoints of both the Government and the recipient, this is equivalent to a *non-means-tested* benefit of $323.40, combined with a 50% *tax surcharge* on that part of income between $60 and $140, and a 70% tax surcharge on that part of income between $140 and $544.86, but no surcharge on that part of income above $544.86; the tax surcharge pays for the extension of the dole to workers. At the income tax threshold of $207, the 20% tax rate combines with the 70% surcharge to produce an effective marginal tax rate of 90%.

Thus, in reality, taxpayers are already meeting the cost of extending the dole to workers. And the additional tax falls on an income range below minimum full-time earnings; this is the worst possible range for employment prospects, because it obliges employers to compensate low income earners—including new employees—for the tax. But because the resulting tax burden is disguised as an income test, politicians can pretend that it does not exist, and the mug Australian voter can imagine that he is not paying it. The equivalence between means-testing and taxation is developed in more detail in Section 5.8.

If the income test were officially classified as a tax surcharge (Step 10), voters would object to the high marginal rates for low income earners and demand that the burden be spread more evenly over the full range of income. The dole would take the place of the tax-free threshold, allowing a flat tax on all earned income (and instantly eliminating every tax-minimisation device involving the splitting of income between persons and between years). For low-income employees, the GR would provide a guaranteed minimum income. For high-income employees, the GR would compensate for the loss of the tax-free threshold.

2.4.2 Rationalism of the remedy

> **wĕt** … *n.* … (US Hist.) one favouring sale of alcoholic liquor; (UK Polit.) pragmatist, less opposed to government regulation of the economy than the dries; (sl.) stupid or inept person. …
>
> — *Concise Oxford Dictionary*.

Those who are sympathetic to government intervention in the economy, such as public ownership, protectionism, regulation, subsidies and tax concessions, are called *wets*. Those who generally oppose such intervention, preferring privatisation, free trade, deregulation and the level playing field, are called *dries*. In Australia, the dries are also called *economic rationalists*. The epithets *wet* and *dry* originally referred to factions in the UK Conservative Party during the leadership of Mrs Thatcher, when one did not have to be very wet to be called wet. In Australia, there are wet and dry factions in both the Liberal and Labor parties, while the minor parties (including the Nationals) are distinctly wet. In the Liberal and Labor parties, each faction has more in common with the like faction in the opposing party than with the opposing faction in the same party. Consequently, major policy changes depend more on the internal power struggles of the major parties than on the results of general elections; the Howard government's electoral mandate for tax reform was a spectacular exception.

Where might the GR fit into this confused political landscape? Because the GR is a large-scale intervention in the economy, it might well be described as wet, especially as it functions as a wage subsidy for employers. However, because the GR is not income-tested, it cannot influence the decision to seek employment and does not generate any artificial externality from job creation. In contrast, because the Newstart allowance *is* income-tested, it reduces the incentive to seek employment and generates an artificial positive externality which biases the market against job creation. Moreover, while the GR is described as a wage subsidy throughout this book, the word "subsidy" is used loosely. In reality, the present Newstart allowance forces employers to subsidise the Government, because every extra job produces a saving in Newstart payments; replacing Newstart with the GR removes this subsidy, because the GR is payable to the employed as well as the unemployed. As the GR exerts less influence on the economy, and is less worthy to be called a "subsidy", than Newstart, it ought to be regarded as *drier* than Newstart.

The driest social security system is no social security system. The second-driest is one in which eligibility for a benefit is independent of the economic behaviour of the recipient, so that economic decisions cannot be influenced by an individual's desire to claim the benefit, or by an employer's obligation to compensate an employee for the loss of the benefit. As I am not aware of any Australian social reformers seeking the total abolition of social security, my advocacy of the second-driest option—the GR—identifies me as the driest of the dries.

2.5 Quack remedies for unemployment

2.5.1 Cutting the dole

When you eventually find a job, you lose the dole, incur work-related expenses, surrender a large fraction of your discretionary time, and collect a pay cheque that may not be much larger than a dole cheque. The cost of travel to and from work is not tax-deductible, and the benefit of deductible expenses is small if you are in the lowest tax bracket. On balance, your financial situation may not improve as a result of your success, in which case you have no financial incentive to succeed.

The problem is that the dole is too close to the minimum wage. This has led some conservative commentators to suggest that the dole should be reduced in order to increase the gap between the dole and the minimum wage, giving more incentive to work. When it is pointed out that the same effect could be achieved by increasing the minimum wage, these same commentators immediately answer that an increase in the minimum wage would "price workers out of a job". That answer is an admission that employment levels are limited by the willingness of employers to employ, and not by the willingness of the unemployed to work. Because the proposed reduction of the dole is aimed at the latter, it cannot make a major difference to employment levels. The most that can be said for it is that it would increase the determination of new employees to avoid the sack, which might make them more diligent and more profitable to employ. How much more profitable is a matter of speculation.

Besides, the reason why the gap between the dole and the minimum wage is so small is that the dole has kept up with inflation while the minimum wage has not; it is not that the dole has become more generous, but rather that the minimum wage has become less so.

To the limited extent that unemployment is caused by a lack of incentive to work, the replacement of the means-tested Newstart allowance with the non-means-tested GR is a better solution than cutting welfare, because the GR ensures that the reward for working is in addition to—not instead of—the reward for not working. But more importantly, the GR also ensures that employers are properly rewarded for offering paid employment.

2.5.2 Tariffs, import quotas, export subsidies

> PETITION OF THE MANUFACTURERS OF CANDLES ...
>
> TO MESSIEURS THE MEMBERS OF THE CHAMBER OF DEPUTIES
>
> GENTLEMEN,
>
> We are suffering from the intolerable competition of a foreign rival, placed, it would seem, in a condition so far superior to our own for the production of light, that he absolutely inundates our national market with it at a fabulously reduced price. ... This rival ... is no other than the sun.
>
> What we pray for is that it may please you to pass a law ordering the shutting up of all windows .... If you shut up as much as possible all access to natural light and create a demand for artificial light, which of our French manufacturers will not benefit by it?
>
> ...For as long as you exclude, as you do, iron, corn, foreign fabrics, in proportion as their prices approximate to zero, how inconsistent it would be to admit the light of the sun, the price of which is already zero during the entire day!
>
> — Frédéric Bastiat (1801–1850).[1]

Yes, it's a spoof, although the logic of the final *reductio ad absurdum* cannot be faulted. Henry George, in *Progress and Poverty* (1879), put it more dryly:

[1] Quoted by Heilbroner [13, pp. 178–9]; edited.

> The present method of taxation operates upon exchange like artificial deserts and mountains; it costs more to get goods through a custom house than it does to carry them around the world [11, p. 434].

But while the political battles continued, the intellectual battle was already history.

The most celebrated demolition of the “mercantile system”, as protectionism was then called, is found in Book IV of Adam Smith’s *Wealth of Nations* (1776), which is cited in the following discussion as “*WN*”. The closing sentences of Book I set the tone of what is to come:

> The interest of the dealers . . . in any particular branch of trade or manufactures, is always in some respects different from, and even opposite to, that of the public. To widen the market and to narrow the competition, is always the interest of the dealers. To widen the market may frequently be agreeable enough to the interest of the public; but to narrow the competition must always be against it, and can serve only to enable the dealers, by raising their profits above what they naturally would be, to levy, for their own benefit, an absurd tax upon the rest of their fellow-citizens. The proposal of any new law or regulation of commerce which comes from this order ought always to be listened to with great precaution, and ought never to be adopted till after having been long and carefully examined, not only with the most scrupulous, but with the most suspicious attention. It comes from an order of men whose interest is never exactly the same with that of the public, who have generally an interest to deceive and even to oppress the public, and who accordingly have, upon many occasions, both deceived and oppressed it [22, pp. 358–9].

Needless to say, forcing the public to pay inflated prices for the products of a protected industry (by means of tariffs or quotas on imported competition, or subsidies on exports) reduces the funds available to create employment in every other industry. That observation, by itself, pulls the rug under the notion that tariffs create jobs; tariffs can shift jobs from one industry to another, but they cannot raise the overall level of employment.

Moreover, with just one additional observation, it can be shown that tariffs *reduce* the overall level of employment. Suppose an import-substitution industry cannot survive without tariff protection. If the tariffs are removed, and if the industry sells its goods at prices that can compete with imports, the industry makes a loss. If the tariffs are reimposed, the prices of competing imports rise, and the industry can likewise increase its prices while remaining competitive, so that it makes a profit. The difference between the loss and the profit is not a reward for any additional wealth that the industry has created, but is simply a cost imposed on the public. In other words, while the industry *appears* to make a profit, it has in fact merely dumped its losses onto customers, and is no more beneficial to the nation than any other loss-making industry. The increases in prices received by the protected industry are effectively a tax paid by the rest of the nation, not to the Government, but to the industry; the tariffs paid on the competing imports go to the Government, but the increased prices paid for the local products go to the local industry. The effect of this tax is to encourage investment in the loss-making industry that receives the tax, and discourage investment in other (profitable) industries which pay the tax or whose customers pay the tax—in other words, to divert capital from profitable investments to unprofitable ones. This diversion reduces the national income; that is, it reduces the capacity of the economy to pay wages, and therefore reduces overall employment.

In other words, if tariffs preserve a certain number of jobs in one industry, they necessarily prevent the creation of a *greater* number of jobs in other industries. Conversely, if the abolition of tariffs causes the loss of a certain number of jobs in one industry, it necessarily facilitates the creation of a *greater* number of jobs in other industries. Calculations performed by Prof. Warwick McKibbin for the Dept. of Foreign Affairs and Trade suggest that if Australia were to abolish all tariffs, the net addition to employment would be 40 000 jobs within two years. Job losses would be concentrated in "plant and machine operation", but the greater number of new jobs would be spread across all other major occupational groups. Over five years, pre-tax wages would rise 1.5% higher than they otherwise would.[2] But because a loss of jobs in one industry receives more media coverage than the creation of jobs in several others, public opinion is biased in favour of tariffs; the notion that tariffs protect jobs has become "a political truth, as distinct from a literal truth."[3]

Import quotas inflate the prices of local products, not by increasing the prices of imported competition, but by restricting the supply of imports. Quotas do not generate any revenue for the Government, but otherwise their effect is similar to that of tariffs: the inflation of prices is a tax paid to the protected (unprofitable) industry by other (profitable) industries and their customers. There-

[2] Peter Hartcher, "A free trade in words", *Australian Financial Review*, December 22, 1997, p. 12.

[3] ibid. Indeed, employment levels continue to decline even in protected industries, perhaps because governments provide as little protection as the political climate will allow.

fore quotas divert capital from profitable industries to unprofitable ones, hence reduce the national income, hence reduce the national capacity to pay wages, hence reduce employment.

The stupidity of export subsidies (or “bounties”) is even more easily demonstrated. An export trade that cannot survive without a subsidy is a losing trade, and the subsidy cannot be funded except by imposing additional tax on other (profitable) industries and their customers. This tax is eventually pocketed by the foreigners who buy the subsidised exports—it is overseas aid! Moreover, subsidies designed to encourage exports of a product reduce the supply of that product in the domestic market and raise the price paid by domestic customers. This price increase is a tax paid to the subsidised industry by the rest of the nation. Therefore export subsidies divert capital from profitable trades to unprofitable trades (*WN* IV.v.2–3), reduce the national income, reduce the national capacity to pay wages, and reduce employment.

The effects of these measures on consumers are summarised by Adam Smith as follows:

> In the restraints upon the importation of all foreign commodities which can come into competition with those of our own growth or manufacture, the interest of the home consumer is evidently sacrificed to that of the producer. It is altogether for the benefit of the latter that the former is obliged to pay that enhancement of price which this monopoly almost always occasions.
>
> It is altogether for the benefit of the producer that bounties are granted upon the exportation of some of his productions. The home consumer is obliged to pay, first, the tax which is necessary for paying the bounty, and secondly, the still greater tax which necessarily arises from the enhancement of the price of the commodity in the home market. . . . (*WN* IV.viii.50–51).

Of course the consumers who pay these inflated prices and taxes include low income earners.

“But,” says the mug voter, “what if other countries have tariffs or quotas or subsidies? How can we compete with them if we don’t do the same?”

The mug voter might as well ask, “If my neighbour attaches leeches to himself, how can I compete with him if I don’t do the same?” My argument is that protectionism damages the national economy by diverting investment from profitable industries to unprofitable ones. *This argument assumes nothing about the reasons why particular industries are profitable or unprofitable.* If a certain Australian industry is unprofitable because competing industries in other countries are protected by tariffs or quotas or subsidies, it is still unprofitable, and it is still against the national interest to prop it up at the expense of more profitable industries. *We gain by lowering our trade barriers, whether other countries reciprocate or not.* If the Japanese want to impoverish themselves by imposing import quotas, that is their problem. If we refrain from following their example, we gain an advantage over them; if we follow their example, we throw our advantage away. If the French want to subsidise butter exports so that we can buy French butter cheaper than the French can buy it themselves, courtesy of French taxpayers, whose problem is that? As Smith remarks,

> … In every country it always is and must be the interest of the great body of the people to buy whatever they want of those who sell it cheapest. The proposition is so very manifest that it seems ridiculous to take any pains to prove it; nor could it ever have been called in question had not the interested sophistry of merchants and manufacturers confounded the common sense of mankind. Their interest is, in this respect, directly opposite to that of the great body of the people. As it is the interest of the freemen of a corporation to hinder the rest of the inhabitants from employing any workmen but themselves, so it is the interest of the merchants and manufacturers of every country to secure to themselves the monopoly of the home market. … (*WN* IV.iii.38).

If the mug voter also attaches leeches to himself, the only winners are the leeches.

But, while the lowering of trade barriers is beneficial even without reciprocation by other countries, reciprocation certainly helps. Universal free trade allows a division of labour between nations, the benefits of which are analogous to those of the division of labour between persons: each nation can capitalise on its strengths and cover its weaknesses.

> … It is the maxim of every prudent master of a family never to attempt to make at home what it will cost him more to make than to buy. The tailor does not attempt to make his own shoes, but buys them of the shoemaker. The shoemaker does not attempt to make his own clothes, but employs a tailor. The farmer attempts to make neither the one nor the other, but employs those different artificers. All of them find it for their interest to employ their whole industry in a way in which they have some advantage over their neighbours, and to purchase with a part of its produce … whatever else they have occasion for.
>
> What is prudence in the conduct of every private family can scarce be folly in that of a great kingdom. If a foreign country can

> supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry employed in a way in which we have some advantage.... (*WN* IV.ii.11–12).

In the opening paragraph of Book III, Smith notes the benefit of free trade within a nation, especially between the city and the country:

> Among all the absurd speculations that have been propagated concerning the balance of trade, it has never been pretended that either the country loses by its commerce with the town, or the town by that with the country which maintains it [22, p. 480].

In other words, if it is such a good idea to impose tariffs on imports, why don't city councils protect city farmers by imposing tariffs on all food "imported" from the surrounding country, and why don't the country shires protect country workshops by imposing tariffs on manufactured goods "imported" from the city? And why do the constitutions of federal nations invariably require free trade between the states or provinces? Section 92 of the Australian Constitution demands free trade between the States because the founding fathers knew two things: first, that free trade is beneficial to every State; second, that if free trade were not enshrined in the Constitution, opportunistic State politicians would restrict "imports" into their States in order to capitalise on the popular but erroneous belief that such restrictions are beneficial to the State that imposes them. As there is no supranational constitution to prevent opportunistic national politicians from building trade barriers between nations, the barriers are built, but still no good comes from them; what is good for the states of a federation is also good for the nations of the world. Admittedly, a federal constitution can ensure that the removal of trade barriers between parts of a nation is reciprocal; but, as we have seen, free trade remains beneficial even in the absence of reciprocity.

Am I saying, then, that protected Australian industries, such as the car industry and the textiles, clothing and footwear (TCF) industries, owe their existence to unwarranted taxpayer-funded privileges and should therefore be allowed to go down the plughole?

No! Australian minimum wages, although scandalously low by comparison with Australian average earnings, are high compared with minimum wages in most other countries. Consequently, the Australian industries that employ the highest proportions of low-wage workers are the ones that have the most difficulty competing with their counterparts in other countries, and hence the ones that are always demanding protection. Because the GR makes up a higher fraction of income for low income earners than for high income earners, *the industries that benefit most from tariffs are also the ones that would benefit most from the GR*. Indeed, the GR gives more assistance than tariffs; by reducing wage costs and thereby allowing producers to charge lower prices for their products, the GR assists both exports and import substitution, whereas tariffs only assist import substitution. Moreover the GR, unlike tariffs, does *not* give special privileges to particular industries. The existing social security system tilts the playing field against low-wage industries because it requires employers to compensate low-income earners for the Newstart income test, which is a hidden tax surcharge on low income brackets; but the GR removes the income test and levels the playing field. Thus the GR, although it is a "rationalist" free-trade policy, offers more protection to the car industry and TCF industries than the existing "protectionist" policy.

Furthermore, because tariffs raise the prices of cheap imports which would otherwise be bought by the poor, *tariffs are taxes on the poor*. In contrast, a GR *reduces* the cost of living by reducing the prices of locally produced goods and services. Thus a GR is not only more effective than tariffs in promoting local industry, but also more equitable. That is why Step 4 calls for the abolition of tariffs with the introduction of the GR.

2.5.3 Industry welfare

In 1994–95, Australian State governments spent about \$2.5 billion on direct assistance to industry, and granted another \$3.2 billion worth of payroll tax exemptions. According to the Industry Commission, most of that assistance did nothing to increase the national industrial output, but simply diverted investment from one State to another at taxpayers' expense. In addition, the Federal Government spends about \$10 billion per year on assistance and subsidies to industry.[4]

Even if assistance is given preferentially to industries that would not otherwise survive, it is counterproductive for the same basic reason that tariffs and export subsidies are counterproductive: it is a system of taxes collected from profitable industries and their customers for the benefit of unprofitable industries. Hence it diverts capital from profitable investments to unprofitable ones, reduces national income, reduces the national capacity to pay wages, and therefore reduces employment. In short, industry assistance props up selected industries at the expense of the rest of the country, wherefore it is widely condemned as "industry welfare".

[4]*Australian Financial Review*, February 24, 1998, p. 1.

Existing forms of industry assistance, including tariffs, quotas and export subsidies, are usually not contingent on employment levels. The GR, understood as a wage subsidy, is also a form of industry assistance. However, because the GR paid to an individual as income support does not become a wage subsidy until someone employs that individual, the industry assistance given by the GR *is* contingent on employment outcomes. Moreover, while conventional industry welfare competes with the social security system for limited tax revenue, the GR *unites* industry assistance with social security: industry is assisted *though* the individual (the employee), not at the expense of the individual.

2.6 Underinvestment in education and training

With 8% of the workforce officially unemployed, it is hard to believe that there are common trades in which employers find it difficult to recruit appropriately skilled labour. Yet employers frequently complain of a skill shortage. Some economists dismiss these complaints, arguing that if there really were a skill shortage, employers would be investing in apprenticeships and traineeships to overcome it. That would have been a valid argument 30 years ago, when employers who provided training could require the trainees to work exclusively for them for a certain period after graduation. But these “bonded” traineeships are now regarded as anti-competitive behaviour and are proscribed by the Trade Practices Act and similar legislation. In other words, our governments in their wisdom have decreed that any employer who invests in education or training shall be investing in an exclusively public good—an employee trained at one employer’s expense is free to run off and work for someone else. Not surprisingly, employers are reluctant to train their own employees, hoping that some other employer will do the job for them. In the employment pages of newspapers, it is rare to see an employer who wants to take graduates fresh from universities or colleges, let alone from schools. Instead, the typical advertisement indicates what specific skills are required, how much experience is required in what lines of work—everything but the name of the rival company whose employees the advertiser wants to poach.

Thus the skill shortage is another example of government-induced market failure. The remedy is to ensure that employers who invest in education and training are able to claim a fair reward. A return to the old bond system is clearly unacceptable because it gives too much power to the employer. This is especially the case at a time of high unemployment, when the fear of unemployment could force young people to accept traineeships with bonds attached. Fortunately, however, a bond system is unnecessary. Employers will happily invest in education and training if they are reasonably confident that the cost can be recovered from *someone*—it does not matter from whom. If an employee trained by company A continues to work for the company for several years, the company has presumably recovered the investment from the employee through improved performance. But if an employee trained by company A immediately resigns and starts working for company B, it is only fair that the training cost should be recovered from company B; company A then gets its money back, while company B only incurs the cost that it would have incurred if it had done its own training. In other words, what is needed is not a bond system, but a transfer fee system (Step 18). The system requires a standard method of accounting for training costs, and a standard period over which the cost is deemed to be recovered *pro rata* as long as the newly trained employee continues to work for the same employer. If the employee departs before the end of this period, the balance is recoverable from the new employer, if any. If there is no new employer (e.g. if the employee goes into private practice), no transfer fee is payable; this is the only circumstance in which old employer suffers loss. A complication arises if the claim against the new employer is unenforceable (for example, because the employer is outside the jurisdiction of Australian courts). In that case, if the law were to allow the cost to be recovered from the employee, the employee would not accept the new appointment unless the new employer voluntarily agreed to reimburse the old. In no case would the employee actually be forced to pay the bill.

The operation of the transfer fee scheme need not be acrimonious. If one company recruited too many trainees and a similar company too few, the scheme would allow the former company to recover its excess costs, and the latter to obtain additional trained staff for something like the usual cost. No coordination would be required. The former company would simply announce that would not be heartbroken if a certain number of trainees were to obtain employment elsewhere, and declare the prices on their heads.

It is vital to note that the transfer fee scheme would *not* force employers to meet additional training costs for the same level of training, but would merely redistribute the costs in a more equitable manner. The scheme would reduce the losses of trained staff through poaching, increase the willingness of employers to recruit new graduates from universities and colleges, and consequently reduce seasonal unemployment.

2.7 Underinvestment in R&D

Research and development (R&D) is a rich source of positive externalities. When researchers publish their findings in journals, as they must if they are to receive any recognition, the information can be used by anyone without paying a fee. When a manufacturer brings a new product to market, rival manufacturers get ideas for further products and can learn from the first manufacturer's mistakes. Business practices pioneered by one company can be emulated by others. Know-how developed in one company is transferred to other companies through staff turnover, professional societies and informal contacts. Without government intervention, this leakage of rewards would cause investment in R&D to fall short of socially optimal levels.

Direct government funding of R&D in universities and other institutions lifts the national R&D effort above the free-market level and helps to compensate for market failure. Such funding is also essential to the role of a university as a place where students are taught by leaders in their disciplines—that is, by people who extend the boundaries of those disciplines through research—and where selected students earn higher degrees by research. Governments also have a unique ability to support *curiosity-driven* research. Although such research may be safely assumed to have some economic or social benefits, it is unlikely to attract the attention of private industry, not only because the benefits may be externalities, but also because the benefits tend to be delayed or of uncertain nature. But this long-term emphasis is also the reason why direct government funding is not a complete solution to the R&D shortfall. The economy needs some R&D with immediate commercial applications, but governments do not have sufficient breadth and depth of expertise to judge the commercial potential of every R&D proposal—that judgement can only be made by commercial interests. Hence government-funded R&D tends to emphasise the "R" at the expense of the "D".

R&D can also be encouraged by tax concessions. Under the corporate income tax system, expenses incurred in earning an income are usually tax deductible. Under this rule, 100% of the expenses related to R&D, including salaries, fees, depreciation, rents, interest, etc., would be deductible from taxable income. By varying the rule to allow a deduction for, say, 150% or 200% of R&D expenses, the Government can encourage a higher corporate investment in R&D than the free market would allow. Needless to say, when corporate executives decide to invest in R&D, they choose projects which in their judgement are likely to yield commercial benefits within a reasonable time, which is more than can be said for direct government funding. However, tax concessions for R&D cause two serious problems. First, they challenge companies to find ways of dressing up their existing investments as R&D in order to avoid tax. This requires a strengthening of anti-avoidance measures, including a precise legal definition of R&D and the employment of additional public servants to ensure compliance. When the definition is in place, companies choose their "R&D" activities so as to comply with the letter of the definition, which does not necessarily accord with the spirit of it. As companies keep finding new loopholes, the Government keeps tightening and complicating the definition, causing an escalation of administrative and legal costs, and leaving a trail of abandoned projects which were started in the false belief that they would satisfy the definition. Second, tax concessions for R&D can be reduced as a short-sighted cost-cutting measure during times of fiscal stringency. In 1996, the Howard government cut the R&D concession from 150% to 125%. In other words, the tax deduction for R&D is now only 25% above the deduction for any other business expense. Combined with the corporate tax rate of 36%, the concession is equivalent to a 9% subsidy. This hardly justifies the paperwork involved in applying for the concession, let alone the risk that the application will be rejected after the project has started. As a result, some companies have abandoned their R&D efforts, while others continue their R&D but do not bother to apply for the concession.

Another method of encouraging private investment in R&D is the patent system. A *patent* is a contract between an inventor and the Government whereby the inventor, in return for disclosing the invention, receives a temporary exclusive right to profit from it. The definition of "invention" is wide enough to cover almost anything under the "D" in "R&D". By its nature the patent system focuses on commercial applications. It may therefore be regarded as an alternative to tax concessions for R&D.

The problem with the patent system is the cost. If you apply for a standard patent, the Patent Office charges application fees for the provisional and complete applications, an examination fee and, if you are successful, a sealing fee and annual renewal fees. Assistance from a professional attorney is an essential additional expense. Expect to pay about $2000 before you get your patent. That patent gives you protection in Australia only. If you want protection in several countries, you incur fees in every country—there is no such thing as an international patent, although there is such a thing as an international patent *application* under the Patent Cooperation Treaty (PCT). Your overseas application(s) must be lodged within a certain time after the lodgement of the Australian application, or you lose the opportunity. If you are a private inventor and need corporate backing to manufacture and market your invention, you can be extremely confident that you will *not* get it. And if by some miracle your invention is a runaway success, rival manufacturers will look for ways to circumvent your patent. If they market rival products which appear to breach your patent, the onus is on you to take legal action. If you win, the loser may not be able to pay your legal costs even if it is ordered to do so. If you lose, you pay the costs of both sides and/or declare yourself bankrupt. Moreover, circumvention is not the only hazard: the *validity* of a patent is also open to challenge in the courts. If your patent is overturned, you pay the legal costs of both sides, and you have no comeback against the Patent Office that granted you a dud patent.

It is my considered opinion that spending one's own money on a patent is about as sensible as betting the same amount on number 36 on the roulette wheel. I have never set foot in a casino, but I must confess that in my reckless youth I patented two inventions at my own expense, one in Australia [18] and the other in the USA [19, 20], and that I subsequently allowed both patents to lapse because of a lack of commercial interest. Then I grew up. On two later occasions I submitted a provisional application (to establish priority) and immediately sought commercial backers, which were not forthcoming. So the later two ideas only cost me $80 each. That I was unable to get commercial backing for the later inventions is not surprising—small and medium-sized companies cannot afford to take on someone else's patent risks, while large companies have too many other fish to fry.

Now, with the above litany of costs and pitfalls in mind, re-read Step 19 (p. 5).

Chapter 3

The cost of red tape

3.1 Making work destroys jobs.

> Pass a law to this effect: No one shall henceforth be permitted to employ any beams or rafters but such as are produced and fashioned by blunt hatchets. . . . Whereas at present we give a hundred blows of the axe, then we shall give three hundred. The work which we now do in an hour will then require three hours. What a powerful encouragement will thus be given to labour!
>
> — Frédéric Bastiat.[1]

Yes, Mr Bastiat is joking again. If certain workers were required to work at one third of their normal pace, and if they were paid the normal hourly rate, their employer would have to pay three times as much for the same work. To repair the damage to the bottom line, the employer would be forced to *rationalise* its activities—that is, close down its least profitable operations and sack the workers involved. And which workers would they be? Obviously the ones working at one third of the normal pace. But what if those workers cannot be sacked? What if they are the accountants who make sure that the company complies with taxation laws and company laws, and have been slowed down by new complications in those laws? The question is not hypothetical.

> **Case 1:** From April 1998, every employer in Australia must pay Fringe Benefits Tax (FBT) on refreshments consumed by its em-

[1]Letter to the Minister of Commerce, quoted by Heilbroner [13, p. 179]; edited.

ployees while attending a business function hosted by another employer, and the host can claim deductions for the tax paid by the guests' employees.[2] Consequently, the employees must ask the host about the cost of refreshments, the host must establish all the employer-employee relationships among the guests, the accountants for all the participants must collect the records and calculate the tax liabilities, and the Australian Taxation Office (ATO) must employ staff to ensure compliance. Even before this amendment, the cost to business of complying with FBT legislation was equal to 10.5% of the tax paid,[3] and the complexity of the legislation was such that most public-sector agencies in NSW were unable to comply with it; a report by the NSW Auditor General found that 38 out of 55 agencies had made significant errors with FBT on cars.[4]

Case 2: Under the pay-as-you-earn (PAYE) system, employers deduct income tax from employees' wages and salaries and remit it to the ATO. Under legislation due to take effect from July 1998, employers with a total group tax obligation of more than $1 million per year will have to remit tax *twice weekly*, whereas in the past they have remitted it fortnightly or monthly. Temporary personnel agencies will be especially hard-hit, because the nature of their business gives them a group tax liability out of proportion to their size. All affected employers will be forced to hire or engage additional accountants to manage the transition process and the more frequent remissions. On top of that, the ATO will require tax to be remitted electronically, forcing employers to acquire additional computing facilities at their own expense.[5] The Government could have obtained a similar revenue advantage at a much lower cost to employers by simply increasing the company tax rate.

It is clear that the unnecessary complexities of the tax system make a great deal of work for accountants, and for other staff who must supply the raw data to the accountants. It is equally clear that if the ATO were to send a bunch of thugs with baseball bats to smash every window in your house, it would make a great deal of work for glaziers, or that if local Councils were to make a speciality of digging holes and filling them up again, they would make a great

[2] *Australian Financial Review*, January 27, 1998, p. 21.
[3] *Australian Financial Review*, February 25, 1998, p. 2.
[4] *Australian Financial Review*, December 29, 1997, p. 4.
[5] *Australian Financial Review*, May 16–17, 1998, p. 3.

deal of work for men with shovels. The first example is no less ridiculous than the other two; all three are cases of "making work", where "work" is understood to mean *unproductive* work.

"But," says the mug Australian voter, "by creating employment for accountants, the tax system reduces unemployment." Wrong. The mug voter forgets that employees must be paid, and that the money used to pay them has an *opportunity cost*: if it is paid to one group of employees, it is not available to pay any other group. The accountants who look after the tax affairs of an enterprise are *unproductive*: they do not generate any revenue, but are needed to keep the enterprise out of trouble with the law. The enterprise earns its revenue through the work of other employees, such as those involved in production, sales, or research and development (R&D), but some of the wages that would otherwise have been paid to such employees must be *diverted* to the unproductive accountants. *Moreover, if the enterprise can afford to employ a certain number of employees who earn no revenue, it can afford to employ a larger number of employees who earn some revenue to offset their wages.* Consequently, any law that compels an enterprise to employ labour in an unproductive activity, such as the calculation and remission of tax, reduces the *total* number of employees that the enterprise can employ. In other words, making work destroys jobs.

To see how the foregoing argument translates into individual employment decisions, consider the marginal profitability of an additional employee. If the additional benefit due to the employee's work is greater than the additional cost of hiring the employee, the appointment is profitable; otherwise it is not. If the enterprise is completely free to hire or refrain from hiring as it sees fit, it can hire any marginally profitable employee (even if, in practice, it hires the potential employees in order of decreasing profitability, and each person hired reduces the marginal profitability of the next). But if the complexity of taxation law compels the enterprise to maintain a permanent group of loss-making accountants, it must compensate for the loss by demanding a *larger* margin of profitability when hiring productive staff, with the result that the number of productive staff that can be hired is reduced. Having fewer productive staff means having less revenue, hence less capacity to pay wages, hence fewer staff overall.

A third explanation considers the time dimension. The costs and benefits of hiring a new employee are not simultaneous; the costs begin immediately, while the benefits do not begin to accrue until the new recruit learns the role and becomes productive. Thus, in the normal turnover of staff, an enterprise must support some employees who are temporarily unproductive because they are new, and the cost of supporting them must be offset by the revenue generated by more experienced employees. If the complexity of taxation law requires the enterprise to support a permanent group of unproductive employees, the number of new recruits that it can support is correspondingly reduced, so that the rate of recruiting is reduced.

However the argument is put, the conclusion is the same: making work destroys jobs. If you can't sack the hewer with the blunt hatchet, you have to sack someone else.

Let no one conclude that Putland wants to throw accountants out of work. My central argument—that an enterprise can support a larger number of productive workers than unproductive workers—remains valid when the discussion is confined to workers of any particular profession. Hewers who use blunt hatchets are underproductive because they use blunt hatchets, not because they are hewers. Accountants who work on tax are unproductive because they work on tax, not because they are accountants. If an enterprise can afford to employ a certain number of accountants to calculate its tax liability, it can afford to employ a larger number of accountants in more productive roles, such as evaluating and managing new business ventures. There is more to bookkeeping than taxation, and there is more to modern commerce than bookkeeping. Hence accountants have their productive uses. Navigating the artificial quagmire of taxation law is not one of them.

3.2 Making work ruins lives.

> THE annual labour of every nation is the fund which originally supplies it with all the necessaries and conveniences of life which it annually consumes, and which consist always either in the immediate produce of that labour, or in what is purchased with that produce from other nations.
>
> — Adam Smith,
> *The Wealth of Nations*,
> first sentence [22, p. 104].

The maintenance of a desired standard of living in Australia implies a certain level of consumption of goods and services, which must be either produced in Australia, or purchased from other countries with income derived from goods and services produced in Australia. In either case, we must work to produce enough goods and services to sustain our consumption. If the Government forces us to perform *unproductive* work, that work must be performed in *addition* to the productive work that sustains our standard of living, so that we must collectively work that much harder in order to keep ourselves in the manner to which we are accustomed.

Furthermore, because unproductive work reduces the overall capacity of employers to pay wages and consequently reduces the fraction of the population in paid employment, the increased workload is concentrated on fewer workers. In other words, those remaining workers face a *multiplier effect*: they perform not only the additional work that is made for them, but also some of the work left undone by those who have lost their jobs.

Thus we arrive at the absurdity of unemployment in the midst of excessive toil. On the one hand, we have something like two million people who are officially unemployed or underemployed or who have given up looking for work; on the other, those who have full-time jobs complain that they are overworked.

3.3 Making work invites stagflation.

> **stăgflā́tion** *n.* (Econ.) state of inflation without corresponding increase of demand and employment. [f. STAGNATION+INFLATION]
>
> — *Concise Oxford Dictionary*.

Stagflation, the scourge of the 1970s, is the combination of unemployment and inflation. How making work causes unemployment was explained in Section 3.1. It remains to explain how making work fuels inflation.

The prices of goods and services must be sufficient to pay the wages and rents involved in their production, plus a reasonable profit margin. If the wage bill includes not only the wages of labour involved in production, but also the wages of unproductive work generated by unnecessarily complex government requirements, the additional wage cost (i.e. the compliance cost) is built into the prices of goods and services. This in turn makes it more difficult for wage earners to sustain a given standard of living, causing them to agitate for higher wages, which again feed into prices, and so on. Making work is thus the first step in a vicious circle of inflation.

The circle can be broken by getting rid of the unproductive work, so that the next wage rise does *not* feed into prices. Therefore if inflation seems to be accelerating, especially in the presence of unemployment, the Government should urgently seek ways to reduce compliance costs.

3.3.1 The NAIRU theory and why it's bunk

The Chairman of the US Federal Reserve, Dr Alan Greenspan, has warned that inflationary pressures will emerge if "the reservoir of unemployed people available to work is drawn down".[6] In Australia, a study by Debelle and Vickery of the Reserve Bank has estimated the Non-Accelerating-Inflation Rate of Unemployment (NAIRU) at 7%.[7] In both cases, the fear is that if unemployment drops below the NAIRU, competition between employers will cause upward pressure on wages. And because inflationary expectations are built into wage deals, upward pressure on wages causes not just inflation, but a *continuous increase* in the rate of inflation. If this theory is true, there is no point in devising policies aimed at the restoration of full employment, because the success of such policies will cause runaway inflation.

But if higher wages are indeed the result of free competition between employers, those employers must be convinced that it is profitable to offer higher wages in spite of the effect on production costs. This means either that higher wages are compensated by higher productivity, so that price increases are avoided, or that any price increases are driven by demand rather than by production costs ("demand pull" rather than "cost push"). In the former case, there is no inflationary effect; in the latter, wage increases do not cause the price increases, but merely absorb some of the increase in profit margins which would otherwise occur as a result of price increases. In neither case are wage increases the *cause* of inflation.

The assumption that wage increases are driven purely by competition for labour is crucial to my argument. If a wage increase in one industry can automatically flow on to another industry and affect all employers therein, it will be the *cause* of price increases in the latter industry. But as long as wage agreements are strictly enterprise-based (Step 3), wage increases caused by labour shortages will not cancel themselves out by feeding into inflation, and there is no need to maintain Dr Greenspan's hideous "reservoir of unemployed people".

3.3.2 The American evidence

The unemployment rate in the USA has fallen below previous estimates of the NAIRU without any sign of renewed inflation. For this pleasing but perplexing observation, the following explanations have been offered:[8]

[6] *Australian Financial Review*, June 12, 1998, p. 35.
[7] *Australian Financial Review*, June 12, 1998, p. 4.
[8] *The Australian*, July 25, 1997, p. 40.

- Low overall unemployment has not eliminated uncertainty in employment, because corporate restructuring and downsizing have continued apace. The uncertainty has moderated wage demands.

- Free trade has exposed American producers to imported competition, so that they cannot easily compensate for wage rises by raising prices. This observation further undermines the notion that free trade causes unemployment; in fact free trade reduces the risk that low unemployment will cause inflation, thus removing one barrier to the implementation of full-employment policies.

- The deunionisation of the workforce, it is said, has reduced the bargaining power of workers. But I must point out that deunionisation reduces the likelihood that wage increases in one industry will flow on to another, and therefore increases the likelihood that wage increases are driven by competition between employers, as I assume in Subsection 3.3.1 above. To reduce the bargaining power of workers *at the enterprise level* is unnecessary—not to mention unjust.

- Technological advances have made workers more productive, so that employers can pay higher wages without having to raise prices. I cannot resist pointing out that one can also improve productivity, without any capital investment, by getting rid of red tape!

3.4 Making work erodes culture.

The culture of a nation is the harvest of its leisure. If the producers of culture are amateurs, they produce in their leisure time. If the producers are professionals, they produce for the leisure of their patrons. So both the amateurs and the professionals are entirely dependent on leisure. The professionals are also dependent on the spending capacity of their patrons.

Red tape creates unemployment, and so creates a class of persons who cannot afford to patronise art—except the cheapest sort, which is mostly imported. Red tape also extends the working hours of those who remain in employment, and so creates a class of persons who do not have time to patronise art—except the instant pre-packaged sort, which is mostly imported. Thus the culture of the nation tends to be reduced to the cheap and the quick: the sitcom, the video, the cinema, the CD. There is little scope for local content, unless it is subsidised by governments. As a result, Australian culture—whatever that is or was—is being swamped by the dominant international culture in which it is immersed: American culture.

Similarly, but more rapidly, the cultures of immigrant communities in Australia are being swamped by the culture of the host nation, be it Australian or American.

When Greek immigrants came to Australia between the wars, they encountered strange customs, strange religions, and a strange language replete with dialectal quirks. Understandably, they responded by living close together, doing business with each other, employing each other, and assembling in a common church; in short, they formed a ghetto. Their Australian-born children—the second generation—spoke English at school and Greek at home, and were acutely conscious of their Greekness. They formed social and professional relationships with members of the wider community, but the majority of them married other Greeks. Their children—the third generation—speak broad Australian as their first language, but have learned a bit of Greek as a courtesy to their grandparents. Most of them marry non-Greeks. Some of them have shed all pretence of Greekness and become simply Australians with exotic names; they are said to have “skipped”.[9]

Note that the entire process is heavily influenced by shortages of time. The first generation formed the ghetto partly because they did not have time to master English. Now the third generation are losing their identity partly because they do not have time to master Greek. At each stage, time shortages are exacerbated by red tape.

The Australianisation of the third generation has alarmed the religious authorities. In Australia, what is called the Greek Orthodox Church is an archdiocese of the Ecumenical Patriarchate of Constantinople (Istanbul), and is in communion with the other canonical Orthodox churches (Greek, Russian, Serbian, Antiochian, etc.), who together constitute the world-wide Orthodox Church. The Orthodox Church, like the Roman Catholic Church and in opposition thereto, claims to be the original Church founded by Christ and the Apostles. But Greeks, in Australia as elsewhere, do not necessarily regard their Orthodoxy as an affirmation of eternal truth. They are more likely to regard Orthodoxy is part of being Greek—mere cultural baggage. So when they “skip”, they are liable to apostatise as well. As to what should be done about this, two schools of thought have arisen. The older school seeks to hold back the tide: conduct services in (Byzantine) Greek and make the children learn Greek, so that they do not lose their Greekness. The newer school seeks to *divert* the tide: conduct services and catechetical classes in English, and make a clear distinc-

[9] The word is both a metaphor for desertion and, yes, a pun on Skippy the kangaroo.

tion between being Greek and being Orthodox, so that the young people can lose their Greekness while retaining (regaining?) their Orthodoxy, or perhaps even rediscover their Greekness by *first* rediscovering their Orthodoxy. The mere existence of the latter school, be it right or wrong, shows how strong are the forces tending to destroy cultural identity.

The various Asian communities are newer than the Greek community, but in the fullness of time they will all suffer the same fate. In the Vietnamese suburbs of Brisbane, one is already accustomed to hearing Vietnamese children speaking broad Australian. Their children may speak nothing else.

The new lunatic fringe in Australian politics holds that immigration constitutes a threat to Australian culture. The real threat is in the other direction: immigrant communities find it difficult to maintain their separate identity for more than two generations before they dissolve in the all-pervasive culture of the host nation, as a drop of paint dissolves in a can of turps. Similarly, the real threat to Australian culture comes from its immersion in the all-pervasive international culture dominated by the USA. In both cases, the loss of culture is at least partly attributable to lack of leisure, which in turn is at least partly attributable to red tape. Even the initial formation of ghettos—the temporary "failure to assimilate" which so infuriates the lunatic fringe—is partly a symptom of a lack of discretionary time.

3.5 Further costs of unemployment

To the extent that red tape causes unemployment, it is indirectly responsible for the evil consequence of unemployment. Some of these consequences, as we shall see, generate more red tape, hence more unemployment.

3.5.1 Subversion of traditional morality

> Now concerning the things whereof ye wrote unto me: It is good for a man not to touch a woman. Nevertheless, to avoid fornication, let every man have his own wife, and let every woman have her own husband.
>
> — 1 Corinthians 7:1–2.

More women than men are graduating from Australian universities. Women under the age of 30 now earn higher incomes than their male counterparts. But as soon as women decide to have children, their careers plummet and their financial prospects depend more on their partners' incomes than on their own. So when today's educated, liberated, financially independent single women are asked what they look for in a husband, they rank earning capacity as highly as their great, great grandmothers did. *Women don't want to marry unemployed men.* And the established rules of courtship, which women have not tried to change, ensure that women have the last word. Man proposes, woman disposes.

But hormones have no respect for economic circumstances. As unemployment has deprived men and women of a lawful sexual outlet, namely marriage, they have found unlawful outlets instead. Marriage has given way, not to celibacy, but to cohabitation and promiscuity.

The problem is compounded by the social expectation that weddings are occasions of lavish expenditure. The cost of a normal wedding and reception is quite out of the question for an unemployed person, and is enough to deter a substantial minority of well-paid professionals. Whatever tradition may decree, the groom cannot safely assume that the parents of either partner will be willing, let alone able, to meet the cost, and in any case he may consider it unconscionable to impose such a burden on others. If the cost is accepted by the couple themselves, it is a financial calamity from which they will never recover. Even if a man spends a month's salary—or three months' unemployment benefit—on an engagement ring, the ring is a permanent reminder to his bride of how much easier her life would be if he had spent the money on something else. A diamond is a lost opportunity forever.

Cohabitation avoids all these expenses. Therefore, if the Christian churches were serious about promoting marriage as a superior alternative to cohabitation, they would lay down strict rules to limit expenditure on weddings, and would not allow their clergy to officiate at weddings that did not adhere to the rules. The failure of the churches to take such action indicates either that they are *not* serious about defending marriage, or that they do not understand the problem.

In recent years some of the mainstream Protestant churches have been accused by their more traditionalist brethren of pursuing socio-political objectives at the expense of personal morality. In view of the connection between employment and eligibility for marriage, I submit that at least one of those socio-political objectives, namely full employment, is not a substitute for a return to traditional morality, but a prerequisite thereto.

3.5.2 Crime

> Temptations to sin are sure to come; but woe to him by whom they come!

— Jesus of Nazareth (Luke 17:1b, RSV).

When unemployment deprives young people of the opportunity to earn an honest living, some of them will seek a dishonest living. When unemployment deprives young people of social status and of the right to marry, some of them will seek solace in drugs, then turn to crime to support their habits. But one does not yield to a temptation that never presents itself. An unknown percentage of prisoners under the age of 35 would be law-abiding citizens if they had grown up in times of full employment. An unknown percentage of law-abiding citizens over the age of 50 would be jailbirds if unemployment had been as high in the 1950s and 1960s as it is now.

Rational men and women are usually receptive to the argument that prevention is better than cure. Logically, the argument applies as much to crime as to any other calamity. Politically, however, crime is an exception: if you campaign for the removal of temptations to commit crime, you are liable to be accused of being "soft on crime". The accusers never suggest a plausible motive for being soft on crime, but their own motive is perfectly clear: they want to score political points by being tough in the *punishment* of crime, and consequently have no desire to see a reduction in the *incidence* of crime, at least while the other side is in government.

Needless to say, crime makes work—for security firms, police forces, courts and prisons. Necessary as this work is under the circumstances, none of it creates any wealth; all of it diverts resources from wealth creation and reduces the overall capacity of the economy to create employment.

3.5.3 Xenophobia

> … We now have approximately 2 million unemployed with a shameful youth unemployment figure of around 30 per cent. To add 100 000 extra migrants each year is insanity. These people predominantly take jobs from the existing pool or join the dole queue. …
>
> — One Nation.[10]

In reality, the effect of immigration on unemployment depends on the composition of the immigrant intake. Immigrants in the business and professional

[10] Pauline Hanson's One Nation Policy Document: *Immigration, Population and Social Cohesion*, http://www.gwb.com.au/onenation/policy/immig.html#3 (July 2, 1998).

categories create more jobs than they take, while those in the family and humanitarian categories take more jobs than they create. All of them have been educated to some extent at other countries' expense. Hence, in times of high unemployment, the appropriate adjustment to immigration policy is to *increase* the intake, with emphasis on the business and professional categories. This does not rule out an increase in absolute numbers in the family and humanitarian categories, as long as the increase in the business and professional categories is dominant.

Notice, however, that it takes many more words to tell the truth than to say "Migrants take jobs." So the lie prevails. The only way to stop the lie from spreading is to restore full employment, so that nobody cares whether migrants take jobs or not.

3.5.4 Environmental damage

It is clear that this planet cannot support indefinite population growth. Authorities disagree in their estimates of the maximum sustainable human population, but all agree that there is a maximum.

Whether the planet can support unlimited *economic* growth is less clear. Consider the following projects:

1. The clear-felling of a native forest for wood chips;

2. A nationwide tree-planting program to reduce soil erosion and salination.

From an economic viewpoint, both activities are positive contributions to GDP and may therefore be ingredients of economic growth. From an ecological viewpoint, however, they could hardly be more different. The clear-felling of a native forest is clearly an environmental disaster. But private enterprise is likely to find such a project profitable. And in times of high unemployment, governments come under political pressure to approve such projects *simply because they create jobs*. A tree-planting program is environmentally desirable. But because such a project produces positive externalities and takes many years to pay dividends, it is not likely to be adequately funded by private enterprise. Neither can governments easily afford to fund such projects during times of high unemployment, because the tax base is small at such times.

In general, economic activity can be good or bad for the environment. But unemployment reduces the freedom of governments to choose the good and reject the bad; hence, on balance, unemployment is bad for the environment.

3.5.5 Deterioration in working conditions

In times of full employment, employers must compete with each other for labour. They compete by offering the best possible remuneration and conditions. In times of high unemployment, employees must compete with each other for jobs. They compete by working unpaid overtime, by accepting uncertainty in the form of casual and temporary employment, and by not rocking the boat. There is also a more direct causal relationship between unemployment and long working hours: if fewer people are working to create wealth, those who do work must work longer in order to support the entire working and non-working population.[11]

The Workplace Relations Act has given new freedom to employers and employees in negotiating conditions of employment. When negotiations are free, the outcome favours the party in the stronger bargaining position. In times of high unemployment, when workers must compete with each other for jobs, employers are in the stronger position. Hence the Workplace Relations Act was seen as favouring management at the expense of workers. In times of full employment, when employers must compete with each other to attract and retain staff, workers are in the stronger position. If the Workplace Relations Act had been introduced forty years earlier, at a time of full employment, it would have been seen as favouring workers at the expense of management.

3.5.6 Unjust dismissal

In general, wages and working conditions improve most rapidly during times of full employment. An exception is the introduction of unfair dismissal laws in Australia in the 1980s, and the exception proves the rule.

In times of full employment, an employee who does not get on with the boss will quickly find another boss. When the demand for labour exceeds the supply, employers fear resignations more than employees fear the sack, and unjust dismissal laws are not needed. Only in times of high unemployment does an employee need his job so much that he would continue working for a hostile boss. Only in times of high unemployment would labour unions see any advantage in laws that enable their members to keep working for hostile employers.

Unjust dismissal laws lead to litigation, which makes work and destroys jobs. Furthermore, if a new employee turns out to be unsuitable, is dismissed,

[11] Note the direction of causation; I do *not* suggest that those who work overtime are taking work from the unemployed, because that argument is based on the false assumption that there is only so much work to be done; see Subsection 6.1.2.

sues the employer and loses, the employer will have little chance of recovering legal costs from the former employee. In effect, the employer will lose regardless of the outcome of the case. This risk is enough to deter employers from hiring.

3.5.7 Sexual harassment

In times of full employment, bosses must compete with each other to attract staff, and any male boss who does not treat his female staff with due respect will lose them to his competitors. Only in times of high unemployment does a female employee need her job so much that she might put up with unwelcome sexual advances from a superior. Only in times of high unemployment do other employees need their jobs so much that they might tolerate sexually-motivated favouritism in the quest for promotion. It is no accident that sexual harassment in the workplace first came to public prominence at a time of high unemployment.

Sexual harassment leads to litigation, which makes work and destroys jobs.

3.5.8 Discrimination

When there are more job vacancies than applicants, employers cannot afford the luxury of indulging their prejudices or of maintaining any kind of religious or cultural uniformity within their walls. They must fill each vacancy with the first marginally suitable applicant, whether that applicant is white or coloured, male or female, straight or gay, married or single, pregnant or not, Catholic, Protestant or neither. Necessity knows no prejudice.

But in times of high unemployment, when applicants outnumber vacancies by ten or twenty to one, and when prestigious employers receive hundreds of applications for each vacancy, base prejudice offers a quick and easy method of reducing the pile of applications to a more manageable size. So it is in times of high unemployment that workers have demanded and received anti-discrimination laws. As a result, employers must spend many unproductive hours comparing applicants of nearly equal merit in an effort to avoid being sued. It is easier and safer not to employ anyone at all. Litigation makes work and destroys jobs; fear of litigation discourages job creation.

I am *not* suggesting that anti-discrimination laws be abolished—that would send the wrong messages to employers, employees and international observers. But the pursuit of equal opportunity is not only about sending messages. It is also about getting results. First restore full employment, then allow employers to claim compensation for the actual economic costs of equal opportunity policies (see Step 17 and Section 4.5), and the problem of discrimination will solve itself without any help from the courts.

Chapter 4

The employer's burden

4.1 Two imperatives

Unemployment is the debris of a collision between two absolute imperatives:

1. Workers must be paid enough to support themselves and their dependants;

2. In the long term, the income earned by workers *for their employers* must justify the full cost of employing them.

The first imperative, which may be supported by legislation or by decisions of industrial commissions applicable to particular classes of workers, imposes lower limits on wages. The second imperative, which cannot be overridden by any amount of legislation or litigation, imposes upper limits on the wages of particular persons. The chronically unemployed are those for whom employers conclude that the lower limit is higher than the upper limit.

It is futile to suggest that employers should be more generous. If an employer is a public company, its allegiance is to its shareholders; if this were not so—or at least seen to be so—no public company would ever be successfully floated. If the employer is a government, its allegiance is to its constituency; if this were not so—or rather seen to be so—the constituents would elect an alternative government. (The government's constituency should not be confused with that of any other government; in Australia, a State government that creates unemployment is not entirely answerable to its own constituency, because the resulting increase in social security expenditure and decrease in income tax receipts are borne by the Commonwealth.) If the employer is a private company, its allegiance is to its proprietor(s); if proprietors were expected to run their companies for anyone else's benefit, very few would think it worth their while to start a business. In no case does an employer owe allegiance to its employees, except as a means to an end. In no case, therefore, can an employer hire labour in defiance of the second imperative.

Even if, in some imaginary utopia, corporate employers were satisfied with mere survival rather than maximisation of profits, this would not lead to increased employment in the long term, for three reasons. First, as profit margins are limited, so is the scope for increasing employment by cutting profit margins. Second, as business is inherently uncertain, aiming for a reduced profit margin increases the risk of going bankrupt, leaving the entire workforce unemployed. Third, and most decisively, a reduced profit margin means a reduced rate of corporate growth, hence a reduced capacity to create employment in future.

The second imperative, like the law of gravity, is *descriptive*: violation of it is impossible. The first imperative, like the commandment forbidding adultery, is *prescriptive*: violation of it is not impossible, but only immoral. In the United States, where governments and employers ignore the first imperative, unemployment is low (less than 5% in May 1998), but millions of full-time workers cannot earn enough money to marry and raise a family. In continental Europe, where governments enforce the first imperative but forget the second, life is materially comfortable for those lucky enough to have jobs, but unemployment is high (typically 12% in May 1998).

For a particular person in a particular occupation, the first imperative determines the minimum acceptable wage and the second determines the maximum. If the minimum is lower than the maximum, we have what we may call a *wage window*: a range of wages at which the person may be acceptably employed. If, for some reason, the minimum increases or the maximum decreases, the wage window becomes narrower. If the window closes completely, the person is unemployable (unless the first imperative is broken).

For today's unemployed, the wage window has been forcibly closed by government policy. As explained in Chapter 2, the income test on the dole makes it harder for employers to pay an adequate living wage (the first imperative) because it forces employers to pay the full wage, not just the difference between the full wage and the dole. The solution is the GR (Steps 1 and 3). As explained in Chapter 3, the complexity of the tax system and other regulations makes it harder to employ labour profitably (the second imperative) because it demands the employment of unproductive workers and increases the required productivity of other workers. Part of the solution, as we shall see, is to simplify the tax system.

4.2 Unpaid tax collectors

> Woe unto him that buildeth his house by unrighteousness, and his chambers by wrong; that useth his neighbour's service without wages, and giveth him not for his work . . .
>
> — Jeremiah 22:13.

If you work for a wage or salary, you must either fill in your tax return or pay someone else to fill it in. Either way, you have to collect all the raw data, and you will not be paid for this work—although you are doing it at the behest of the Government.

If you are an employer, you are also responsible for the company tax, payroll tax and fringe benefits tax (FBT) owed by your company, and for withholding and remitting personal income tax (PIT) on behalf of all your employees. Depending on the nature of your business, you may even be obliged to calculate and withhold tax on behalf of some of your customers and service providers, especially if they fail to tell you their tax file numbers. You are not paid for any of this work. If you do it yourself, it reduces your availability for more productive activities, disrupts your private life, or deprives you of sleep. If you pay someone else to do it, you incur a monetary cost. In either case, you divert time and money from productive employment to unproductive employment, thereby reducing your overall capacity to create jobs.

The cost in time and money of calculating and remitting tax—over and above the actual tax paid—is called the *compliance cost*. Compliance costs make work and destroy jobs; they are a tax on employment.

Because the employer's compliance workload includes some components that are independent of the size of the business, the burden on small business is disproportionately heavy, leading some small-business proprietors to suggest that the Government should pay them for their tax-related work. Morally, their claim is unanswerable—workers must be paid, and that's that. Legally, the situation is more interesting. Civil conscription is prohibited by Section 51(23A) of the Constitution (see Appendix D), but in the context of medical and dental services. It does not follow that the prohibition extends to other kinds of work. Moreover, even if the prohibition is held to be general, it could be argued that unpaid tax collectors are not conscripts, because conscripts are paid! In that case, the treatment of small business proprietors is *worse* than civil conscription, but nevertheless legal under s. 51(23A). A more promising Constitutional provision is s. 51(31), which allows the Commonwealth to acquire the property of a person or State *on just terms*. If time constitutes property for the purposes of this Section, the failure to compensate proprietors for the time spent on tax compliance would appear to be unconstitutional.

While monetary compensation for compliance costs would satisfy constitutional requirements, it would not alter the fact that compliance costs are a total waste, and would not eliminate the costs, but would merely shift the costs from tax collectors to taxpayers. Therefore compensation is at most a second line of defence; the first line is to reduce compliance costs as low as possible. If compliance costs are sufficiently low, employers will not think it worth their while to agitate for compensation.

4.3 Unpaid superannuation agents

Question 1: What is the difference between (a) a compulsory superannuation contribution that provides a retirement income for every worker, and (b) a tax that provides a retirement pension for every worker?

Answer: Compulsory superannuation promises greater equity between generations. Under a tax/pension system, each generation pays for the retirement of the previous generation; but under a compulsory superannuation system, each generation provides for its own retirement.

Question 2: But if each generation supports its parents in retirement, and is in turn supported in retirement by its children, isn't that treating all generations alike? And if you change the system so that each generation pays for its own retirement, won't one generation have to pay for *both* its own retirement and its parents' retirement?

Answer: No comment.

Question 3: If each generation must pay for its own retirement, what is the difference between (a) requiring employers to save a certain percentage of their payroll to finance the retirement of current employees, and (b) requiring the Government to save a certain percentage of current tax receipts to pay for the retirement of current employees?

Answer: Option (b) is out of the question because it would require the Government to exercise the same discipline that it is now seeking to impose on employers.

Both options require today's taxpayers to pay twice: once for their parents' retirement and once for their own retirement. But option (b) requires them to pay twice through their taxes, whereas option (a) requires them to pay once through their taxes, and once through higher prices caused by employers passing on their superannuation costs to customers. So, under option (a), voters are less likely to notice that they are paying twice.

Question 4: What is the difference between (a) requiring employers to make a 7% superannuation contribution for their employees, and (b) requiring employers to increase wages and salaries by 7% and then requiring employees to roll over the pay rise into superannuation?

Answer: Under option (b), it is too obvious that the employees—i.e. the vast majority of voters—are paying for their own retirement. Worse still, when they retire and come up against the means test for the age pension, they will discover (if they do not already know) that the Government has forced them to make superannuation contributions for so many years *in order to deprive them of the pension*. And they will exact vengeance at the ballot box. (Actually, there is nothing in the Constitution to stop the Parliament from depriving people over a certain age of their right to vote, although it probably wouldn't try.)

Under option (a), employers must divert effort from their core business to the administration of superannuation. This reduces their revenue and their capacity to employ labour, leading to higher unemployment and reduced job security. But most voters don't know that making work destroys jobs, and wouldn't believe it if you tried to explain it to them, so it doesn't matter. Employees who change jobs will usually change their superannuation funds, so that those who move from one casual job to another will end up holding multiple superannuation funds and incurring multiple management fees to eat up their interest. This is unfortunate, but will change when every enterprise fund is required by legislation to roll over a member's assets into another fund at the member's request.

But the decisive advantage of (a) is that the employer picks the superannuation fund, and the employer's choice is likely to be better informed than the employee's.

> **Question 5:** But if employees were required to choose their own funds, couldn't the Government—or the Australian Securities and Investments Commission—exercise prudential supervision over the funds, maintain a list of approved funds, close down dubious funds and require members thereof to move their assets into better-performing funds?
>
> **Answer:** Yes, but that supervision would be carried out by public servants on the public payroll. By forcing employers to do the quality control, the Government effectively pushes public servants onto the private payroll, making the *official* public sector—and the *official* tax burden—smaller. Forcing the private sector to do the Government's work is one of the two most effective cost-shifting techniques available to the Federal Government. The other, of course, is cutting grants to the States.

Employers routinely make payroll deductions for various purposes, such as union dues and insurance premiums. It is not a major burden, especially if the payroll is computerised: the employee completes and signs the appropriate form (and indemnity), the accounts clerk punches the information into the computer, and the machine does the rest. The employee is expected to check the deductions shown on subsequent pay slips to ensure that all is in order (hence the indemnity). Compulsory superannuation could have been handled the same way,[1] placing the principal responsibility on the employee: if you want a job, pick a fund; if you change your job, take your fund with you.

But if there is a way to turn a simple idea into an administrative nightmare, a politician will find it. First the Keating government decided that superannuation funds would be attached to employers instead of employees, so that each employee would have small deposits languishing in several funds. Then the Howard government was elected with a policy of reducing the scatter of small deposits by forcing employers to offer a choice of five funds, so that a person who changes jobs *might* be able to continue with the same fund. But first the new Treasurer slapped a 15% tax surcharge on superannuation contributions for high-income earners. Because most fringe benefits were not included in the income test, employers were kept busy by high-income employees wanting to repackage their salaries and perks so as to avoid the surcharge. Employers' cash flows were further damaged by the advance payment, equal to 50% of the previous year's surcharge, which must be paid even if the employee has died

[1] Nevertheless, Subsection 6.5.1 proposes that the entire workload of payroll deductions, including PAYE tax, be handed over to the banks.

or the employer is insolvent.[2] The implementation date slipped as the enabling legislation was held up in the Senate. Amid the confusion over the surcharge, the implementation of choice of funds was officially postponed from July 1998 to July 1999, and the enabling legislation was moved to a separate bill so that it could not threaten the passage of other legislation needed by July 1998.[3] At this writing, employers are still objecting to the increased workload of providing a choice of funds—especially the obligation to educate their staff, for which the Government has provided funding equivalent to one postage stamp per employee![4]

To make matters more complicated, the Parliament of Western Australia has passed its own choice-of-funds legislation with effect from July 1, 1998, so that employers in that State will need to comply with two sets of laws.[5]

4.4 Employment as welfare

> Paid work now represents something more than the attainment of earnings: it has a welfare function in its own right, closely linked to the value of participation and self-esteem in society. Policies of welfare reform need to aim, first and foremost, at the creation of full employment.
>
> — Mark Latham [15, p. 203].

Indeed. But the welfare function of work is not confined to "participation and self-esteem"; it also includes an adequate income. And as long as governments regard that income as a *substitute* for transfer payments, rather than a supplement thereto, the burden of providing an adequate income falls entirely on employers. As a result, the welfare function of work is *incompatible* with full employment, because it requires employers to pay workers at a certain minimum rate whether it is economic to do so or not; if not, the workers simply will not be employed at all.

The proposed General Rebate (Step 1) is a *supplementary* transfer payment. By breaking the nexus between wages and take-home pay and taking over the function of minimum wages (Step 3), it allows employers to pay economic wages without leaving employees in poverty.

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[2] *Australian Financial Review*, June 26, 1998, p. 23.
[3] *Weekend Australian,* Personal Finance supplement, May 30–31, 1998, p. 3.
[4] *Australian Financial Review*, May 26, 1998, p. 9.
[5] *Australian Financial Review*, June 9, 1998, p. 6.

4.5 Employers pay for equal opportunity.

Employers would rather hire single women than married women for the same reason that the Roman Catholic Church prefers celibate priests to married priests: a married person has family responsibilities which may compete with responsibilities to the employer, whether that employer is secular or religious. In the secular sphere, discrimination on the ground of marital status is a bigger problem for women than for men, because most men—whether they admit it or not—still regard family duties as women's work. If men ever assume a fair share of responsibility in the home, they will find themselves just as vulnerable to discrimination as women. Notice, however, that the inexcusable behaviour of married men has given employers a perfectly respectable reason to discriminate against married women: it is likely to be less economic to employ a married woman than a single woman or a married man, because a married woman is likely to have conflicting duties. The lack of equal opportunity in the home means that there is a price to be paid for equal opportunity in the workplace, and that price is paid by employers.

But the price is not always the product of discrimination elsewhere. Suppose three women are shortlisted for a permanent full-time job. One of them seems marginally superior according to the selection criteria, but she is single and six months pregnant. If she is appointed, she will disappear after three months. She will be unpaid in her absence, but it will be necessary to hire a temporary replacement and there will be some loss of productivity as the replacement negotiates the learning curve. When the new mother returns to work, she will have to combine full-time work with caring for an infant—all without any visible assistance from a partner. She will be perpetually tired and her performance at work will be impaired, to the detriment of the employer. All things considered, it is more economic to hire one of the other applicants.

If you are the employer, what do you do? You can't reject the best applicant on the ground that she is pregnant, because that's illegal. Neither can you reject her on the ground that her uncertain availability renders her unsuitable for the job, because the criterion of availability, although perfectly reasonable in itself, is an indirect means of discriminating on the ground of pregnancy; it is not discriminatory in *intent*, but it is discriminatory in *effect*. If you are unscrupulous enough—or if your financial position is desperate enough—you may be tempted to engage in some creative interpretation of the selection criteria and manufacture a legal excuse to employ one of the non-pregnant applicants. Whether you can get away with this depends on the onus of proof in the event of a complaint. If the onus is on the complainant, the outcome is uncertain—probably uncertain enough to deter the complaint, given the virtual impossibility of getting legal aid in civil cases. If the onus is on you, then obviously you have no chance of proving that you were not influenced by the pregnancy—and indeed you were—so you must hire the pregnant woman and accept the resulting economic loss. In the former case, the law has failed to protect the woman against discrimination. In the latter, the cost of equal opportunity has been dumped on the employer.

Suppose you advertise for a computer system administrator, and the best applicant is a paraplegic. The system administrator will need to move throughout your building, but the building has no wheelchair access and the cost of providing such access would bankrupt the company. Should the law allow you to reject the applicant on the ground that the cost of wheelchair access is prohibitive? If it does, it fails to protect the paraplegic against discrimination. If it does not, it sends your business to the wall and causes all your staff—including the new system administrator—to lose their jobs.

Paid sick leave is a form of social security that logically ought to be funded by the Commonwealth. But employers are compelled to fund it for at least two weeks annually. Hence they have an incentive to build health requirements into their selection criteria in order to minimise the number of days on which they will have to pay absentee workers. If this is legal, it discriminates against the sick. If it is illegal, the law further burdens employers with a social security function. If the law in a particular case is uncertain, it makes the kind of work that costs more money—and therefore destroys more jobs—than any other: litigation.

(It is well known that most "sick leave" is taken for reasons other than the sickness of the absent employee. But some of this is understandable. How else is a working single parent supposed to attend a sick child, or keep an appointment with the plumber or the electrician? The same applies to working couples. Hence Step 16 calls for greater access to unpaid leave and flexible hours.)

In general, anti-discrimination laws either do not work or force employers to pay for equal opportunity. When they do not work they are not merely useless, but counterproductive. In the days before anti-discrimination laws, an employer could state in a job advertisement that persons of particular classes "need not apply", so that such persons did not waste their time writing applications that had no chance of success. Nowadays, employers cannot advertise their discriminatory selection criteria, with the result that unsuspecting applicants can invest many hours preparing their applications only to be discriminated against in the selection process.

The only solution is to *remove the temptation to discriminate* by allowing employers to claim compensation from the Commonwealth for the cost of equal opportunity (Step 17). When an employee goes on maternity leave, the

Commonwealth should pay a scheduled sum to the employer to cover the cost of training a replacement. When a building is modified for the benefit of a disabled employee, the Commonwealth should pay the bill. When an employee goes on sick leave, the Commonwealth—not the employer—should provide income support (Step 16). The universal Commonwealth Maternity Allowance, which was introduced in 1912 and abolished in 1978,[6] should be reintroduced to replace paid maternity leave. Such measures attack the causes of discrimination. Anti-discrimination laws treat the symptoms—and express commendable sentiments—but do not treat the cause.

"But," says the mug voter, "won't all this mean higher taxes?" Yes, sir. The cost of equal opportunity must be funded either by taxpayers or by employers. If it is funded by employers, it leads to higher prices for goods and services, higher unemployment, and reduced job security for all workers, including you. Choose your poison.

4.6 Employers support the jury system.

Our politicians are staunch defenders of the English criminal justice system and, in particular, the right to trial by jury; indeed, such is their reverence for the jury system that jurors are among the lowest-paid workers in the country. If jurors were required to take leave without pay from their regular employers, any full-time worker called up for jury service would suffer a pay cut, and consequently would object. The most vehement objections would come from the highest-paid workers, who tend to be the ones who would make the best jurors.

To get around this problem, employers are required to compensate workers for "the difference between the amount received from the court for jury duty and an employee's ordinary rate of pay as prescribed by the relevant award." The quote is from the minimum standards for Australian Workplace Agreements under the Liberal Party's industrial relations policy [2, pp. 51–2]. Jury leave is also one of the twenty Allowable Matters under the Workplace Relations Act 1996.[7] The usual method of implementation is that the employer grants paid leave to the juror, and the fee for jury service is paid to the employer instead of the juror. The end result is that the employer pays some (or most) of

[6] A. Graycar, "Social Security", *Australian Encyclopaedia*, 6th Ed. (Australian Geographic P/L, 1996). Graycar notes that Maternity Allowance was worth two weeks' wages when introduced, but less than one day's wages when abolished.

[7] Department of Industrial Relations, *What awards cover and how they will be simplified*, http://www.dwrsb.gov.au/wract/factshet/fact3.pdf (accessed May 30, 1998).

the wages of a person who is working for the court instead of the employer.

I am not impressed by the premise that jurors should receive the same salary for jury service as they receive during their normal employment. It seems to me that jurors ought to receive equal pay for equal work, and that if a government wants eminent persons to serve on juries, it should set the uniform pay rate accordingly. But, whatever jurors are paid, it is sufficiently clear that the responsible government should not only bear the entire cost of their remuneration, but also compensate their employers for the resulting disruption to business. This is the ubiquitous "user pays" principle, which governments are increasingly willing to impose on all users but themselves.

4.7 Employers support emergency services.

After disasters such as the Thredbo landslide and the New South Wales bushfires, the mug Australian voter congratulates himself on the way we Australians pull together in times of need. But he does not put his money where his ego is. The overwhelming majority of personnel who battle against floods, landslides and bushfires, especially in country areas, are volunteers,[8] who train in their spare time and take leave from their regular jobs when disaster strikes. Whether they are paid while on leave depends on their conditions of employment or, in some cases, the arbitrary decisions of their employers. If the volunteers are paid, the cost is borne by employers; if not, the loss—along with the risk of death and injury—is borne by the volunteers themselves. Furthermore, even the *non-wage* costs of emergency services are deemed too great for taxpayers to bear. So the funds provided by all levels of government need to be supplemented by donations and by fundraising activities conducted by the volunteers—as if their training and active service were not enough. Because volunteer fundraising cannot fully compensate for the lack of funding from general taxation, the emergency services are chronically underfunded and under-equipped; thus, for example, we periodically hear of fire-fighters being fried in their trucks because the cabins are not adequately insulated and cooled. If this is the way we treat volunteers, we don't deserve to have any.

If mateship were more than a myth, civil emergency services would be organised along the same lines as the Army Reserve: the personnel would be paid out of general taxation for their training and for their service, and the only demand on employers would be leave without pay. The personnel would have the best equipment that money can buy, courtesy of the taxpayers. Any

[8] For links to WWW information maintained by emergency services, see Victoria State Emergency Service, *Useful WWW links*, http://www.ses.vic.gov.au/links.html (accessed May 31, 1998).

suggestion that taxpayers cannot shoulder this burden is ludicrous because the same burden is currently borne by a *small fraction* of taxpayers, namely the volunteers, their employers, and disaster victims whom the emergency services are not yet able to help. The question is not whether the taxpayers are *able* to pay, but whether they are *willing* to pay; if they are not, the heroic deeds of emergency service personnel are not representative of the national character.

But I digress. In the case of those volunteers who qualify for paid leave, emergency services add to the burden on employers.

4.8 Bottom priority: creating jobs!

It is easy to blame employers for unemployment: if a significant fraction of available workers cannot find work, it seems that employers are not offering enough jobs. But, as this chapter has made clear, we demand considerably more of employers than job creation. Employers must:

- not employ anyone unless it is economic to do so,
- pay all employees at prescribed rates, even if it is uneconomic to do so,
- calculate and remit their own taxes, according to rules that keep changing and increasing in complexity,
- collect and remit taxes on behalf of employees and associates, according to rules that keep changing and increasing in complexity,
- arrange superannuation for employees, according to rules that keep changing and increasing in complexity,
- maintain equal opportunity in employment, even if it is uneconomic to do so, and
- pay employees who are not working (sick leave) or working for someone else (jury service, emergency service).

Note that the above duties are non-negotiable; the first is a matter of survival and the others are required by law. But there is not, and cannot be, any legal obligation for employers to create employment. Thus employers are required by law to give *bottom priority* to job creation: when the juggling becomes difficult, job creation is the first ball to be dropped.

This absurdity has arisen because the majority of voters are not employers, do not like paying taxes, and do not understand that if they don't pay for something through their taxes, they will pay for it some other way. Hence governments find it politically expedient to minimise visible taxes on employees by maximising the load on employers. This situation will continue until a majority of voters wake up to one simple reality: if we weigh down employers with a load of compulsory secondary duties, we should not be surprised if they are no longer able to discharge their primary duty of creating jobs.

Chapter 5

The tax burden

> The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest amount of hissing.
>
> — Jean Baptiste Colbert (1619–1683).[1]

The purpose of this chapter is to define the feathers and the hissing. It might be thought that the amount of feathers (total tax receipts) is a self-explanatory quantity, and that the hissing (negative effects of taxation, or taxpayer resentment?) is largely intangible. But in fact the reverse is the case. While the undesirable effects of taxation are not easy to calculate or measure, they are easy to define. And while it is easy to say how much revenue the Government has collected according to an agreed definition of "revenue", it is not so easy to agree on an appropriate definition; indeed, Budget statements on tax receipts and expenditure are subject to much creative accounting, especially in the area of social security. When we explore these questions, we find that the greater part of the "tax reform debate" is much ado about nothing, and that many substantive issues are not being debated at all.

5.1 Some terminology

According to the technical definitions, the burden of a *direct* tax is borne by the taxpayer, whereas the burden of an *indirect* tax can be *passed on* or *shifted*—i.e. dumped on someone else. A personal income tax (PIT) is called a direct tax

[1] Much quoted, e.g. by Clark [3, p. 206].

because the burden of any increase in PIT is said to fall on the taxpayers themselves. Company tax is called direct because a company attempts to maximise its profit, and the tactics that maximise profit are said to be independent of the fraction of profit that disappears in tax; hence an increase in the tax will not be passed on. A Wholesale Sales Tax (WST) is called indirect because it is paid by the seller but immediately passed on to the buyer as part of the sale price. A Goods and Services Tax (GST) is a problematic case. In theory, GST is a *direct* tax on the final consumer; at each transaction, GST is collected by the seller and paid by the buyer, and every buyer except the last claims a refund. In practice, however, the seller remits GST at the end of each accounting period, and must charge sufficiently high tax-inclusive prices to cover the tax; so a GST is called *indirect*.

In reality, however, the interconnectedness of the economy ensures that no tax is purely direct or purely indirect. If doctors did not have to pay income tax, they could charge lower fees; so at least some of their income tax is passed on to patients. The tactics that maximise company profit are not really independent of company tax, because the tax affects one's competitors as much as oneself; hence company tax is partly borne as an increase in prices to customers and/or a reduction in dividends to shareholders. A retailer, in pursuit of higher unit sales, may elect not to pass the full WST on to customers. The burden of the "indirect" GST falls on the final consumer, who cannot pass it on—except perhaps by demanding higher income to compensate for the tax. Because of such complications, we tend to think of *direct* taxes as taxes on income (possibly with deductions) and *indirect* taxes as taxes on spending; in most cases, this distinction is in rough agreement with the technical definitions.

If a tax takes a constant percentage of your income, whether your income is high or low, the tax is said to be *proportional*. If a tax takes a higher percentage of your income as your income increases, it is *progressive*. If it takes a lower percentage of your income as your income increases, it is *regressive*. A direct tax, by itself, is usually progressive; for example, the income tax is progressive over most of the income scale, although it becomes regressive at extremely high incomes because of elaborate schemes involving negative gearing, dividend imputation, superannuation concessions, family trusts, and expensive advice [3, pp. 104–6]. An indirect tax, by itself, is usually regressive because it is built into the prices of goods and services, on which low-income earners spend a larger fraction of their income than high-income earners. But there are spectacular exceptions on both sides. A sales tax on luxury cars is indirect and progressive. A *poll tax*—a fixed annual amount collected from every citizen, rich or poor—is direct and highly regressive. Hence a *negative* poll tax—which I call a GR—is highly *pro*gressive and can be used to compensate or overcompensate for the regressive effects of other taxes.

5.2 Tax paid

If you pay $10 000 in tax and receive $1000 in family allowance, does this mean that you pay $10 000 and get $1000 back, or does it mean that you only pay $9000 ? And does it mean that the Government receives $10 000 and spends $1000 of it, or that the Government only receives $9000 ? The correct answer to both questions is "It doesn't matter." But politicians have found that they can score political points by pretending that it does matter. As it happens, the usual budgetary convention is to count the whole $10 000 as tax and the $1000 as expenditure. Hence, if the Government can deprive you of the $1000 by imposing a means test on family allowance, and then reduce your tax bill to $9000, it can claim that it has cut taxes, when in fact it has done nothing but complicate the welfare system. This pretence, as we shall see, is the foundation of the entire labyrinthine science of means-testing, and of the Government's preference for providing industry assistance in the form of tax concessions rather than subsidies. In the mean time, simply note that the expression "tax paid" does not mean anything until we agree on a method of classifying return payments *to* taxpayers as either refunds (which reduce "tax receipts") or outgoings (which do not).

When you have agreed on a method of classification and thereby calculated how much tax you are paying, you notice that you also receive certain monetary and non-monetary benefits in return. The monetary benefits may include family allowance and Medicare rebates. The non-monetary ones may include public hospital treatment, education for you or your children, military defence, weather forecasts, tide information, subsidised public transport, access to roads and bridges, etc. If you add up the costs of providing all the benefits that you receive, and compare the total cost with your tax bill, you may find that you receive more or less than you pay for. But, if the Government is perfectly efficient in collecting taxes (!) and perfectly wise in spending them (!), citizens will receive *on average* exactly as much in benefits as they pay in taxes. Thus, whether the total amount of tax collected is great or small, the *net* cost to the average taxpayer will be zero.

Now suppose that the Government increases taxation (however we define "taxation") and increases its expenditure to match. You will find that you pay more tax and receive more benefits in return. If the increase in your tax bill is greater than the increase in benefits, you will say that the burden on you has become heavier; if it is less, you will say that the burden on you has become lighter. But, if the Government is perfectly efficient in collecting the extra taxes and perfectly wise in spending them, citizens will receive *on average* exactly as much in extra benefits as they pay in extra taxes. Thus the average citizen is no better off or worse off as a result of the increase in taxation. Similarly, the average citizen is no better off or worse off as a result of a *reduction* in taxation. These observations raise two questions:

1. If the level of taxation is so unimportant, why do politicians invariably lose elections if they promise to increase taxation?

2. If tax reductions do not make any difference, why not reduce taxes to zero and leave the provision of services to the free market?

The answers are:

1. Some voters, in spite of the apparent universality of public education, still think they can have something for nothing, and any politician who tries to kill the myth will be undercut by an opponent who would rather exploit it.

   Other voters believe, rightly or wrongly, that they are paying taxes for other people's benefit rather than their own, and resent it. The tactic of exploiting such beliefs for political gain is known as "wedge politics" or "downward-envy politics", and is increasingly prevalent.

2. There are some essential services that free markets cannot supply in sufficient quantities, or cannot supply at all. If the provider of a service cannot capture all of the profit from its provision, the service is more profitable to society than to the provider, and will therefore be undersupplied unless it is subsidised or fully funded by governments.

Answer 2 indicates that *governments must raise enough revenue to compensate for the effects of market failure*. This requirement places a *lower limit* on the acceptable level of taxation. But it does not of itself impose an upper limit, and there is nothing in the foregoing discussion to suggest that higher tax receipts are necessarily more burdensome, in terms of their total effect on the people, than lower tax receipts.

In summary, the "total tax paid" is a nebulous concept whose precise definition depends on some arbitrary distinctions between refunds and outgoings. Even when it is given a precise definition, the total tax paid has little to do with the actual burden on the people. When a politician promises that "There will be no increase in taxation as a proportion of GDP," it seems that the appropriate response is "So what?"

5.3 Collection cost and other waste

> The costs, charges, and expenses incident to the collection, management, and receipt of the Consolidated Revenue Fund shall form the first charge thereon . . .
>
> — The Constitution, s. 82 [16, p. 399].

Of course governments are not perfectly efficient in collecting taxes. Taxes are collected by bureaucracies, which cost money, which comes out of tax receipts. The Australian Taxation Office has a staff of about 18 000 persons [8, s. 1(4)], none of whom creates any wealth; the ATO *collects* and *redistributes* wealth, but does not create it. The cost of this army of public servants, including salaries, superannuation, insurance, office space, transport, communications, consultancy and litigation, is a dead loss to the taxpayer. If, by some massive simplification of the tax system, it were possible to make 10 000 of these public servants redundant, the resulting savings could be used to employ *more* than 10 000 persons in activities that *do* create wealth, because the salaries of these persons would be at least partly offset by their wealth creation. Hence the employment of these people at the ATO does not even represent a saving of unemployment benefits.

Neither are governments perfectly wise in their spending of taxpayers' money. Some waste is unavoidable, because the demand for government services cannot be predicted with certainty. Neither can governments be certain, even with the best intentions and the best advice, that their policies will always have the intended effects. Nevertheless, some waste is the result of political obfuscation and opportunism (see Appendices B and C). For this, voters are at least partly to blame; if voters would take the trouble to inform themselves on economic issues, they would not be so easily fooled.

However they occur, inefficiency and waste are *uncompensated* losses to the taxpayer and add to the material burden of taxation. Note that the amount of tax paid can be compensated by government services, while inefficiency and waste cannot. Hence, when assessing the overall tax burden, inefficiency and waste must be considered *more important* than the amount of tax collected.

5.4 The compliance cost

Vandalism is worse than theft. If I steal your watch, your loss is my gain. If I smash your watch, your loss is nobody's gain.

If the Government collects tax from you, your loss is the Government's gain, so that you might be tempted to regard taxation as theft. But it isn't, because at least some of your tax comes back to you in the form of benefits and services, and whatever does not come back to you probably goes to someone less fortunate than yourself. Because you never know when you yourself will join the ranks of the less fortunate, paying taxes for their benefit is a form of insurance.

Recall that your *tax compliance cost* is the cost—in time or money—of calculating and remitting your tax liability, and does not include the actual tax paid. When you incur a compliance cost, your loss is not the Government's gain. Neither is it the gain of the less fortunate. It may appear to be your accountant's gain; but it isn't, because if you can afford to pay your accountant to work out your tax bill, you could afford to pay her more to plan your next business move. So your loss is nobody's gain. Taxation is not theft, but the creation of compliance costs *is* vandalism. Hence my window-smashing analogy in Section 3.1.

The collection costs or operating costs of the ATO amount to just over 1% of Federal revenue, and this percentage has remained almost constant since the 1960s [17, p. 70]. During the same period, the perceived complexity of the tax system has greatly increased. One reason why the added complexity has not added to the official collection cost is that the ATO, under the euphemism of "self-assessment", has offloaded its work onto the private sector, resulting in increased compliance costs for taxpayers and their employers. In February 1998, the ATO released the results of a study carried out on its behalf by the ATAX research group at the University of NSW, concerning compliance costs in the 1994–5 financial year.[2] The taxes included were personal income tax (PAYE), wholesale sales tax (WST), company tax (including income tax and capital gains tax), fringe benefits tax (FBT) and the Prescribed Payments System (PPS). For each tax, the revenue raised in 1994–5 is shown in the second column of Table 5.1 (counting the "Tax" column as the first column). The total nationwide compliance cost is shown in the third column, and the compliance cost as a percentage of revenue in the fourth column. For future years, the tabulated compliance costs should be considered optimistic; as a result of legislation introduced in 1997, real compliance costs are expected to increase significantly in June 1998 and again in June 1999.[3]

Now notice how figures can lie. If you express the compliance cost of PAYE tax as a percentage of the revenue raised (fourth column), it looks like

[2] *The Australian*, March 4, 1998, p. 21.

[3] *Australian Financial Review*, February 25, 1998, p. 3.

Table 5.1: Tax compliance costs incurred by Australian business in 1994–5. "Company" tax includes corporate capital gains tax.

Tax	Revenue ($ million)	Compliance cost ($ million)	Compliance cost (% revenue)
PAYE	51 238	688	1.3 %
WST	11 100	519	4.7 %
Company	31 000	2106	6.8 %
FBT	2 736	286	10.5 %
PPS	2 169	477	22.0 %

a very small cost to business, but only because the amount of revenue raised is very large. If you multiply by the revenue and work out the actual cost to business (third column), you discover that PAYE is the second-worst offender. Moreover, because anyone who employs labour is required to deduct PAYE tax, the PAYE compliance cost is a direct disincentive to job creation. For these reasons, I advocate the elimination of paperwork associated with the tax-free threshold and multiple marginal rates (Step 6).

The opposite effect is seen with the Prescribed Payments System (which, in an attempt to suppress tax avoidance in the cash economy, requires purchasers to withhold tax from certain transactions). The gross inefficiency of the PPS, revealed by the fourth column of Table 5.1, is cause for concern; but the third column shows that the total cost of the PPS is less than that of the PAYE system.

It should be noted that there is considerable variation in estimates of compliance costs. For example, the Australian Chamber of Commerce and Industry (ACCI) estimates that the compliance cost of FBT is 42% of the revenue raised,[4] which is four times the estimate in Table 5.1. The figures in the table should therefore be regarded as order-of-magnitude estimates.

What about the proposed GST? It depends on the details. If

- the GST applies at a single rate,
- exemptions are allowed only for reasons of efficiency (Step 14),
- merchants are allowed to hide the GST in their prices,
- the GST is calculated and remitted fairly infrequently (e.g. quarterly),
- the GST rate does not change *within one accounting period*, and

[4] Australian Financial Review, July 10, 1998, p. 41.

- the GST replaces a sufficient number of other taxes,

then the introduction of a GST will result in a massive *reduction* in overall compliance costs. But if the politicians complicate the GST with vote-grubbing exemptions, keep the rate too low in an attempt to avoid a political backlash, and retain other inefficient taxes to compensate for the narrow base and low rate of the watered-down GST, then they might succeed in increasing overall compliance costs. These issues are discussed in Chapter 7.

In 1994–5, business compliance costs amounted to about 9.4% of all Federal revenue raised from or through business, and total compliance costs amounted to about 7% of total Federal revenue. Thus compliance costs are considerably larger than collection costs and amount to a significant fraction of the total tax bill. Whether a tax is progressive or regressive, the associated compliance cost is *regressive* because it depends not on the amount of tax owing, but on the amount of calculation required, which does not necessarily rise with income. Furthermore, compliance costs are a dead loss to taxpayers, while the actual taxes paid are not. Voters might reasonably re-elect a government that increases their taxes, provided of course that the extra revenue is well spent. *But voters should be absolutely merciless on any government that increases their compliance costs.*

5.5 The distortionary cost

> The taille, as it still subsists in France, . . . is a tax upon the supposed profits of the farmer, which they estimate by the stock that he has upon the farm. It is his interest, therefore, to appear to have as little as possible, and consequently to employ as little as possible in its cultivation, and none in its improvement. Should any stock happen to accumulate in the hands of a French farmer, the taille is almost equal to a prohibition of its ever being employed upon the land.
>
> — Adam Smith,
> *The Wealth of Nations* III.ii.19 [22, pp. 493–4].

Pareto optimality is a situation in which no one can be made better off without making someone else worse off. A departure from this situation is called *distortion*. A taxpayer responds to tax laws—if he can understand them—in such a way as to maximise his own welfare. If, in so doing, he damages the welfare of someone else, he causes a departure from Pareto optimality, so that the tax laws lead to distortion. More generally, we say that the tax system is *distortionary* if it causes taxpayers to act contrary to the public interest. Among the more obvious distortionary features of the present system are the compliance costs, which represent a diversion of resources from productive to unproductive uses, and hence a reduction in national wealth. But there are others.

If personal income tax is calculated on income above a certain threshold, a group of people (e.g. a family) can minimise their combined tax by dividing income among themselves, thereby taking advantage of the maximum number of tax-free thresholds. They can do this by trading through a company or trust rather than as individuals. If capital losses are *quarantined* (i.e. if they can be offset against capital gains but not against other income), tax can be minimised by imputing losses to trust members who have matching gains. If your income is somewhat variable, and if income tax is calculated at progressive rates on a financial-year basis, you can reduce your tax by timing your cash settlements so as to transfer income from a fat year to a lean year—i.e. from a higher tax bracket to a lower tax bracket. If your marginal personal tax rate is higher than the company tax rate, or if you have certain expenses that can be legally written off against company income but not against personal income, you may be able to reduce your tax by trading as a company. If interest on borrowings is deductible or non-deductible according to the purpose of the borrowings, investors can reduce their tax by making judicious choices between debt financing (purchases from borrowings) and equity financing (cashed-up purchases). If superannuation receives preferential tax treatment as part of a government policy to encourage saving, canny investors can reduce their tax by dressing up their investments as superannuation. If most assets purchased with after-tax income are subject to capital gains tax (CGT) but your principal place of residence is exempt, you have an incentive to build an unnecessarily large house rather than invest in shares, causing a diversion of resources from export-earning industries to real estate. If two countries have different company tax rates, a company trading in both countries can reduce its tax by adjusting its transfer prices (prices at which goods and services are traded between the national subsidiaries) so as to shift profits from the high-tax country to the low-tax country . . .

All such behaviour is contrary to the public interest. At best, it increases the load on other taxpayers. At worst, it diverts massive resources, including some of the nation's finest mathematical minds, from income-producing activities to tax-reducing activities, thereby diminishing the national income and hence the national capacity to employ labour; in other words, it makes work and destroys jobs.

Companies are notorious tax-minimisers. Some of them are established by individuals for the sole purpose of avoiding tax, and the others have ample opportunity for tax avoidance because of the complexity of their affairs and because of their capacity to engage professional tax advisers. This is why, in the previous section, I did not make an issue of company tax: much of the so-called compliance cost of company tax, which is by far the largest cost in the fourth column of Table 5.1, might be better described as an avoidance cost.

It is pointless to suggest that companies should be more civic, because they are not established for that purpose; in particular, any listed company that did *not* minimise its tax by every legal means would be acting against the interests of its shareholders, to whom it owes its first allegiance. Similarly, it is pointless to suggest that individuals should not arrange their affairs so as to avoid tax, because if the unproductive tax-minimising activities of companies and other individuals are reducing your income and increasing your tax rates, you can ill afford to eschew such activities yourself, even if you find them distasteful. Besides, if the Government makes if financially attractive for you to arrange your affairs in a certain way, you are entitled to conclude that the Government *wants* you to arrange your affairs that way.

The only solution is to redesign the tax system so that individuals and companies pay the same tax *regardless of how they arrange their affairs*. If "income tax" is levied at a flat rate with no threshold (Step 6), tax liability is always a fixed fraction of income, so that splitting income between family members or between financial years has no effect on the total tax payable. If company tax rate is brought into line with personal tax (Step 7), incorporation ceases to be an artificial tax advantage. If all interest is combined with principal and treated as saving or dissaving (Steps 6 and 7), there is nothing to be gained by juggling one's finances between debt and equity. If all savings and investments are given the same tax treatment as superannuation (Step 6), saving and investment are uniformly encouraged and are not diverted in pursuit of artificial tax advantages. If all capital gains are treated alike (Steps 6 and 7), capital is not artificially diverted from productive investments to unproductive investments. If Australian company tax applies to consumption instead of profit (Step 7), companies can reduce their Australian tax liability as much by investing in Australia as by transfer pricing. And if multinational employers of Australian labour are offered a wage subsidy in the form of the GR (Step 1), they will continue to employ Australians in spite of the difficulty of avoiding company tax.

5.6 The *real* cost

> In the silver mines of Peru, we are told by Frezier and Ulloa, the proprietor frequently exacts no other acknowledgement from the undertaker of the mine, but that he will grind the ore at his mill, paying him the ordinary multure or price of grinding. Till 1736, indeed, the tax of the King of Spain amounted to one-fifth of the standard silver, which till then might be considered as the real rent of the greater part of the silver mines of Peru, the richest which have been known in the world. If there had been no tax this fifth would naturally have belonged to the landlord, and many mines might have been wrought which could not then be wrought, because they could not afford this tax.
>
> — Adam Smith, *WN* I.xi.76 [22, p. 274].

The *deadweight cost* of taxation, also known as the *excess burden* or *efficiency cost* or *welfare cost*, is the reduction in national income (or national economic output) caused by the tax system. Deadweight embraces all the real costs described in earlier sections of this chapter. All distortion is deadweight. All compliance costs, collection costs and other forms of waste represent a diversion of funds from productive to unproductive uses, and therefore contribute to deadweight. If a tax does not cause deadweight, it does not change the national income, in which case all the wealth collected by the tax must eventually be recycled so that there is no net loss; but if the tax causes deadweight, it depletes the national income. In this sense, the deadweight cost is the *real* cost of taxation, the cost most appropriately described as "the tax burden", the objective measure of the hissing of Mr Colbert's goose. As the nation's income is produced by its workers and determines the capacity of the economy to pay its workers, the deadweight cost is also a measure of the *employment cost* of taxation, and hence the *social cost* and *human cost* of taxation. Deadweight is not merely a part of the tax burden or a consequence of the tax burden; it *is* the tax burden.

Furthermore, deadweight costs are regressive. If an additional cost is imposed on the community, everyone tries to shift the cost onto someone else, so that those who finally carry the cost tend to be those with the least economic and political power. In particular, if the Government complicates the tax system, the additional complexity has a compliance cost and hence a deadweight cost, which falls preferentially on those with the least power. If the declared purpose of the added complexity is to improve equity, there is a grave danger that the more equitable distribution of the tax bill will be cancelled out—or worse—by the inequitable distribution of the resulting deadweight cost. Conversely, if the tax system is simplified, the reduction of deadweight may lead to a more equitable system, even if the initial redistribution of the tax bill seems inequitable. Equity is a tricky business.

> **Myth:** Tax reform is about winners and losers. Whatever is gained by the winners is lost by the losers.
>
> **Fact:** The myth tacitly assumes that the entire cost of taxation is the actual tax collected, and concludes that if some people pay less, others have to pay more. This argument completely ignores deadweight. If tax reform reduces the deadweight cost, the total income of the community increases. There need not be any losers; and even if there are losers, the gains of the winners must outweigh the losses of the losers, so that the winners can afford to compensate the losers and still have some of their gains left over. If this is done, the end result is that there are winners and no losers.

As noted above, one manifestation of deadweight is unemployment. Every tax is a tax on employment inasmuch as it reduces the profitability of the activity subject to the tax; every tax occasionally makes the difference between viability and non-viability, so that an otherwise viable employment-creating venture does not proceed. Personal income tax (PIT) creates a gap between the wages paid by the employer and the wages taken home by the employee, so that the employer must pay more in order to provide an adequate income to the employee. Company taxes reduce dividends and/or retained profits. If they reduce dividends, they make it harder to raise job-creating capital; if they reduce retained profits, they reduce job-creating investment. Indirect consumption taxes, such as sales taxes and the proposed GST, increase prices and reduce sales; and the price increases are pocketed by the Government and not by the seller, so that the seller's profits—and capacity to employ labour—are reduced. State payroll taxes are passed on to customers in the form of higher prices, and consequently have a similar effect to sales taxes or a GST.

Because every tax tends to deter the activity subject to the tax, and because the deterrent effect obviously depends on the size of the tax, we may be tempted to conclude that that there is a necessary proportionality between the deadweight cost of taxation and the total amount of tax collected. This conclusion is demolished by the following observations:

- While taxation *by itself* deters economic activity, the purpose to which the revenue is put may—and indeed should—compensate for the deadweight by encouraging productive activity. A well-educated workforce reduces the training costs of business. Modern transport networks facilitate all forms of industry and commerce. An impartial and affordable system of justice would (note the subjunctive) reduce commercial risks by enforcing contracts and deterring fraud and deceit. A seamless social security system would widen the market for goods and services, and hence the profitability of business, by ensuring that every consumer has a basic level of spending power (see Section 5.7). All these facilities depend to some extent on taxation. Therefore, in assessing the deadweight of the tax system, *one must consider taxation and expenditure as a package and not focus on taxation alone*. Mathematical models purporting to show that the deadweight cost of a tax is proportional to the square of the tax rate[5] are invalid because they fail to account for the effects of expenditure; they assume that the supply and demand curves (graphs of supply and demand vs. price) do not move when the tax is imposed, but in fact the curves may move in response to government initiatives funded by the tax.

- Among successful national economies, there is a huge variation in total taxation as a percentage of gross domestic product (GDP). In 1994, Australia collected about 33% of GDP in tax, compared with 52% for the Netherlands, 58% for Sweden, and 60% for Denmark [14, p. 106]. In 1997 and 1998, all three of those countries had lower unemployment than Australia.[6]

- As explained in Section 5.2, the "total amount of tax collected" is a quantity whose definition is somewhat arbitrary and subject to political manipulation.

Hence, while deadweight is a strong function of distortion, compliance costs, collection costs and waste, it is by no means clear that deadweight is necessarily a function of the overall tax take.

5.7 Transfers don't count.

Government expenditure on goods and services, such as public works, health and education, is called *exhaustive expenditure*, and is a component of GDP.

[5] These models, known as *partial equilibrium models*, are briefly described by Prof. John Freebairn in Chapter 3 of reference [1]. Freebairn notes that such models fail to account for a range of flow-on effects.

[6] *Australian Financial Review*, July 6, 1998, p. 41.

Government expenditure on welfare payments such as pensions, unemployment benefits and family allowance, together with subsidies and interest on government bonds, is called *transfer expenditure*; it is not a component of GDP, but affects the distribution of GDP.[7]

Transfers, together with the taxes that pay for them, *do not constitute a flow of revenue from the private sector to the public sector*, but merely “transfer” spending power from one part of the private sector to another. As far as the private sector *as a whole* is concerned, transfers might as well be tax refunds. This observation by itself is a strong argument for taking the entire social security system “off budget”—that is, for treating welfare payments as tax refunds so that they are not counted as taxation or expenditure. But the argument is stronger in the case of the proposed GR (Step 1), which not only replaces some existing welfare payments (the dole, dependent spouse payments, most of the old-age pension, the living expenses component of study allowances, and most forms of “industry welfare”), but also some existing off-budget items (the tax-free threshold and part of the minimum wage). The GR is universal, whereas the proposed supplements thereto (Step 2) are paid only to persons in particular circumstances, and recipients of the GR are more likely to pay direct taxes than recipients of the supplementary benefits. For these reasons, the GR looks more like a tax refund, and less like a welfare payment, than the supplements. Besides, if the supplements are also classified as tax refunds, the welfare budget is reduced to zero, which does not look good—although in reality it does not change anything. Accordingly, I have suggested that the GR be off-budget (Step 1) and that the supplements be on-budget as welfare payments funded by taxation (Step 2).

I make no apology for the blatant political calculations in the preceding paragraph. The on-budget/off-budget fiddle simply reinforces the point with which I began this chapter: budget papers are full of creative accounting. If governments must publish fiction, it might as well be wholesome fiction. The classification of the entire existing welfare system as on-budget expenditure is a singularly *unwholesome* fiction because it provokes unwarranted resentment: it suggests that the welfare budget is a net burden on the people, when in fact it is paid straight back to them—in cash.

I anticipate the following objections to my argument:

1. While the welfare budget is returned to the people *as a whole*, individual taxpayers do not necessarily reap what they sow.

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[7] P. Groenewegen, “Taxation and Public Finance”, *Australian Encyclopaedia,* 6th Ed. (Australian Geographic P/L, 1996).

2. If the welfare safety net is too safe and too comfortable, people will not have sufficient incentive to work, and the national income will consequently decline.

3. Even if welfare payments are classified as tax refunds, they do not reduce *marginal* tax rates, and indeed must be funded by *increasing* marginal tax rates. This reduces the reward for work and hence the incentive to work, causing a deadweight cost.

I respond seriatim:

1. The more fortunate (financially speaking) reap less than they sow, while the less fortunate reap more than they sow. Objections to this philosophy come from certain taxpayers in the former group, whose lack of compassion is matched only by their irrational confidence in their continuing good fortune. Tomorrow they may be sick, injured, widowed, deserted or unemployed, and consequently in need of the benefits for which they are unwilling to pay today. Their attitude has a simple antidote: consolidate most benefits into a single *universal* payment—the GR—so that anyone who asks for a cut in welfare expenditure will be asking for a cut in a component of his own income. It is said that the only popular tax is a tax on someone else. The same logic suggests that the only popular benefit is a benefit to oneself. That can be arranged.

2. While a safety net reduces the incentive to work, it also reduces the disincentive. Any job-creating, wealth-creating economic venture involves some risk of failure. A universal safety net moderates the consequences of failure, so that more people are willing to take risks in the pursuit of success. I concede, however, that the safety net must not be too comfortable. I envisage that the GR would be worth somewhat less than the current minimum unemployment benefit, so that no one would want to live on the GR alone.

3. Australia has certainly managed to construct a welfare system with absurdly high *effective* marginal tax rates (EMTRs) and a crippling deadweight cost. These problems are not inherent features of a welfare state. They arose because the Australian welfare system was never systematically designed, but evolved piece-by-improvised-piece in response to depression, war, prosperity, stagflation, social disintegration and, above all, politics. A welfare system along the lines suggested in Steps 1 and 2 would *offset* the deadweight caused by the taxes that support it. This would occur in two ways:

(a) The GR would function as a wage subsidy (Step 3), allowing firms to hire more workers and create more wealth. In so doing, it would counteract the deadweight of income tax (or the FDET). Income tax, by itself, causes the wages paid by the employer to exceed the wages received by the employee. The difference between the cost to the employer and the benefit to the employee is called the *tax wedge*. If the tax wedge is wider than the wage window (see Section 4.1), it obstructs the hiring of labour under morally acceptable conditions. The GR would counteract the tax wedge, and might even overcompensate for it at the low end of the income range, where unemployment is now most severe.

(b) There is a large class of goods and services of which a person's consumption can be reduced to zero by financial hardship, but cannot be indefinitely increased by financial prosperity. An individual may reasonably want one car, one computer, one desk, one filing cabinet, one stereo system, etc., but is less likely to want more than one or hanker after an unnecessarily expensive model. A family may be able to justify the purchase of one lounge suite, one piano, one refrigerator, one washing machine, one dishwasher, one TV and VCR, but would find it harder to justify the purchase of larger quantities or more up-market units. If you have a higher income, you can afford to replace items more frequently; but if the frequency of replacement is not limited by the expense, it will be limited by the inconvenience. A person may spend a certain amount on recreation and entertainment, and such spending may rise with income; but it cannot rise indefinitely with income because it is limited by time constraints. In economic jargon, we say that the demand for these goods and services is *downwardly elastic but upwardly inelastic* with respect to income. Consumption of such goods and services is maximised by *maximising the number of people whose spending power is above the necessary threshold*—not by maximising overall spending power without regard to its distribution. A guaranteed minimum income, which the GR would provide, means a guaranteed level of spending power for all consumers. This wide distribution of spending power would generate demand for downwardly elastic, upwardly inelastic goods and services, and thereby stimulate economic activity.

The absence of means-testing (Step 2) also reduces deadweight. The main cause of high *effective* marginal tax rates is not the sheer size of the welfare bill, but the income tests that are supposed to reduce the bill. This paradox will be explained in Section 5.8.

I conclude that transfer expenditure, when done properly, does not add to deadweight.

5.8 Means tests: taxation by stealth

> In this they relied on the sound principle that *the magnitude of a lie is a definite factor in its credibility*. For the broad masses of the people in the depths of their hearts are more likely to be corrupted than to be knowingly and intentionally evil, and hence, in the primitive simplicity of their minds, are more likely to fall victim to a big lie than to a small one; for they themselves often lie in small things, but would be ashamed of lies that were too big.
>
> — Hitler.[8]

And in a democracy, much more than in a dictatorship, the art of politics consists in telling the people what they are likely to believe. Hence it is with much trepidation, and with little prospect of success, that I now attempt to shoot down the three biggest lies in Australian politics.

> **Lie 1:** Means-testing of social security payments reduces the tax burden.

This lie is the biggest and most credible of the three. To see through it, you have to understand that *means-testing is taxation by another name*. Means tests are of two kinds: income tests and assets tests. When a benefit is subject to an *income test*, you receive the full benefit if your assessable income (which may be family income rather than individual income) is below a certain threshold; otherwise the benefit is reduced by some number of cents for every dollar by which your income exceeds the threshold, until the benefit is reduced to zero. Under an *assets test*, you receive the full benefit if your assessable assets (which may or may not include your home) are below a certain threshold; otherwise the benefit is reduced by so many dollars per fortnight for every thousand dollars

[8] *Mein Kampf*, ch. 10, par. 31, my emphasis, my English. The accusation is directed against "the Jews and their Marxist (!) fighting organisation". To that extent, it is of course a prime example of very technique that it complains about, and hence of a second technique: the pre-emptive projection of one's own faults onto one's real or imagined opponents.

by which your assets exceed the threshold, until the benefit is reduced to zero. I shall now show that

- an income test is a hidden income tax,
- an assets test is a hidden wealth tax, and
- in each case, hiding the tax makes it more onerous than it would otherwise be.

Consider a hypothetical benefit of \$240 pf (per fortnight), which is subject to an income test as follows: the benefit is paid in full if your (earned) income is below \$480 pf, and is reduced by 50 cents for every dollar by which your income exceeds \$480 pf, until it cuts out at an income of \$960 pf. If the income test is removed, and if your marginal tax rate is *increased* by 50 cents in the dollar for income between \$480 pf and \$960 pf, the net cash flow between you and the Government is unchanged. So, instead of saying that the benefit is income-tested, the Government could say that recipients of this benefit pay a 50% tax surcharge on earned income in the taper range (\$480 pf to \$960 pf). Under the latter convention, which I shall call the *surcharge convention*, the full value of the benefit would be counted in official welfare expenditure, and the revenue from the surcharge would be counted in official tax receipts. Thus taxation would *appear* to increase—which is why the convention is not used. But in reality the adoption of a new accounting convention does not change anything: in effect, income testing is indistinguishable from income taxation.

The surcharge convention *should* be used because it exposes the absurdity of the income test. In the example given, as the surcharge does not apply to income above \$960 pf, persons whose income is between \$480 pf and \$960 pf pay a higher marginal tax rate than those on higher incomes. This is an inversion of the usual progression of marginal tax rates. If the benefit in question is universal, the marginal rate inversion applies to all taxpayers. If the benefit is given for a physical disability, disabled taxpayers whose earned income is in the taper range pay a higher marginal tax rate than able-bodied taxpayers with the same earned income (it is not appropriate to include the benefit in the income comparison; the benefit is not a net gain, but merely compensates for a loss). Thus the surcharge is inequitable. Moreover, the surcharge also falls on a ridiculously narrow base. If the benefit is universal, the same revenue could be collected by imposing a lower surcharge on a wider taper range; indeed, the surcharge would be minimised by applying it to *all* income, which is equivalent to abolishing the "surcharge" and raising the revenue through general income taxation. If the benefit is restricted to a particular category of persons, the base of the surcharge could be broadened even further—and the rate lowered even further—by applying the surcharge to persons who to not receive the benefit; again, this is equivalent to raising the revenue from general income tax. As Treasurer Costello is fond of saying, “the broader the base, the lower the rate.”

If we abandon the surcharge convention and revert to the income-test convention, the argument in the preceding paragraph remains valid. Only the terminology changes. Instead of a surcharge adding to the nominal marginal tax rate, we speak of an income test taper adding to the *effective marginal tax rate* (EMTR). Instead of minimising the official marginal tax rate by abolishing the surcharge and raising the necessary revenue from general income taxation, *we can minimise the EMTR by abolishing the income test and raising the necessary revenue from general income taxation*. Therefore, if we acknowledge marginal rates as a measure of the tax burden, we must conclude that *the tax burden is minimised by abolishing the income test.*

As a second example, consider an income-tested benefit of \$323.40 pf, payable in full for (earned) income up to \$60 pf, decreasing at 50 cents in the dollar for income over \$60 pf up to \$140 pf, then decreasing at 70 cents in the dollar for income over \$140 pf until the benefit cuts out at an income of \$544.86 pf. Under the surcharge convention, we would call this a non-income-tested benefit of \$323.40 pf, combined with a 50% tax surcharge for income over \$60 pf up to \$140 pf, and a 70% tax surcharge for income over \$140 pf up to \$544.86 pf, but no surcharge on income above that limit. This example, although more ridiculous than the first one, is not hypothetical. It is the Newstart Allowance—commonly called the dole—payable in December 1998 to a single person over 21 with no dependants.[9] Newstart is effectively a universal benefit, because almost anyone is potentially unemployed; the only exceptions are those who are unable to work because of age, illness or disability, and they qualify for other benefits with other income tests (or surcharges). Thus *we are already paying for a universal, non-income-tested benefit*. But because the resulting tax burden is disguised as a set of income tests, we can delude ourselves that it does not exist. In the genteel language of public finance, the tax/transfer system is said to “lack transparency”. In the vernacular, it’s a con job.

If anyone asks whether this country can afford a universal non-income-tested income support scheme, I answer that it is a stupid question. We are already paying for such a scheme; and because we are paying for it with what amounts to a narrow-based tax surcharge, we are making unnecessarily heavy work of it. Hence if anyone asks what kind of tax system could support a

[9] Information on actual benefits comes from the Centrelink WWW site at http://www.centrelink.gov.au (accessed October 30, 1998).

universal non-income-tested income support scheme, I answer: a system in which the maximum EMTR is necessarily *lower* than at present. The required EMTR obviously depends on the desired level of income support; but for a given minimum income, a non-income-tested benefit spreads the equivalent tax burden over a broader base, resulting in a lower EMTR, than an income-tested benefit.

As third example, consider an *assets-tested* benefit of \$357.30 pf, payable in full if your assets amount to less than \$215 750, and decreasing by \$3 pf for every \$1000 by which your assets exceed \$215 750, until the benefit cuts out at an asset value of \$334 850. If the assets test is removed, and if your assets are subject to a wealth tax of \$3 pf per \$1000 over \$215 750 up to a limit of \$334 850, the net cash flow between you and the Government is unchanged. So, instead of saying that the benefit is assets-tested, the Government could say that recipients of this benefit pay a wealth tax of \$3 pf per \$1000 on assets in the taper range (\$215 750 to \$334 850). Under the latter convention, which I shall call the *wealth-tax convention*, the full value of the benefit would be counted in official welfare expenditure, and the revenue from the wealth tax would be counted in official tax receipts. As the change of terminology does not change the net cash flows, an assets test is indistinguishable from a wealth tax with an upper limit on taxable wealth. But again the change of terminology exposes the absurdity of the system: if the assets test were officially called a wealth tax, voters would demand that the upper limit be removed in exchange for a reduction in the rate.

Again, the example just given is not hypothetical. It is the age pension payable in December 1998 to a single non-home-owning retiree over the age of 65 (different thresholds apply to couples and homeowners). If you are a retiree over 65, you pay this wealth tax—unless of course you turn your wealth into an annuity, in which case you are hit by an income test instead of an assets test. The same wealth tax applies to numerous other benefits besides the age pension. Within the taper range, the rate of \$3 pf per \$1000 is equivalent to paying an annual interest rate of 7.8% on your own money (not much of an incentive to save), or paying an annual rent of 7.8% of the capital value of your own home. This rate could be lowered, at no cost to revenue, by removing the upper limit on taxable wealth, and could be lowered much further by removing the lower threshold. More importantly, the revenue raised by the wealth tax could be raised more simply—and without harassing people in their old age—by imposing a tax on inheritances. If wealth taxes and inheritance taxes are regarded as political non-starters, the same judgement should apply *a fortiori* to assets tests.

If the hidden taxes masquerading as income tests and assets tests were brought into the open, the political process would ensure that the taxes were made fairer by broadening the bases and lowering the rates. Hence, as Step 10, I have proposed the following constitutional amendment:

> If a pension or like benefit funded by the Commonwealth is subjected to a means test, the amount withheld in consequence of the means test shall be counted as taxation, and the full value of the benefit shall be counted as expenditure, even in cases where the means test causes the full value to be withheld.

I have suggested that the GR should be off-budget and that the supplementary benefits should be on-budget. The above amendment, by itself, is not so prescriptive; it allows both the GR and the supplements to be on-budget or off-budget *as long as they are not means-tested*. But if a benefit is means-tested, the full value of the benefit must be on-budget, and the means test must be counted as taxation. The result is that no government stands to gain any political advantage by imposing a means test.

Constitutional amendments can have unforeseen consequences. But the above amendment is extremely safe because it has no legal effect on what the Government can and cannot do; it only affects the manner in which the Government reports its activities in the Budget.

> **Lie 2:** In Australia, the highest marginal income tax rate is 47%, or 48.5% if we include the Medicare levy.

As far as the individual taxpayer is concerned, the marginal income tax rate is the number of cents that you lose from each additional dollar that you earn. Whether those cents are taken away by the ATO or the DSS or both is irrelevant; what matters is that the money is gone. Accordingly, economists have invented the term *effective marginal tax rate* (EMTR), which includes the effects of income taxation by the ATO and income testing by the DSS.

The income test applicable to family allowance withdraws the benefit at 50 cents in the dollar. This withdrawal rate *by itself* is higher than the so-called top marginal income tax rate of 48.5%. The family allowance is typically withdrawn over an income range in which the nominal marginal income tax rate is 35.5% (including Medicare), in which case the withdrawal rate and the tax rate combine to produce an EMTR of 85.5%. At lower incomes, calculation of the EMTR becomes more complex, and the result occasionally rises above 100%, indicating that an increase in earned income causes a *decrease* in take-home pay.

The complexity and absurdity of the system are well illustrated in a graph produced by Harding and Polette [1, p. 80], showing the EMTR vs. fortnightly income for a single-income couple with two children in 1994. For income between \$70 pf and \$404 pf, the EMTR never drops below 70%, and peaks at 108%. For income between \$460 pf and \$606 pf, the EMTR is always above 80% and peaks at 104%. Below \$606 pf, there are no fewer than 12 different EMTRs. I quote the caption to the graph in full, with explanatory notes in square brackets:

> The reasons for the high EMTRs are as follows. Between \$70 and \$398, the reference person's DSS allowance [Newstart] is reduced at the second rate (EMTR = 90%), his allowance rebate ends (EMTR = 76%), his allowance cuts out and his income starts reducing the spouse's [Newstart] allowance (EMTR = 90%). At \$398 per week, the reference person starts paying tax at the third marginal rate [34%] and his low income rebate starts getting reduced (EMTR = 108%). Between \$407 and \$557, the spouse starts receiving basic parenting allowance (EMTR = 38%), the family's more than minimum family payments (MMFP) starts being reduced (EMTR = 88%), the reference's low income rebate ends (EMTR = 84%) and the reference person starts paying Medicare (EMTR = 104%). At \$557, the family's Medicare shade-in finishes (EMTR = 85.5%) and at \$606, the family's MMFP entitlement cuts out (EMTR = 35.5%).

Only above \$606 pf does the EMTR remain at the nominal marginal income tax rate, including Medicare.

In July 1997, the Institute of Chartered Accountants published a calculation of the effective tax burden on a single-income family in a rented home, with a son at secondary school and a daughter at primary school, for the 1996–7 financial year. If such a family increased its earned income from \$20 000 to \$30 000 (per annum), its disposable income after tax and benefits *decreased* by \$1730; that is, the extra \$10 000 was taxed at an effective rate of 117.3%.[10]

The effective tax rates on working housewives have been studied by the National Centre for Social and Economic Modelling (NATSEM). One example concerns a mother with two small children and a husband earning \$397 per week. If the mother starts working 25 hours/week at \$8.60 per hour, the family's disposable income increases by \$11.60 per week; the effective tax rate on the mother's earnings is 94.6%, and the mother effectively works for 46 cents per hour. A second example concerns a mother of three with a husband earning \$540 per week. If the mother is capable of earning \$8.60 per hour, the fam-

[10] *Courier-Mail*, Brisbane, July 28, 1997, p. 1.

ily's disposable income is higher if the mother stays at home than if she works between 1 and 19 hours/week. Thus the mother faces an EMTR above 100%. She does not get paid to work; she pays to work.[11]

As far as I can establish, none of the above EMTRs accounts for any work-related expenses other than childcare. The largest such expense, namely transport to and from work, is not even tax-deductible. Thus the real situation is worse than the above figures suggest.

If your EMTR approaches or exceeds 100%, you are caught in what is called a *poverty trap*: if you have trouble making ends meet, you cannot solve the problem by working more hours and earning more income, because the Government will confiscate everything that you earn.

This problem is belatedly receiving attention from senior Federal politicians. Treasurer Peter Costello has given an example of an unemployed husband and father who finds employment earning \$200 per week, then \$350 per week, then \$650 per week. The three income increments are effectively taxed at 68%, 84% and 69%, respectively [6, p. 9]. Mark Latham, the former Shadow Minister for Education and Youth Affairs, citing the research of Harding and Polette, has written:

> ... if a family with one child aged under thirteen and without rent assistance increases its paid earnings from \$417 to \$485 per week (the range of the income test taper for Additional Family Payments), its disposable income increases by just \$1.99. Further, a single unemployed person renting privately faces an EMTR of up to 140 per cent through the income range at which rent assistance is progressively withdrawn [15, p. 223].

I am encouraged by the number of academics and politicians who are campaigning against Lie 2. But I do not know of a single one who has attacked Lie 1 and advocated the complete abolition of income testing as the solution to high EMTRs. Perhaps Mr Hitler did not tell us the full story: perhaps if the lie is big enough, it will deceive not only the "vast masses of the nation", but also the vast majority of the intellectual elite who ought to know better. Or perhaps the elite, and especially the few politicians among them, are holding their peace for fear of political opportunists who cannot—or will not—understand the argument. The constitutional amendment suggested in Step 10 might clear the way for a more candid debate.

> **Lie 3:** High income earners pay higher marginal tax rates than low income earners.

[11] *Weekend Australian*, October 4–5, 1997, p. 21.

High EMTRs are the combined effect of taxation and income testing, and the cutoffs for the income tests are below full-time average weekly earnings (FTAWE). Consequently, high EMTRs affect low income earners more than high income earners. In the graph by Harding and Polette [1, p. 80], EMTRs above 50% are confined to incomes below FTAWE. While the graph applies to a particular family situation, Prof. Harding comments that no one in the most affluent 20% of families faces an EMTR above 50%.

5.8.1 Algebraic treatment

In refuting Lie 1, some numerical examples were used to demonstrate the equivalence between means-testing and taxation. As these examples do not constitute a rigorous proof of the equivalence, I offer the following general algebraic proof. Those readers who faint at the sight of mathematical symbols may skip to the next section. Those who do not will see that there is hardly anything to prove.

Let

$$
\begin{aligned}
x &= \text{earned income, before tax and benefits} \\
y &= \text{final income, after tax and benefits} \\
b &= \text{full value of benefits} \\
w &= \text{benefits withheld due to means tests} \\
t &= \text{tax paid.}
\end{aligned}
$$

Then

$$y = x + b - w - t \ . \tag{5.1}$$

For the means-test convention, we group b and w, obtaining

$$y = x + (b - w) - t \ , \tag{5.2}$$

where the expression in parentheses is the means-tested benefit. For the tax convention (surcharge convention or wealth-tax convention), we group w and t in Eq. (5.1), obtaining

$$y = x + b - (t + w) \ . \tag{5.3}$$

The non-means-tested benefit b now appears on its own, while the parenthesised expression is the sum of tax and withheld benefits. As far as final income is concerned, it does not matter how much of that sum is classified as tax and how much as withheld benefits; the sum is all that matters.

The net cost to the Government is $y - x$. Rearranging Eq. (5.2) gives

$$y - x = (b - w) - t \tag{5.4}$$

for the means-test convention, while rearranging Eq. (5.3) gives

$$y - x = b - (t + w) \tag{5.5}$$

for the tax convention. Again, what counts is the sum of t and w ; it does not matter how much of that sum is called t and how much is called w.

Thus, for both the taxpayer and the Government, there is no difference—except in name—between taxation and the withholding of benefits.

5.9 Lead us not into temptation.

> The law, contrary to all the ordinary principles of justice, first creates the temptation, and then punishes those who yield to it; and it commonly enhances the punishment, too, in proportion to the very circumstance which ought certainly to alleviate it, the temptation to commit the crime.
>
> — Adam Smith, *WN* V.ii.28 [23].

In July and August of 1998, the Federal Government ran full-page newspaper advertisements on social security fraud, proclaiming “4,500 people have been convicted of fraud. Don’t be the next.”

One type of fraud is failure to declare income for the income test. This is the easiest of all crimes to commit, because it is an omission rather than a action. It is also the easiest of all crimes to rationalise, because welfare recipients are always caught in poverty traps. That the Government can confiscate the entire proceeds of your labour is patently unjust and oppressive; that it confiscates the entire marginal wages of the poor, but only some of the marginal wages of the rich, is infuriating. Those who commit fraud under these conditions may well imagine that the law itself is cheating, and that they are merely fighting fire with fire. Many of the offenders are mothers with children and may imagine that they are acting for their children rather than for themselves. Some debt collectors think nothing of terrorising children in an effort to extract money owed by their parents. Moreover, while persons accused of fraud are presumed innocent, debtors have no such privilege. Given a choice between being arrested and being “visited” by debt collectors, a mother might well prefer to be arrested.

Because income tests discriminate on the basis of marital status and take the incomes of partners into account, low income earners have an incentive to live in sin rather than marry, and to conceal the relationship from the DSS. The rationalisation for this behaviour is the same as for non-declaration of income, with one additional component: the law is seen to be inconsistent because it excludes family ties from taxation law in order to maximise tax, but includes them in social security law in order to minimise benefits; in other words, income splitting is forbidden for taxation purposes but compulsory for social security purposes.

Under my proposed welfare reforms (Steps 1 and 2), the frauds described above would be impossible; there would be no income test, and the partners of a marriage or de facto relationship would be treated separately. Admittedly it would still be possible to commit other frauds, such as claiming a disability allowance by faking a disability, or claiming two child allowances for the same child, or claiming two GRs for oneself; but such frauds would be harder to rationalise in the absence of poverty traps, and the risk of detection—through a combined tax/welfare computerised database—would be high. Moreover, the supplementary benefits, being supplements to the GR rather than complete living allowances in their own right, would be smaller than the corresponding benefits in the present system; hence the temptation to claim them on false pretences would be reduced.

The gross complexity of current taxes on personal and corporate income, with their numerous thresholds, rates, deductions, concessions and exemptions, presents "a standing challenge to taxpayers' ingenuity" [8, s. 6]. Honest but antisocial taxpayers can avoid or minimise tax by arranging their affairs so as to qualify for preferential tax treatment, while dishonest taxpayers can evade tax by falsely claiming that they have so arranged their affairs. As the exploitation of these loopholes is seen as the exclusive opportunity of the rich, the poor may decide to "get even" by rorting the social security system, and may attempt to rationalise their action by claiming—quite correctly—that welfare fraud by the poor is less of a drain on the economy than tax avoidance and evasion by the rich.

The simplified system proposed in Steps 6 and 7, with no thresholds, a single rate, and a minimal set of deductions, is less susceptible to legal and illegal manipulation by privileged taxpayers, and consequently less provocative to the underprivileged.

5.10 The welfare burden

The true cost of the welfare system, like the true cost of the tax system, is the deadweight cost: the reduction in national economic output. The conclusion of Section 5.6 is that the tax burden has little to do with the amount of tax collected. Similarly, the conclusion of Section 5.7 is that the welfare burden has little to do with the total payout of benefits. The welfare burden, like the tax burden, can be divided into components.

5.10.1 Administrative cost

The administrative cost of the welfare system, corresponding to the collection cost of the tax system, is the cost to the Government of running the DSS, and is funded by taxation. As the DSS does not create wealth, the cost of running it is a dead loss to the economy; the employment of DSS staff does not even represent a saving of unemployment benefits, because if the economy can afford to employ a certain number of staff in the DSS, it could afford to employ a greater number in the creation of wealth.

The main cost of running the DSS is the administration of the eligibility tests, income tests and assets tests. Under my proposed reforms (Steps 1 and 2), the income tests and assets tests would disappear, and the eligibility tests would be reduced in number and complexity because of the reduction in the number of benefits: every adult would be qualify for the GR, and reasonable criteria for the supplementary benefits (child allowances, study/training allowances, sickness/maternity benefits, carers' benefits and age/disability pensions) are easily specified.

5.10.2 Compliance cost

Just as not all of the administrative burden of the tax system is borne by the ATO, not all of the corresponding burden of the welfare system is borne by the DSS. If you apply for any pension or benefit, you have to supply all the information that the DSS needs for its eligibility tests, income tests and assets tests. You can expect a list of questions as complicated as the Tax Pack, exploring personal matters that you would rather not discuss with anyone but a priest or counsellor, and loaded with dire penalties for wrong answers. Those newspaper advertisements declaring that "4,500 people have been convicted of fraud" (July 1998) also state that 570 000 people have found to have been overpaid since July 1996, and have had their payments reduced or stopped. Presumably the overpayments must be recovered. As those 570 000 were not convicted of fraud, it must also be presumed that their overpayments were the results of honest mistakes, in which case the vexation and financial hardship involved in correcting the overpayments must be counted as compliance costs. The excessive number of benefits, combined with changing circumstances of recipients, also causes inconvenience. Between July and September 1995, 22% of working-age welfare recipients moved from one benefit to another [15, p. 224].

Again, these costs would be reduced by the removal of means tests and a reduction in the number of benefits (Steps 1 and 2).

5.10.3 Distortion

If transfer payments are subject to means tests or other tests, people will try to arrange their affairs so as to pass the tests. In so doing, they will divert time and other resources away from the creation of wealth. If family allowance is subject to an income test which includes salary but excludes fringe benefits (as used to be the case), employees have a strong preference for fringe benefits over salary, and employers seeking highly qualified staff find it profitable to offer fringe benefits in spite of high FBT rates. If the income test causes your family allowance to drop suddenly to zero at a certain threshold of income (as is still the case), you will arrange your affairs to ensure that you are below the threshold or well above it, but not slightly above it.

But the most grotesque distortion of all is the poverty trap. When you reach the bottom of a broad income band in which the EMTR is close to 100%, you can no longer benefit from any plausible pay rise; hence you have no reason to work harder, no reason to impress your boss and earn a promotion, and no reason to improve your qualifications and find a more lucrative job—unless you can somehow reach that stratospheric income range in which your nominal marginal tax rate is your real EMTR. Similarly, your boss cannot offer you any positive incentive to improve your performance, because any reward given by your boss will be taken away by the Government. Poverty traps produce unmotivated workers. Lower motivation means lower productivity, hence lower profits, hence lower capacity to pay wages, hence higher unemployment.

If means tests are eliminated (Step 2), there is nothing to be gained by structuring salaries and fringe benefits around income thresholds or asset thresholds, and there are no poverty traps.

5.10.4 It's the EMTR, stupid!

The art of welfare consists in so slicing the cake as to give the smallest possible slice to the baker without causing him to close the bakery. I refer of course to a marginal cake and a marginal slice. Whether the baker can improve his lot by selling more cakes depends on his EMTR. If his EMTR is sufficiently low, so that he keeps a sufficiently high percentage of the fruits of his additional labour, he has a reason to exert himself. It is often said that 50% is an important psychological threshold: if his EMTR exceeds 50%, he is a minority shareholder in the fruits of his additional labour, and is likely to lose enthusiasm—although, in the examples discussed in Section 5.8, EMTRs above 50% are the norm. If his EMTR approaches or exceeds 100%, he might as well take it easy.

At present, high EMTRs are caused by income testing. In the absence of income testing, high EMTRs might be a symptom of an excessively generous GR, which would also be a disincentive to industry: if the baker is given too many of other people's cakes, he does not need to bake any of his own. But the connection between high EMTRs and disincentives is not broken.

When economists publish calculations of the income tax rates that would be required to fund the abolition of means tests, the calculated tax rates are the real EMTRs. Therefore, when assessing the acceptability of those tax rates, it is essential to compare them with present EMTRs—not with present *nominal* income tax rates. One such calculation was contained in a joint report of the National Centre for Social and Economic Modelling (NATSEM) and the Melbourne Institute of Applied Economic and Social Research, released in November 1997 and summarised by Prof. Peter Dawkins in the *Australian Financial Review*.[12] The calculation assumed a "basic income / flat tax" system, which can be shown to be equivalent to a GR and a flat income tax with no threshold (see Section B.3). If the basic income were high enough to ensure that no existing social security recipient suffered any loss, the tax rate would be 57%; that is, the EMTR for *every* taxpayer would be 57%. *This figure is less than half of the maximum EMTR of the present system,* a huge improvement on the typical EMTRs currently faced by low income earners (see Section 5.8), and only slightly higher than the current maximum EMTR for above-average income earners; yes, by comparison with the absurd figures in Section 5.8, an EMTR of 57% is only "slightly" higher than the top nominal tax rate of 48.5%.

The calculated tax rate of 57% is an overestimate because, as its authors acknowledge, it is a "day after" costing; it assumes that nothing changes except the tax/transfer system. In reality, the tax/transfer changes would trigger further changes. The elimination of poverty traps would improve the motivation and productivity of workers, and the reduction of minimum wages (offset by the transfer system) would reduce the cost of hiring low-skilled workers, so

[12] P. Dawkins, "Hip pocket solution to unemployment", *Australian Financial Review,* November 3, 1997.

that more workers could be profitably employed. The reduction of compliance costs would allow large numbers of unproductive workers to be productively redeployed. The increase in both the number and the productivity of employees would increase the capacity of the economy to pay wages, so that a lower tax rate would raise the same revenue. So one could start with a tax rate of 57% and reduce it over time, or start with rate below 57%, knowing that the initial deficit would be recovered through subsequent economic growth. For the system proposed in this book, the required FDET rate would be still lower, for the following reasons:

- I do not think it necessary or desirable to guarantee that no social security recipient would be worse off. In particular, the GR should be worth somewhat less than the dole so that the unemployed are encouraged to find work. Reducing the dole would be unconscionable in the current environment of high unemployment, in which work is simply not available, but would be reasonable in a full-employment environment.

- Additional revenue would be raised from a GST (Step 14). For reasons to be explained in Chapter 7, the introduction of the GST would *not* cause a one-off increase in the cost of living, and therefore would *not* devalue savings. This claim is not true of every possible GST, and is not true of the GST proposed by the Howard government; but it is true of the complete package proposed in this book, because other components of the package tend to *decrease* the cost of living, while the GST rate is chosen so as to compensate for this effect.

So 57% is an overestimate of the FDET rate required to fund the proposals in this book.

But I repeat: even a 57% rate would be better than the present system, in which EMTRs over 100% are commonplace. Thus the calculation by NATSEM and the Melbourne Institute supports my contention that the abolition of income tests allows a reduction in the maximum EMTR. High EMTRs are caused by income testing; the cure consists in the removal of the cause.

5.11 Does "size of government" matter?

In Section 5.2, I explained that market failure imposes a lower limit on the acceptable level of taxation. I did not give any hint of an upper limit until Subsection 5.10.4, which mentions the disincentive effect of high EMTRs. As the meaning of "high" is vague, the resulting upper limit is less precise than the lower limit, perhaps suggesting that it is better to err on the side of high taxation than low taxation. I would not want to leave the reader with that impression.

Market failure is caused by externalities. Positive externalities (benefits that do not flow back to the producer) cause a product to be undersupplied. Negative externalities (costs that do not hit the producer) cause a product to be oversupplied. For these reasons, governments spend public funds on products that the free market undersupplies (health, education, welfare, defence, law and order, etc.), and impose punitive taxes on products that the free market tends to oversupply (tobacco, alcohol, greenhouse emissions, etc.). In the absence of externalities, however, the market works remarkably well, and it would be presumptuous and unrealistic to suppose that any form of government intervention—other than the rule of law for the protection of property and the enforcement of contracts—could make it work better. This observation justifies what we might call a *presumption of non-intervention*: when someone advocates intervention in the market, the onus is on the interventionist to explain how the market has failed and how the intervention will repair the damage. There are indeed cases in which such an explanation can be given.

There are also cases in which the argument for intervention is marginal, or in which there is scope for disagreement over the form that the intervention should take. Recent debates over the privatisation of essential services belong to this category. Such debates tend to be inconclusive because the arguments for and against privatisation are of roughly equal merit. It follows that the economic consequences of privatisation, be they good or ill, are not very great; hence the issue of privatisation will not be considered further in this book. That the case for intervention is often marginal helps to explain why relatively successful countries display such a large variation in the level of taxation as a percentage of GDP. There are indeed upper and lower limits on the acceptable level of taxation, but the margin between those limits is huge.

Finally, it should be noted that the extent of government interference in the market does not only depend on the "size of government" as expressed by the level of taxation or the public sector's share of the economy. A "big government" can charge high taxes and run a large public service, and yet go about its business unobtrusively, doing its own work at its own expense. Equally well, a "small government" can charge low taxes and run a small public service, and yet cause gross interference in the market by passing excessively complex legislation, demanding too much information, and offloading the resulting administrative costs onto the private sector. An example of the latter kind is the Howard government, which has made a virtue of cutting expenditure and privatising public utilities, but has caused an unprecedented blowout in compliance costs by complicating the laws relating to taxation and superannuation;

in 1997, for example, the body of tax law grew by 15 new acts, including 1400 pages of law and 1350 pages of explanation.[13]

5.12 Conclusion: Beware of promises.

> Knock, knock! Who's there, in th'other devil's name? Faith, here's an equivocator, that could swear in both the scales against either scale, who committed treason enough for God's sake, yet could not equivocate to heaven: O, come in, equivocator.
>
> — Shakespeare, *Macbeth* II.iii.

This chapter has shown that the most important issue in tax reform is the deadweight cost, which is caused mainly by compliance costs and distortion. Major causes of distortion include poverty traps, which are caused by income tests on welfare, and disincentives to saving, which are caused by assets tests on welfare. The *least* important issue in tax reform is the level of taxation!

John Howard became Prime Minister by promising, among other things, that there would be no new taxes and no increases in existing taxes. Because the need for revenue was obviously not going to abate, the promise implied that no existing taxes could be abolished or reduced—in other words, no tax reform. Hence what Mr Howard really meant was this: "I know the tax system is broken; but I promise not to fix it in my first term, because you voters are too stupid to understand the need for change."

Beginning its long campaign for a second term, the Government set out five guiding principles for tax reform [6, p. 19]. Deadweight costs, compliance costs and distortion did not rate a mention. The first principle on the list, hence presumably the one that the Government wished to portray as the most important, was that "there should be no increase in the overall tax burden"—whatever that meant. If it meant no increase in the deadweight cost, it was not good enough; it should have prescribed a drastic *reduction* in deadweight. If it meant no increase in taxation as a percentage of GDP, it pandered to the ignorance and prejudice of the electorate by portraying the least important issue in tax reform as the most important. The Treasurer added to the confusion by complaining that average income earners were about to move into the 44.5% tax bracket, as if that were a bigger problem than the near-100% EMTRs for lower income earners.

[13] *Australian Financial Review*, January 3–4, 1998, p. 30.

When the Government's re-election tax package was eventually unveiled on August 13, 1998, it revealed that low-income and middle-income families would face a typical EMTR of 61.5%, comprising 30% for tax, 1.5% for Medicare, and 30% for the withdrawal of family allowance. This would be a considerable improvement on present EMTRs. But for a family with children receiving the common youth allowance, the combined means tests could still produce EMTRs as high as 100%.[14] Even an EMTR of 61.5% would be higher than the top marginal income tax rate, and is *higher than the most pessimistic estimate of the flat tax rate required to fund the abolition of means tests*.

On August 27, 1998, the Labor Party released its tax policy. Its solution to poverty traps was an earned-income tax credit (EITC) of 10 cents for every dollar of earned income up to a limit of \$39 000 per annum (for four or more children), withdrawn at 15 cents for every dollar of earned income above that limit.[15] The effect of this proposal is to reduce the family EMTR by 10 cents in the dollar for income up to \$39 000 per annum, and *increase* it by 15 cents in the dollar for income between \$39 000 and \$65 000 per annum. A similar effect could have been achieved by cutting marginal tax rates for low income earners and increasing them for middle income earners; the only advantage of the EITC option is that one does not have to *admit* that one is increasing marginal rates over any range of income. Moreover, an EITC further complicates the already incomprehensible tax/welfare system; see Section B.4.

In the campaign for the election of October 3, 1998, both sides persisted in the hypocrisy of disguising income taxes as income tests. Neither side admitted that high EMTRs are caused by income tests and cured by the abolition of income test. Both sides played to the belief that the cost of taxation is the tax paid. Neither side dared to admit that the true cost of taxation is deadweight. Both sides published elaborate tables showing how taxpayers in various situations with various incomes would be better off under their proposed changes, as if those situations and incomes would remain the same; compliance costs and distortionary costs, which determine whether people have situations or incomes at all, did not enter into the calculations.

[14] P. Dawkins, "Negative tax a positive step", *Australian Financial Review*, August 18, 1998, p. 16.

[15] *Australian Financial Review*, August 28, 1998, p. 5.

Chapter 6

FDET: a simplified direct tax

> The hardest thing in the world to understand is income tax.
>
> — Einstein.

If you have never heard of a Flat Direct Expenditure Tax (FDET), that is because no country in the world has any kind of direct expenditure tax, flat or otherwise.[1] But the technical advantages of direct expenditure taxes are widely acknowledged by economists. An FDET replaces personal income tax (PIT), company tax, fringe benefits tax (FBT), capital gains tax (CGT), death duties and gift duties (some features of which are built into the CGT), and superannuation taxes. It replaces not only the actual or potential revenue of these seven taxes, but also their logical functions, and is superior to them in that it does not penalise saving.

The seven taxes to be replaced are either adaptations of the income tax or efforts to plug leaks in the income tax, and there is not one person in this country who understands them all. Even the drafters of the income tax legislation could not understand it, with the result that the ATO must resolve ambiguities by issuing interim rulings—making up the rules as it goes, and often changing its mind afterwards. An FDET, in contrast, is so simple that I am about to explain it in one chapter.

[1] "Taxation: The nature of taxation: Classes of taxes: Direct and indirect taxes: Direct taxes", *Britannica CD 98 Multimedia Edition.*

6.1 The inequities of income tax

6.1.1 Income vs. capacity to pay

It is often alleged that income taxes are fairer than consumption taxes because income is a good measure of ability to pay, and because income can be taxed at progressive rates so that the rich pay a higher fraction of their income than the poor. But consider the following (hypothetical) cases:

- Joe is a builder's labourer. Bill is his boss. Bill drives his car from site to site and claims the resulting expenses as a tax deduction. Joe drives as far as Bill; but he cannot claim a deduction, because his travel is to and from his home. His travel expenses are high because he cannot afford inner-city rents and is forced to live in a fringe suburb, but that makes no difference.

- Joe's daughter works short shifts, often at short notice, and at low rates of pay, with the result that a third of her income is consumed in bus and taxi fares as she travels to and from work; but again, because such travel is not recognised as a work-related expense, she pays tax as if her travel expenses were zero.

- John works full-time while Joan stays home and looks after the kids. Bob and Beth live together, work two days a week each, and earn the same total income as John, but they pay less total tax because they get two tax-free thresholds instead of one.

- Jack is a property investor. Some of the properties are held in his wife's name in order to obtain a second tax-free threshold for the rental income. Jill is also a property investor, but she cannot split the rent with her husband because he died twenty years ago.

- The Smiths own part of a company, from which the profits are distributed to family members through a trust, taking advantage of multiple tax-free thresholds. The Browns have the same income as the Smiths, but earn that income from one full-time job; so they get only one tax-free threshold and pay more tax than the Smiths.

- Fred and Jim are both intermittently employed; but because the intermittence is caused by the state of the labour market rather than the nature of their work, they are not eligible for income averaging. Fred finds work from April to September, so that his income is split between two financial years, allowing him to claim two tax-free thresholds and pay little tax. Jim is unfortunate enough to find similar work from July to December, so that all his income is in the same financial year and the Tax Office takes a bigger bite.

- Joe's son is unemployed. Several small businesses in the neighbourhood would be glad to hire an extra pair of hands if it did not involve so much additional paperwork, largely connected with income tax.

As these examples show, income tax is often grossly *unfair* because

1. it defines work-related expenses in a way that discriminates against low-income earners;

2. it causes gross violations of *horizontal equity*: people in comparable situations pay vastly different amounts of tax because of differing applications of the threshold and progressive rates;

3. it deters employment and consequently deprives people of a start in life.

Proponents of consumption taxes argue that the best measure of financial comfort is not how much income one earns, but how much of that income one dares to spend on consumption, excluding essentials. The problem is how to allow for essential consumption, which of course depends on such factors as the taxpayer's age, health, and number of dependants. Two possible solutions are:

- Devise a consumption tax with a threshold, which exempts an amount of expenditure appropriate to the taxpayer's circumstances;

- Fund essential consumption through the social security system.

The solution proposed in this chapter may be said to include *both* of the above features.

6.1.2 A triple tax on employment

> If direct taxes upon the wages of labour have not always occasioned a proportionable rise in those wages, it is because they have generally occasioned a considerable fall in the demand for labour. The declension of industry, the decrease of employment for the poor, the diminution of the annual produce of the land and labour of the country, have generally been the effects of such taxes.

— Adam Smith, *WN* V.ii.133 [23].

Obviously income tax is a tax on labour because the Government takes some of the wages which are the fruit of your labour. This in itself is a cause of inequity—surely it is fairer to tax people on their unearned windfalls rather than on their hard-earned wages. Moreover, any kind of tax on labour causes the wages received by a worker to be less than the cost to the employer, making it more difficult for the employer to pay an adequate living wage. Thus a tax on labour is a tax on employment.

Less obviously, but more importantly, income tax is a *double tax on capital*. To make money out of a capital investment, you must first save up the capital out of income on which you have already paid tax once, and then you pay tax again on the earnings of your capital. You cannot escape the double tax by using borrowed capital, because the principal must be repaid out of after-tax income and the interest must be sufficient to enable the lender to pay tax on that interest—i.e. on the earnings of the lender's capital—while retaining a reasonable after-tax return. Besides, the lender is also taxed twice: once when accumulating the capital out of after-tax income, and once on the interest.

In particular, when you deposit money in a savings account in a bank (that is, when you *lend* money to the bank), you make the deposit out of after-tax income and pay tax on the interest. Thus income tax is a *double tax on saving* (to say nothing of the means test for pensions, which is yet another tax on savings).

"Well," says the mug Australian voter, "if capital is taxed twice and labour is only taxed once, the equity of taxing capital more than compensates for the inequity of taxing labour, so that income tax is equitable overall." Wrong. The mug voter forgets that:

- capital creates employment, and
- capital improves productivity, but
- capital cannot do either of the above unless it makes a profit.

The better your workplace is equipped, the more productive you are and the more your employer can afford to pay you—and the more likely it is that the employer can justify employing you at all. Taxes on capital inhibit investment in workplaces, leading to lower levels of employment, lower productivity and lower real wages. In economic jargon, we say that the *legal incidence* of the tax is on capital, but the *economic incidence* is more likely on wages [1, p. 37]. How equitable is that?

"But," insists the mug voter, "capital does not create employment. It buys machines that displace labour and create *unemployment*!" Wrong again. The mug voter's argument is based on the assumption that the total amount of work to be done is limited, so that if more work is done by machines, less is done by people. But the amount of work to be done is not limited by some divine or natural law; it is determined by human wants, and human wants know no bounds. If you are employed, you can probably think of a long list of tasks that need to be done in your workplace, but which remain undone because none of the existing staff have time to do them and because your employer cannot afford to hire more staff. And you can certainly think of many things that need to be done at home, but which remain undone because you do not have time to do them and cannot afford to pay someone else to do them. Unemployment exists not because there is a shortage of work to do, but because it is not economic to get it done.

Chapter 4 gave a long list of reason why employers cannot afford to get their work done. Now we have another: income tax, which falls once on labour and twice on capital, is a triple tax on employment. In contrast, payroll tax, which falls once on labour and does not touch capital [1, p. 37], is only a single tax on employment. Yet it is payroll tax—not income tax—that is denounced by populist politicians as a tax on employment. "So why don't they tell me the truth?" asks the mug voter. Because if they told you the truth, you wouldn't believe it. I repeat: the art of politics consists in telling the people what they are likely to believe.

6.2 A direct consumption tax

One way to reduce the inequity of income tax is to allow a deduction for savings (including lendings, investments and repayments of borrowings) and expand the definition of taxable income to include *dissavings* (borrowings, sales of investments and repayments of lendings; note that the three components of dissaving are the inverses of the three components of saving). With this modification, capital is saved out of *pre-tax* income instead of after-tax income, while the returns on capital, including principal and interest, are taxed. The result is that that capital is taxed only once (instead of twice), and employment is taxed only twice (instead of thrice). If you borrow money in order to invest, the borrowing is taxable but the investment is deductible, so that your immediate tax liability is zero (as with an ordinary income tax), and you pay tax once on the returns from the investment. The lender's capital is also taxed only once, during repayment.

Now let us work out exactly what is being taxed. All income and dissavings are either saved (invested) or consumed (spent on consumable goods and services) or paid in tax; that is,

$$\text{income} + \text{dissavings} = \text{savings} + \text{consumption} + \text{tax}\ . \tag{6.1}$$

Subtracting savings from both sides gives

$$\text{income} + \text{dissavings} - \text{savings} = \text{consumption} + \text{tax}\ . \tag{6.2}$$

The left-hand side of Eq. (6.2) is the modified taxable income. What is left on the right hand side (other than tax) is consumption. Thus a deduction for savings, combined with the addition of dissavings to taxable income, turns an income tax into a consumption tax. The presence of tax on the right-hand side indicates that the nominal tax rate is *tax-inclusive*; that is, the stated rate is a fraction of consumption+tax, not a fraction of consumption alone.

If we define *net savings* as savings minus dissavings, Eq. (6.2) can be written

$$\text{income} - \text{net savings} = \text{consumption} + \text{tax}\ , \tag{6.3}$$

showing that a consumption tax is equivalent to a tax on income with a deduction for net savings. Rearranging the last equation gives

$$\text{income} = \text{consumption} + \text{net savings} + \text{tax}\ , \tag{6.4}$$

showing that an income tax is equivalent to a consumption tax plus a tax on net savings.

Those who think they are opposed to a broad-based consumption tax may be vexed at the discovery that they already have one hidden in their income tax. The other component of income tax is a tax on net savings. Net savings represent *new* capital, which creates *new* employment—not a smart thing to tax.

6.3 General implementation of the FDET

A tax on income with a deduction for net savings is a consumption tax. It is a *direct* consumption tax because it is calculated on earnings rather than expenditure, but the expenditure is the real target. Accordingly, such a tax is called a *direct expenditure tax* or DET. The act of adding dissavings and subtracting savings on the right-hand side of Eq. (6.2) is called the *expenditure tax adjustment* [5, p. 62]. Now let us consider the components of income, dissavings and savings.

- Income, as usual, is net of expenses incurred in earning that income. Hence every entry under Income has a corresponding entry under Expenses. It is vital to note, however, that because the DET is a consumption tax, *expenses do not include consumables*: clothing, laundry services, books, subscriptions, stationery, postal and communications charges, fuel, travel fares, accommodation, meals, and entertainment expenses are *not* deductible. The abolition of these numerous nuisance deductions, as we shall see, eliminates the need for most wage and salary earners to submit tax returns. Expenditure on "inputs" may include fees for subcontracted services, and corresponds to "fees" on the Income side. Royalties are licence fees derived from patents or copyrights. Outgoing cash gifts are not strictly related to earning income, but must be deductible in order to prevent double taxation of a cash gift that is consumed by the recipient. Outgoing cash bequests are applicable only to the final DET calculation for a deceased taxpayer, and must be deductible in order to prevent double taxation of a cash bequest that is consumed by the heir.

- Dissavings include borrowings, sales of investments, and repayments of lendings. Savings include lendings, investments, and repayments of borrowings. Not all asset acquisitions qualify as investments; for example, the purchase of a block of flats or a commercial vehicle would be an investment, while the purchase of one's own place of residence or one's personal vehicle would be, in most cases, purely consumption. Software is an investment only if it can be resold; otherwise it is consumable. Those assets that constitute investments are called *registered assets*[2] and appear in the table; they are bought out of pre-tax income and are taxable when sold. Other assets are called *unregistered assets* and do not appear in the table; they are bought out of after-tax income and are tax-free when sold. Of course one does not want one's borrowings to be taxable unless they are rolled over into deductible assets. Accordingly, the only borrowings that appear in the table are *registered borrowings* for the purpose of acquiring registered assets; such borrowings are taxable and the repayments are deductible. A loan for a house or car would usually be an *unregistered borrowing* and would not appear in the table; it would not be taxable and the repayments would not be deductible.

Table 6.1 shows the complete subdivision.

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[2] J. E. Meade (Chair), *The Structure and Reform of Direct Taxation* (London: Institute for Fiscal Studies / Allen & Unwin, 1978), pp. 178–83.

Table 6.1: Generalised computation of taxable consumption under a direct expenditure tax (DET).

		+	−
Income:	Wages/salary	xx	
	Sales/fees	xx	
	Dividends/profits received	xx	
	Rents received	xx	
	Royalties received	xx	
	Incoming cash gifts/inheritances	xx	
Expenses:	Payroll		xx
	Materials/components/inputs		xx
	Dividends/profits paid out		xx
	Rents paid		xx
	Royalties paid		xx
	Outgoing cash gifts/bequests		xx
Dissavings:	Registered borrowings	xx	
	Sales of investments	xx	
	Repayments of lendings	xx	
Savings:	Repayments of registered borrowings		xx
	Investments		xx
	Lendings		xx
	Total charges	xx	
	Total deductions		xx
Consumption:	(charges − deductions)	xx	

The table is "generalised", meaning that it is applicable to both personal and corporate tax. This is a substantial departure from earlier proposals for a corporate tax to accompany a personal DET. In the United Kingdom, the 1978 Meade report[3] recommended a personal direct expenditure tax together with a corporate *flow-of-funds tax*, also known as a "Cary Brown tax" [5, p. 33]. The flow-of-funds tax has two forms, one taxing the "R base" (real goods and services) and the other taxing the "R+F base" (real plus financial transactions). It is easily shown that the R+F base is equivalent to an "S base" (share transactions). In each case the taxable base has the form of revenue minus expenses, but *in no case is there a distinction between consumption expenses and investment ex-*

[3] J. E. Meade (Chair), *The Structure and Reform of Direct Taxation* (London: Institute for Fiscal Studies / Allen & Unwin, 1978).

penses; in other words, the flow-of-funds tax is *not* a consumption tax. Hence I do not understand Bretton A. Cooper when he describes the flow-of-funds tax as "the corporate analogue of the personal expenditure tax" [5, p. 31]. In the language of the Meade report, the corporate FDET derived from Table 6.1 may be described as a tax on the R+F base, except that deductions for consumption expenses (including most fringe benefits for employees) are disallowed. Hence it uses a broader base than the flow-of-funds tax, allowing more revenue or a lower rate.

Under an FDET, the personal tax base is personal consumption while the corporate tax base is corporate consumption. The two bases are complementary. As there is no overlap between the two bases, there is no risk of double taxation of the same income. As the two bases together cover the entire private sector, there is no possibility of avoiding tax by shuffling income from one entity to another. Such are the advantages of a uniform philosophy in the design of the tax base. It goes without saying that the personal and corporate FDET rates are the same, so that there is no artificial tax advantage in incorporation, and no possibility of reducing tax by transferring income between a company and its proprietor(s). Similarly, the treatment of a body corporate is independent of the corporate structure: public companies, private companies, trusts and partnerships are all taxed alike, so that the choice of corporate structure is made on purely commercial grounds.

The bottom line of Table 6.1 is taxable consumption. In the type of DET described by Latham and Hinckfuss [15, pp. 135, 346], consumption is taxed on a highly progressive scale of rates, including a tax-free threshold to allow a basic level of tax-free expenditure on the necessities of life. This form of DET, known as a Progressive Expenditure Tax (PET) or Kaldor Tax, is discussed—and rejected—in Section B.5. In my proposed system, the GR and supplementary benefits replace the tax-free threshold and are *not* included in the calculation of taxable consumption in Table 6.1. This taxable consumption is then taxed at a flat rate with no threshold. The result is a much simpler tax: a *flat* direct expenditure tax (FDET).

6.3.1 What happened to interest?

The interest that you receive from the bank on your savings account is taxed as if it were real income, which it isn't—and not only because it is wiped out by fees. The purchasing power of your bank balance is gradually reduced by inflation, and at least some of the interest merely compensates you for this effect. The interest credited to your account is called *nominal interest*. When the compensation for inflation is subtracted from nominal interest, the result is called *real interest*. For low interest rates and low inflation rates, the real interest rate is approximately equal to the nominal interest rate minus the inflation rate. Logically, only *real* interest ought to be taxed, but that is deemed to be too difficult. So we pay tax on nominal interest, and consequently pay too much.

A DET, in its pure form, completely avoids the interest problem. Table 6.1 refers to “repayments of lendings” and “repayments of registered borrowings”, but the repayments are not divided into principal and interest, and the word “interest” does not appear anywhere in the table. Instead, the principal appears on the opposite side of the ledger from the repayments: borrowed money is taxable while the repayments are deductible, and lent money is deductible while the repayments are taxable. The resulting subtractions automatically take care of the interest. This “interest” is real, because if inflation devalues the repayments in a particular year, it likewise devalues the other charges and deductions in that year.

6.3.2 What happened to depreciation?

The computer on which I am typesetting this book is an income-producing asset. When I bought it, I was not allowed to claim the entire purchase price as a tax deduction; instead, the asset is deemed to *depreciate* (lose value) by a certain percentage each financial year, and I can claim that depreciation as a deduction. If I had bought the asset with borrowed money, not all of the repayments would be deductible; only the (nominal) interest would be deductible, because the principal would be reclaimed through depreciation. If I sell the asset at some future time, the sale price will determine the final deductible depreciation. Thus I shall eventually pay tax on the earnings and on the final sale price, but not on the purchase price, so the investment will be taxed only once. But depreciation is not a complete solution to double taxation of capital, because not every income-producing asset loses value of its own accord; for example, you cannot depreciate your bank account or your superannuation fund.

Under a DET, I would have claimed the entire purchase price of the computer as an investment. If I had bought the asset with borrowed money, the borrowing would have been taxable but the purchase would have been deductible—resulting in no immediate tax liability—and the repayments on the loan would be deductible. Whether I borrowed money or not, I would pay for the computer out of pre-tax income and pay tax only on the resulting earnings and on the final sale price. Thus the DET automatically avoids double taxation of depreciable investments without the complexity of depreciation.

6.3.3 What happened to capital gains?

A public company is owned by its shareholders, to whom it distributes profits by paying *dividends* on the shares. If you bought a package of shares in Telstra and sold it at a higher price, you bought the shares with after-tax income and then paid tax again on the *capital gain*, i.e. on the excess of the sale price over the purchase price, adjusted for inflation. This Capital Gains Tax (CGT) is a necessary measure against tax avoidance: if there were no CGT, wealthy taxpayers would find ways to disguise their taxable income as non-taxable capital gains. Note the inconsistency between CGT and the income tax on interest: CGT applies to *real* capital gains (corrected for inflation), while income tax applies to *nominal* interest (not corrected for inflation).

CGT is an extension of income tax in the sense that it is assessed at your marginal income tax rate(s), with a twist: the tax on a capital gain received in a particular year is five times the additional income tax on one fifth of the capital gain. This "averaging" of CGT is intended to avoid hardship for a low income earner who makes a once-in-a-lifetime capital gain—e.g. by selling a small business—and can result in a substantial reduction in your tax bill if you are not in the top income-tax bracket.[4] As an extension of income tax, CGT is a double tax on capital, albeit alleviated somewhat by the adjustment for inflation.

Laws governing CGT are complex, imprecise and incoherent. Whether a profit is subject to income tax or CGT depends on whether it is made in the normal course of business—which is often debatable. Personal items above a certain threshold value are subject to CGT, and the threshold depends on whether the items are legally classified as "listed" or "unlisted". Normally capital losses are deductible against capital gains, but this does not apply to unlisted items; on these, you must share any gains with the Government, but bear all losses yourself. Normally the capital gain on an asset is deemed to be *realised*, and hence taxable, when the asset is sold. But under some conditions a capital gain is taxable when an asset is inherited.[5] Worse, a capital gain on company shares can be deemed to be realised when the company is restructured; thus investors in the company can be hit with a CGT bill as a result of a boardroom decision over which they have no control.[6] These complexities and pitfalls are a significant deterrent to productive investment and, in combination with the CGT exemption for owner-occupied housing, cause a massive diversion of capital into unproductive real estate. As a result, the deadweight cost

[4] *Courier-Mail*, Brisbane, May 9, 1998, p. 68.

[5] ibid.

[6] *Australian Financial Review*, Editorial, July 31, 1998, p. 34.

of CGT is extraordinarily high; in November 1997, a study by Lawrence and Diewert found that the Australian CGT reduced national output by 50 cents for every dollar of revenue.[7]

Under a DET, you claim the purchase price of a registered asset as a deductible investment and pay tax on the sale price. If the real sale price is higher than the real purchase price, you pay more real tax on the sale than you save on the purchase. Thus the DET automatically taxes *real* capital gains, without any separate rules for CGT. (For an alternative explanation, note that the calculation of DET takes place within a single year. As the calculation does not involve comparing capital flows in different years, it is not confused by inflation.) Tax liability is incurred only when an asset is sold; there is no “deemed realisation” of capital gains, except perhaps as a transitional arrangement when the DET is first introduced (see Subsection 6.3.5). A registered asset is purchased out of pre-tax income and taxed on sale, whereas an unregistered asset is purchased out of after-tax income and sold tax-free; in either case, the asset is taxed only once. Under the FDET, the tax rate is flat, eliminating the need for averaging.

6.3.4 What happened to insurance?

An insurance payout on a registered asset is not classified as taxable income under a DET unless the insured asset is written off, in which case the insurance payout is counted as the resale price. If the payout merely finances the repair of the asset, it is not taxed separately, because it contributes to the eventual sale price of the asset and will effectively be taxed at the time of sale; to tax it separately would be double taxation. For consistency, premiums for the insurance of a registered asset must also be counted as deductible investments.

Your health is classified as a registered asset, and medical treatment is classified as repair of the asset. The result is that health insurance premiums are deductible while the benefits received are *not* taxable.

An insurance payout on an unregistered asset is not taxable, and the associated premiums are not deductible.

A life insurance premium often includes an investment component, which must be deductible. Therefore, for simplicity, the life of the insured should be treated as a registered asset, so that the whole premium is deductible and any payout is taxable. Of course the tax on the payout can be delayed by investing the payout. Because some life policies include disability cover, disability insurance must be treated in the same way as life insurance.

[7] A. Mitchell, “Capital tax raises global warning”, *Australian Financial Review*, January 14, 1998.

6.3.5 Transitional provisions

If the present tax system is replaced by a DET, the most obvious transitional provisions for existing assets are as follows:

- If you bought an asset under the old law, you can sell it and pay CGT according to the old law, and the old provisions on interest, depreciation and insurance continue to apply until you dispose of the asset.

- If you buy another asset, you buy it under the new law.

However, the bookkeeping could be simplified by means of a compulsory "bed and breakfast" deal, in which the holder of an asset subject to CGT is deemed to sell the asset and buy it back at the same price, thereby realising the capital gain/loss and removing all administrative vestiges of the old law. The method for determining the price would need to be specified in legislation. Minor uncertainties in the specification could readily be tolerated, because a higher price means a higher capital gain under the old law and a lower one under the new law, with minimal effect on the total tax bill.

6.4 A corporate FDET

> **Myth:** In Australia, companies pay tax on their profits.
>
> **Fact:** Profit, like the overall level of taxation, is a nebulous concept. Under Australian tax law, the "profit" that a company reports to the Australian Taxation Office (ATO) does not need to be the same as the "profit" that it reports to the Australian Stock Exchange (ASX). So companies are free to report the lowest possible profit to the ATO (to minimise tax) and the highest possible profit to the ASX (to maximise share prices). If they were required to report the same profit to the ATO and the ASX, they would face a pretty dilemma—and, according to the Australian Society of Certified Practising Accountants, would save about $800 million per year in compliance costs.[8]

Under an FDET, a company would calculate its consumption for the information of the ATO, and its net savings for the information of shareholders. (A suitable definition of "profit" would be dividends plus net savings.) Obviously the company would want to state the lowest possible consumption and

[8] *Australian Financial Review*, June 9, 1998, p. 5.

Table 6.2: Computation of corporate consumption for a non-financial corporation.

		+	−
Income:	Sales/fees	xx	
	Dividends/profits received	xx	
	Rents received	xx	
	Royalties received	xx	
	Incoming cash gifts/inheritances	xx	
Expenses:	Payroll		xx
	Materials/components/inputs		xx
	Dividends/profits paid out		xx
	Rents paid		xx
	Royalties paid		xx
	Outgoing cash gifts		xx
Dissavings:	Registered borrowings	xx	
	Sales of investments	xx	
	Withdrawals	xx	
Savings:	Repayments of registered borrowings		xx
	Investments		xx
	Deposits		xx
	Total charges	xx	
	Total deductions		xx
Consumption:	(charges − deductions)	xx	

the highest possible net savings; but, as income is divided between consumption and net savings, there is no conflict between these two goals. Compliance costs would be reduced, not only because a single set of books would suffice, but also because the definitions of consumption and net savings are simpler and clearer than the definitions (plural) of profit.

Now let us consider how Table 6.1 applies. A corporation does not receive wages or salaries. It does not give bequests, but may give gifts. “Sales of investments” includes share issues, while “Investments” includes share buybacks. If the corporation is not a bank or financial institution, it does not lend money except by depositing funds in a bank account, and repayments of such “lendings” are called withdrawals. Thus Table 6.1 reduces to Table 6.2. If the corporation is a bank or financial institution, it borrows money by accepting deposits and repays its borrowings by allowing withdrawals. Thus Table 6.1 reduces to

Table 6.3: Computation of corporate consumption for a bank or financial institution.

		+	−
Income:	Sales/fees	xx	
	Dividends/profits received	xx	
	Rents received	xx	
	Royalties received	xx	
	Incoming cash gifts/inheritances	xx	
Expenses:	Payroll		xx
	Materials/components/inputs		xx
	Dividends/profits paid out		xx
	Rents paid		xx
	Royalties paid		xx
	Outgoing cash gifts		xx
Dissavings:	Deposits accepted	xx	
	Sales of investments	xx	
	Repayments of lendings	xx	
Savings:	Withdrawals paid out		xx
	Investments		xx
	Lendings		xx
	Total charges	xx	
	Total deductions		xx
Consumption:	(charges − deductions)	xx	

Table 6.3.

Note that there are *no refunds for negative FDET*. Therefore the deduction for outgoing dividends/profits is of no value unless the company reports sufficient income to pay both the dividends/profits and a non-negative FDET. This imposes a limit on transfer-pricing activity.

If the corporation is a religious or charitable institution (including a hospital or nursing home or educational institution), it should not pay DET. But let us imagine for a moment that it *is* subject to DET. Its lendings and repayments of lendings are as for a non-financial corporation. Because it is a charity, it is not taxed on incoming gifts and bequests (although it may still give gifts to other charities or needy individuals), and does not pay out dividends or profits. Thus Table 6.1 reduces to Table 6.4. Now because the charity receives gifts without having them included in taxable consumption, it should be able to maintain negative taxable consumption and thereby avoid any DET liability. Should one

Table 6.4: Computation of consumption for a religious or charitable institution.

		+	−
Income:	Sales/fees	xx	
	Dividends/profits received	xx	
	Rents received	xx	
	Royalties received	xx	
Expenses:	Payroll		xx
	Materials/components/inputs		xx
	Rents paid		xx
	Royalties paid		xx
	Outgoing cash gifts		xx
Dissavings:	Registered borrowings	xx	
	Sales of investments	xx	
	Withdrawals	xx	
Savings:	Repayments of registered borrowings		xx
	Investments		xx
	Deposits		xx
	Total charges	xx	
	Total deductions		xx
Consumption:	(charges − deductions)	xx	

therefore exempt all charities from DET? Or should one make them subject to DET on the assumption that if they really are charities, they will be able to reduce their DET liability to zero? In other words, could the computation of DET liability be a substitute for other forms of auditing to which charities are subjected in order to ensure their *bona fides*? To answer this question, a competent researcher could compute the taxable consumption for a sample of respected charities and see how many of them would pass a negative-taxable-consumption test.

6.4.1 What happened to FBT?

Expenses incurred by an employer in providing fringe benefits for its employees are normally consumption expenses, in which case they are not deductible as wage/salary expenses. The result is that fringe benefits are taxed in the hands of the employer, whereas wages/salaries are taxable in the hands of the employees. Thus the DET automatically taxes fringe benefits without imposing the heavy compliance costs of the old FBT.

Exceptions include employee share plans and employer-funded superannuation contributions, which are obviously investments rather than consumption expenses. Because these investments are made on behalf of employees, they count as wages/salaries—in which case, if we must have compulsory superannuation, the responsibility might as well rest with employees as suggested in Section 4.3.

What about employer-funded childcare? On the one hand, childcare expenses are consumption and as such should not be deductible. On the other, many workers with children would find it uneconomic to seek employment if childcare were not provided by the employer. Hence some childcare expenses, although not all, are equal-opportunity expenses and as such should be refunded by the Commonwealth (Step 17). A reasonable compromise is to allow employers to claim a deduction for employer-funded childcare, including salaries. This would be consistent with the present practice of exempting childcare from FBT. For simplicity, childcare should be treated as part of the employer's business—there should not be one set of rules for the crèche and another for the rest of the business.

6.4.2 What happened to franked dividends?

Under an income tax regime, *franked dividends* are dividends from company profits on which the company has already paid tax. A credit for this tax is subtracted from the shareholder's tax bill, thereby avoiding double taxation of dividends—and adding considerable complexity to the tax system.

An FDET automatically avoids double taxation of dividends. Under an FDET, dividends paid to shareholders are not consumed by the company, so they are deductible for the company and taxable for the shareholders. There are no franked dividends, no franking credits, and no opportunities for rorts involving the transfer of franking credits from one person to another.

6.4.3 What happened to double tax relief?

While Subsection 6.4.2 (above) refers to double taxation of dividends, the more usual meaning of "double taxation" is taxation of the same income by two different countries. For example, if a citizen of one country invests in another, the tax laws in the two countries may be such that the income from the investment would be taxed in both countries unless preventive steps were taken. Because double taxation is an obvious disincentive to investment and job-creation, countries attempt to prevent it by entering into *double tax treaties*. For example, if a citizen of country A buys shares in a company in country B, country B might withhold tax on dividends paid by the company, and country A might grant a credit for that tax. In return, country B would grant the same treatment or some alternative treatment to country A.

Suppose that Australia has an FDET, and suppose that you, being a citizen of Australia, buy shares in a company in another country that has a withholding tax on dividends. Under the FDET, you buy the shares out of pre-tax income and pay tax on the dividends. If the Australian Government were to grant a credit for the foreign withholding tax, it would lose twice: it would forgo tax on the share purchase in order to help you pay a foreign tax, instead of an Australian tax, on the dividends. It is a noble thing to give aid to needy countries, but one would not wish to give aid to a rich country just because it has an antiquated tax system. To avoid such unwarranted largesse, the Australian Government could[9]

- disallow tax deductions for purchases of shares in a country with a withholding tax, *or*

- allow the usual deductions for purchases of foreign shares, but disallow credits for foreign withholding taxes.

The second option is to be preferred because it is makes no distinction between Australian and foreign share purchases, and consequently has a lower compliance cost.

Now suppose that Australia has a FDET, and that a citizen of another country buys shares in an Australian company. Should the company be required to withhold tax on dividends paid to the foreign investor? It depends on the terms of any double tax treaty between Australia and that the other country. I do not have any knowledge that would enable me to comment on specific cases, but the following general principles seem reasonable:

- If the other country also has a DET, each country should grant deductions for investments in the other country and should not impose withholding taxes on dividends (a free trade agreement).

- If the other country has an income tax regime with no withholding tax on dividends, Australia should grant deductions for investments in that country and should not impose a withholding tax on dividends paid to that country.

[9] Meade report, pp. 438–42; Cooper [5], p. 66.

- If the other country has an income tax regime with a withholding tax on dividends, Australia should grant deductions for investments in that country, disallow credits for withholding tax paid in that country, impose a similar withholding tax on dividends paid to that country, and make a standing offer to drop the withholding tax as soon as the other country does likewise.

6.4.4 What happened to resource rent tax?

If the income derived from an activity or asset cannot be justified as an incentive for engaging in that activity or creating that asset, the income is called an *economic rent*. Because economic rents have no value as incentives, taxes on economic rents have no deadweight costs other than administrative costs. Hence, if one wishes to minimise deadweight—which is the *real* burden of taxation—one should tax economic rents before taxing anything else.

If you are to be persuaded to invest in a company, the expected returns must be sufficient to compensate you for the alternative uses of your money (opportunity cost) and for the risk of losing your money (risk premium). If the returns are higher than would be necessary to persuade you to invest, the excess is economic rent.

Investments in resources (mining and drilling) sometimes produce very high returns. It is said that such returns can be subjected to heavy *excess profit taxes* or *resource rent taxes* (RRTs) without causing deadweight. Against this, it is argued that the "asymmetry" of RRTs is a disincentive to risk-taking. If a resource venture makes more profit than is necessary to justify the investment, an RRT allows the Government to share in the excess; but if the venture makes less profit than is necessary, an RRT does not force the Government to share in the shortfall. This one-sided response forces the resource company to *increase* its estimate of what is an adequate expected rate of return, with the result that some viable projects do not go ahead.[10]

A better reason why resource companies are exceptionally worthy of taxation is that resources are non-renewable. If a tax causes an agricultural, manufacturing or service enterprise to become uneconomic for a time, the business lost during that time is lost forever. But if a tax causes a resource enterprise to become uneconomic for a time, the exploitation of the resource is merely delayed. The resource can only be exploited once; to delay its exploitation is to conserve it. The risk of *delaying* a mining or drilling operation through ex-

[10] R. Ball & J. Bowers, *The Resource Rent Tax: a penalty on risk-taking* (St. Leonards, NSW: Centre for Independent Studies, 1984).

cessive taxation is obviously more acceptable than the risk of *preventing* some other form of industry.[11] This observation, together with the desire to conserve natural resources and not give away too much of their value to multinational interests, has encouraged nations to impose special taxes, including excess profit taxes, on mining and drilling. In Australia, the Commonwealth imposes a 40% RRT on excess profits within its jurisdiction.

Because a DET does not involve a definition of profit, an RRT does not seem to fit into the DET framework. A simpler way to tax resource rents is to impose a *royalty* (a charge resembling an excise or sales tax) on the mineral being extracted (Step 8). Indeed, the States already impose such royalties. (N.B.: Mineral royalties, also called mining royalties, are not to be confused with the "royalties" on patents or copyright which are used in the calculation of DET.)

The philosophical justification for mineral royalties is that the mineral resources of a state or nation are the property of the people, who are represented by their government. The royalty on a particular mineral is the price at which the mining company buys the mineral from the people. When the price has been paid, the mineral become the property of the company, to be disposed of as the company sees fit. Understood in this way, a royalty is not a tax but a purchase price (hence State mining royalties are not classified as excises, which would be unconstitutional). Like any price, the royalty is determined by the market: if the government raises the price too high, it gets no buyers and no revenue; if it drops the price too low, the additional volume fails to compensate for the lower price. To this argument, I anticipate two objections:

1. Mineral royalties make resource exports less competitive.

2. Mineral royalties are taxes on business inputs—fuel, raw materials, etc.—which are built into the prices of exports, especially manufactured exports.

My responses are:

1. Mineral export prices are determined by demand and competition. For the most profitable mines, these prices so greatly exceed the costs of extraction that a royalty merely cuts into the excess profit margin (economic rent) without affecting price competitiveness. Less profitable mines may indeed be rendered uncompetitive by a royalty, but it is not in the national interest to accelerate the depletion of a *non-renewable resource* by giving an artificial tax advantage to a less profitable mine, or to diminish the

[11] Hence the Adam Smith quotation with which I began Section 5.6 is arguably a bad example of deadweight.

lifetime revenue obtainable from any one mine by introducing artificial competition.

2. I repeat: a mineral royalty is not a tax, but a purchase price. One can reasonably argue that manufacturers should not pay taxes on inputs, but one cannot reasonably argue that miners should be allowed to steal the property of the people or that manufacturers should be allowed to receive the stolen property.

   Furthermore, resource inputs are fundamentally different from other business inputs—such as capital, labour, skill and knowledge—in that they are non-renewable. To reduce the prices of resource inputs in the short term is to accelerate their depletion and *increase* their prices in the long term.

   Besides, not every mineral will rise in price. If one supplier of a particular mineral has a large competitive advantage conferring a virtual monopoly in the local market, the resource royalty will cut into the supplier's excess profits without affecting downstream prices.

Because mining royalties are imposed by the States, which compete with each other to attract investment, the royalties are unnecessarily low and the people are short-changed for their mineral resources. If one State has an unusually low royalty for a particular mineral, marginal mines in that State can be brought into production at the same time as more profitable mines in another State, so that the nation's mineral resources are prematurely depleted.

If the Commonwealth were to take over resource royalties from the States (Step 8), the competitive sell-out of Australia's mineral wealth would end. To honour existing contracts and avoid precipitous mine closures, the States must be allowed to maintain existing royalties on existing mines (Step 12). For future mines, however, each mineral should attract a uniform Federal royalty, so that mineral explorers can assess the viability of each proposed operation on the basis of a *known* royalty. To allow for inflation and for fluctuations in mineral prices, the royalty should be *ad valorem* rather than specific. If the royalty for each mineral is initially set at a sufficiently high rate, only the most accessible deposits will be viable. When those deposits have been mined out, the rate can if necessary be lowered in order to allow the exploitation of less accessible deposits, and so on. A high-royalty, low-volume policy maximises both the longevity of the nation's mineral resources and the total revenue raised therefrom.

Fossil fuels, being subject to the carbon excise (Step 8), should be exempt from mining royalties, and the carbon tax rate should be chosen accordingly.

The resulting loss of State revenues can be compensated through the usual fiscal equalisation grants. If the Commonwealth collects royalties on a new mine that would otherwise have been taxed by a State, it is reasonable that the revenue raised (less a small fee or commission) should be refunded to that State.

6.5 A personal FDET

6.5.1 General case

If you are an individual taxpayer, you will not have payroll expenses and will not pay out dividends or profits. Your lendings will be bank deposits and the repayments thereon will be withdrawals. Personal superannuation contributions are counted as investments, and withdrawals from superannuation funds—whether the withdrawals are lump sums or annuities of any kind, and whether the contributions were nominally made by you or your employer—are counted as sales of investments. Thus Table 6.1 reduces to Table 6.5.

A company can be expected to manage its affairs so that it has money set aside to pay its taxes when they fall due at the end of each year (or other accounting period). Indeed, a well-managed company would *prefer* to pay its taxes as a lump sum in arrears, so that it can earn interest on the reserved funds in the mean time. Individual taxpayers, in contrast, prefer a pay-as-you-go system in which they pay their taxes automatically as the necessary funds come to hand. They can tolerate an end-of-year refund, but not an end-of-year bill.

A pay-as-you-go DET is greatly facilitated by a flat rate. Suppose you have chargeable items a and b, and deductible items c and d. Let the tax rate, expressed as a fraction, be R; for example, a 40% tax rate has $R = 0.4$. Then your tax is

$$t = R(a + b - c - d) . \tag{6.5}$$

Using the distributive law, this can be written (for example) as

$$t = R(a - c) + Rb - Rd . \tag{6.6}$$

Now if you deduct c from a and pay tax as-you-go on the difference, you will pay $R(a - c)$; and if you pay-as-you-go on b, you will pay Rb. Your remaining tax liability is then $-Rd$, indicating that you can expect a refund of Rd at the end of the year. Notice that any item on which you can pay-as-you-go at the standard rate, or claim-as-you-go at the standard rate, disappears from the equation at the end of the year. Likewise, any item in Table 6.5 on which you can pay-as-you-go or claim-as-you-go will disappear from the table from which you compute your end-of-year tax bill.

Table 6.5: Computation of consumption for an individual taxpayer.

		+	−
Income:	Wages/salary	xx	
	Sales/fees	xx	
	Dividends/profits received	xx	
	Rents received	xx	
	Royalties received	xx	
	Incoming cash gifts/inheritances	xx	
Expenses:	Materials/components/inputs		xx
	Rents paid		xx
	Royalties paid		xx
	Outgoing cash gifts/bequests		xx
Dissavings:	Registered borrowings	xx	
	Sales of investments	xx	
	Withdrawals	xx	
Savings:	Repayments of registered borrowings		xx
	Investments		xx
	Deposits		xx
	Total charges	xx	
	Total deductions		xx
Consumption:	(charges − deductions)	xx	

In Table 6.5, the pay-as-you-go and claim-as-you-go provisions (loosely called PAYE provisions) might work like this. Your pre-tax wages/salary and any received dividends, profits, rents or royalties are paid into your bank account. Your bank expects them and remits tax from them. Similarly, you bank any sales proceeds or fees with instructions to remit tax. If you pay rent for the purpose of earning an income (not residential rent, which is consumption), you instruct your bank to deduct the rent from your income before deducting tax. Life insurance premiums and superannuation contributions (both under Investments) and repayments of registered borrowings receive similar treatment. Withdrawals from superannuation funds count as sales of investments; these are paid into the bank, which remits tax on them. If an individual donates money to an approved charity, the donation is made out of after-tax income, and the Government tops up the donation to the equivalent pre-tax amount by directly subsidising all funds collected from individual donors. All these items disappear from Table 6.5.

Table 6.6: Remaining consumption (tax return) for an individual taxpayer after PAYE provisions.

		+	−
Income:	Cash gifts/inheritances	xx	
Expenses:	Materials/components/inputs		xx
	Royalties paid		xx
	Cash bequests and unsubsidised cash gifts		xx
Dissavings:	Registered borrowings	xx	
	Remaining sales of investments	xx	
Savings:	Remaining investments		xx
	Total charges	xx	
	Total deductions		xx
Consumption:	(charges − deductions)	xx	

Concerning Withdrawals and Deposits, note that the excess of Withdrawals over Deposits is equal to the nominal interest plus the decrease in nominal balances, or *the real interest plus the decrease in real balances*. Over the course of your lifetime, changes in real balances must cancel out—you came into this world with nothing, and shall surely leave it with nothing. Under a flat tax, the associated tax contributions must also cancel out; in other words, to tax changes in real balances is simply to transfer tax liability from one year to another. Moreover, bank balances tend to constitute only a small fraction of one's fortune because of the low returns. So we might as well ignore the balance changes and consider only the real interest—that is, ignore withdrawals and deposits and require the bank to withhold tax on the real interest.

Problem: If ordinary deposits and withdrawals are not counted as savings and dissavings, the proceeds of an asset sale are not deemed to be reinvested if they are simply left in the bank. If the sale occurs just before the end of an accounting period, and if the proceeds are due to be reinvested early in the following period, the sale proceeds will be taxed as consumption and the tax payment will prevent the intended reinvestment. *Solution:* Allow a "period of grace" during which the deposit can be reinvested or moved into a holding account for rollovers.

The leftovers after the PAYE provisions, including the simplified treatment of withdrawals and deposits, are shown in Table 6.6. This is the format of a relatively *complex* tax return.

Of course the GR and supplementary benefits (Steps 1 and 2) are not chargeable income items. The purpose of the GR is to allow every citizen to sustain a basic level of consumption without being subject to FDET. Some of the supplementary benefits, namely child allowances and study/training allowances, are intended to compensate for increased expenses, and should be tax-free for the same reason as the GR. The others, namely sickness/maternity benefits, carers' benefits and age/disability pensions, are intended (at least in part) to compensate for the inability to work. If they were taxed, they would need to be increased to compensate for the tax; so it is simpler to leave them untaxed. The total of the GR and the supplementary benefits is, in effect, the FDET-free threshold, and replaces the present income-tax threshold. But this FDET "threshold" does not complicate the PAYE process; the banks simply ignore the direct deposits of the GR and supplementary benefits, treating them as if they were savings.

At this writing, the income-tax threshold guarantees that no one pays PIT on the first $5400 of annual income. But it does not guarantee that anyone actually gets $5400 per annum or any other amount. The GR, unlike the PIT threshold, *does* guarantee a minimum income. It is not just a tax-free bucket to be filled with income from somewhere; it is already filled.

Obviously the PAYE process involves a considerable amount of work for the bank. But, now that banks charge fees on almost all accounts, it is reasonable to expect them to earn those fees. It is *not* reasonable to impose any PAYE burden on employers, as it would discourage employment. Moreover, the bank is more likely to have the necessary expertise. To ensure that the bank receives your entire pre-tax wage/salary, your employer would no longer deduct after-tax items such as union dues and staff club membership fees (both of which are consumption); these would be paid by the bank out of your after-tax income.

6.5.2 Simple case

Now let us go back to Table 6.5 and make the following simplifying assumptions. You have no chargeable income except wages/salary. You have no work-related expenses apart from consumption. You do not work from home, so your home mortgage or rent is not even partly deductible. You do not pay royalties. Your deductible gifts are all given to registered charities. You have not just died, so you have not given a bequest. This year you have not borrowed money to invest or disposed of any investments. Your only deductible investments this year are superannuation contributions and life insurance premiums. Thus Table 6.5 reduces to Table 6.7.

Now consider the PAYE process. As usual, withdrawals and deposits are ignored and your bank withholds tax on real interest. Your bank received your

Table 6.7: Computation of consumption for a wage/salary earner (simple case).

		+	−
Income:	Wages/salary	xx	
Dissavings:	Withdrawals	xx	
Savings:	Insurance & super		xx
	Deposits		xx
	Total charges	xx	
	Total deductions		xx
Consumption:	(charges − deductions)	xx	

wages/salary, deducts and pays your insurance premiums and super contributions, and deducts and remits tax on the remainder. Thus all entries in Table 6.7 are disposed of, and *you do not need to submit a tax return*.

From Subsection 6.5.1, the complications that can be handled without a tax return include incoming rents, royalties, dividends, profits, sales proceeds and fees, outgoing rents and repayments of registered borrowings. From Table 6.6, the complications that *do* require a tax return are incoming cash gifts and inheritances, business inputs (other than consumption and investments), outgoing royalties and unsubsidised cash gifts, outgoing cash bequests (for a deceased taxpayer), registered borrowings, remaining investments (after insurance and superannuation), and remaining sales of investments (after withdrawals from superannuation). As a result, most taxpayers in most years would not need to submit tax returns.

Notice that the modified treatment of deposits and withdrawals is instrumental in the elimination of tax returns for most taxpayers. Furthermore, if deposits and withdrawals were treated as savings and dissavings, people who run down their bank accounts during lean times would incur a tax liability for dissaving, but have no money left with which to pay the tax. The modified treatment avoids such hardship.

6.5.3 What happened to the family home exemption?

Nothing, because expenditure on your own place of residence is consumption. Your home loan is unregistered (not taxable) and your repayments, including principal and interest, are non-deductible. The home is also an unregistered asset, so that the purchase price is non-deductible and any capital gain on resale is non-taxable. Maintenance expenses and insurance premiums are non-deductible, and any insurance payouts are non-taxable. If you live in rented accommodation, the rent is also consumption and consequently non-deductible. All these conditions are the same as under the old income tax regime. So as far as the *occupant* of the home is concerned, whether the occupant is an owner or tenant, the introduction of a DET does not change anything, and no transitional provisions are required.

If you are a property investor, however, the rules change. When you borrow money for an investment property, the loan is registered (taxable) and your repayments, including principal and interest, are deductible. The home is also a registered asset, so that the purchase price is deductible (that is, the loan can be rolled over) and the resale price is taxable. Maintenance expenses and insurance premiums are deductible, and any insurance payouts are taxable if the asset is written off. Rent received from the tenant is taxable. "Negative gearing" is allowed in the sense that if your loan repayments exceed the rent, the combined effect is to reduce your taxable income. The main change effected by the introduction of a DET is that you can buy the property out of *pre-tax* income rather than after-tax income. This allows more people to become investors if they wish.

Having explained the position of the landlord, I can now give another reason why owner-occupied housing is not treated as a registered asset under a DET. If you are an owner-occupant, you are both landlord and tenant, renting the home from yourself! The rent that you are deemed to receive from yourself is called *imputed rent*. Now suppose your house is treated as a registered asset. As landlord, you pay tax on the rent; but as tenant, you do *not* get a deduction for the rent. The result is that the imputed rent is treated as taxable income. Needless to say, a tax on imputed rent is a political stink bomb. Most voters would not understand the reasoning behind it, while the remainder would not want to understand, and political rivals would see to it that the level of voter understanding remained as low as possible. It can't be done. Fortunately the problem is easily avoided by treating expenditure on owner-occupied housing for what it is: consumption.

(In the case of owner-occupied business premises, imputed rent can be ignored. The rent is taxable for the occupant as landlord, but deductible for the occupant as tenant, so the tax on the rent cancels out.)

The present income tax regime allows *negative gearing* of investment loans; for example, if you borrow money to buy a house and let it to tenants, the interest on the loan is fully tax-deductible even if it exceeds the rent. The introduction of a DET makes negative gearing more generous in that it allows a deduction for the entire loan repayment—principal and interest, and not just the interest. While this may seem unduly generous to wealthy property investors, it also tends to increase the supply of rental accommodation and reduce accommodation costs for low income earners. If the tax system encourages the provision of rental accommodation, competition between landlords ensures that the tax savings are passed on to tenants in the form of lower rents. If the tax system *discourages* the provision of rental accommodation, competition between tenants ensures that the tenants shoulder the tax burden in the form of higher rents. Furthermore, any attempt to eliminate negative gearing would complicate the DET, increasing its compliance cost and deadweight cost.

6.5.4 Are prizes taxable?

If a prize is taxable in the hand of the winner, it must be deductible for the donor or promoter in order to avoid double taxation. In most cases, this procedure would not result in any broadening of the tax base, but would simply shift tax liability from the promoter to the winner. This would be appropriate for a professional tennis tournament, and perhaps also for a TV game show. It would perhaps be less appropriate when the promoter is a charitable organisation that cannot benefit from a tax deduction; in this case, a tax on the prize would seem fair to the winner but unfair to the promoter. In the case of a charitable lottery, the “donors” of the prize are the ticket purchasers, so that a tax on the prize would require a deduction for ticket prices. No government would enter into such an arrangement, because the revenue forgone through the deduction for ticket prices would exceed the revenue raised by taxing the prize.

6.5.5 Work-related expenses

> Who serves as a soldier at his own expense?
>
> — 1 Corinthians 9:7a, RSV.

The notion that work-related expenses are deductible against income tax is a joke. If the largest such expense—namely travel to and from work—is not deductible, why bother with the rest?

As noted in Section 6.3, many of the work-related expenses that clutter income-tax returns are *consumption* and consequently not deductible under a DET. If such expenses are substantial and genuinely work-related, they ought to be the responsibility of the employer—not the Government, and most certainly not the employee. For example, I find it quite obscene that a junior delivery driver can be required to provide his own vehicle, and that he can be paid a fixed fee for each delivery regardless of distance, regardless of how much damage is done to his car by irate or drunken customers, and regardless of the widespread refusal of insurance companies to cover vehicles used in this manner.[12] I find it similarly obscene that a casual worker can be required to work arbitrarily short shifts, even if the payment for a shift is insufficient to cover transport costs, and may need to work the occasional loss-making shift in order to hold on to the job. Under conditions of full employment, with employers competing against each other to attract labour, workers would not need to tolerate such abuses. In the mean time, there must be statutory limits on the expenses that employers may impose on their workers; without such protection, enthusiastic and unsuspecting juniors may find themselves paying for work instead of working for pay.

6.5.6 Is the FDET a death duty?

No, because an inheritance *never* needs to be sold in order to pay FDET; indeed, because the FDET taxes sales of assets but not acquisitions of assets, it actively discourages the sale of an inheritance.

Death duties, properly so called, are of two kinds: an *estate duty* is a tax imposed on a deceased estate before it passes to the heir(s), whereas an *inheritance tax* is imposed on the portion passing to each heir, treating the inheritance as taxable income. Death duties are unpopular because if the estate or inheritance has insufficient liquidity, some or all of it may need to be sold in order to pay the tax. Such a sale requires a wealthy buyer and therefore tends to concentrate assets in fewer hands. This defeats the alleged purpose of death duties, which is to assist the equitable distribution of wealth. If the inherited asset is a business—such as a farm—and if the heir has worked without pay in the business throughout her adult life, the need to sell the business in order to pay death duties causes severe hardship and injustice by depriving the heir of her hard-earned livelihood.

An obvious way to avoid death duties is to give away one's assets before death. To prevent this, death duties are invariably accompanied by *gift duties*, which tax gifts as if they were bequests. Like death duties, gift duties may

[12] If a delivery driver seeks insurance and is refused, he may be branded for life as a driver who has been "refused insurance", in which case his future premiums will be adjusted accordingly. But most drivers simply assume—incorrectly—that they are covered by their existing policies. Hence some employers cover themselves against property liability by ostensibly requiring their delivery drivers to be insured, but not telling them that their existing insurance policies are rendered void by their employment.

require assets to be sold in order to pay tax.

Under a DET, a cash inheritance is deductible for the benefactor's estate and taxable in the hand of the heir, and even then the tax can be delayed by investing the cash. An inherited non-cash asset, whether it was purchased out of pre-tax or after-tax income, has no effect on the tax liability of the benefactor's estate. It is taxable in the hand of the heir only if it is sold, in which case it is declared as an asset sale by the heir, and even then the sale price can be rolled over into an investment. If an unregistered asset is bequeathed, and if the heir sells it and consumes the proceeds, the result is that an asset purchased with after-tax income is taxed again when it is consumed. This is the only case in which the DET has any resemblance to a conventional inheritance tax, and the resemblance is confined to the aspect of double taxation. Even in this case, the sale of the asset is not forced.

6.5.7 Is the FDET a gift duty?

No, because a gift *never* needs to be sold in order to pay FDET; and again, because the FDET taxes sales of assets but not acquisitions of assets, it actively discourages the sale of a gift.

If you give money to a registered charity, the donation comes out of after-tax income and the Government tops it up to the equivalent pre-tax value. The end result is that the charity gets the pre-tax value and you pay the after-tax value, which is precisely what happens under the old income tax; only the mechanism is different.

We now come to a feature of the DET which is not apparent from the tables. If you give money to a person or organisation other than a registered charity, you have a choice as to whether you declare the gift. If you declare it, it comes out of your pre-tax income and is taxable in the hand of the recipient, and is entered in the tables. If you do not declare it, it comes out of your after-tax income and is untaxed in the hand of the recipient—as under the old income tax—and is not entered in the tables. In either case, the gift is taxed only once—there is no *new* tax on gifts. Of course, to avoid trouble with the ATO, the giver and receiver must agree on whether the gift is declared, and stick to their story.

If you give a non-cash gift, whether it has been purchased out of pre-tax or after-tax income, it has no effect on your tax liability. It is taxable in the hand of the recipient only if it is sold, in which case it is declared as an asset sale by the recipient, and even then the sale price can be rolled over into an investment. If an unregistered asset is given away, and if the recipient sells it and consumes the proceeds, the result is that an asset purchased with after-tax income is taxed again when it is consumed. This is the only case in which the DET has any resemblance to a conventional gift duty, and the resemblance is confined to the aspect of double taxation. Even in this case, the sale of the asset is not forced.

The most common gifts—such as Christmas, birthday and wedding presents—would be undeclared, undeducted and untaxed, as under the old system. A major cash gift—such as the transfer of part of one's estate, made in contemplation of death—would be declared.

6.5.8 Respect your elders!

> Yea, I hated all my labour which I had taken under the sun: because I should leave it unto the man that shall be after me. And who knoweth whether he shall be a wise man or a fool? yet shall he have rule over all my labour wherein I have laboured, and wherein I have shewed myself wise under the sun. This is also vanity.
>
> Therefore I went about to cause my heart to despair of all the labour which I took under the sun. For there is a man whose labour is in wisdom, and in knowledge, and in equity; yet to a man that hath not laboured therein shall he leave it for his portion. This also is vanity and a great evil.
>
> — Ecclesiastes 2:18–21.

As Subsection 6.5.6 makes clear, any attempt to describe a DET as a "death duty" or "inheritance tax" would be mischievous in the extreme. Nevertheless, it may be salutary to explain what a terrible price Australia has paid for the abolition of death duties, and why it is necessary to tax inheritances at least when they merely finance the *consumption* of the heir.

Estate duties imposed by the States were phased out between the mid-1970s and the mid-1980s. Commonwealth estate duties and gift duties were abolished in 1979.[13] The earlier abolition of the pension assets test by the Whitlam government[14] was reasonable in itself, because a means test is just another tax (Section 5.8). But when death duties were also abolished, large estates were placed beyond the reach of the tax system. When such estates were inherited, the absence of any taxes on capital gains allowed the heirs to add to their unearned wealth without paying tax. Untouchable estates, untouchable capital gains, the ageing of the population, and the shrinking of the tax base due

[13] P. Groenewegen, "Taxation and Public Finance", *Australian Encyclopaedia,* 6th Ed. (Australian Geographic P/L, 1996).

[14] S. Garton, *Out of Luck: Poor Australians and social welfare, 1788–1988* (Sydney: Allen & Unwin, 1990), p. 156

to unemployment—not to mention tax avoidance—were the ingredients of the fiscal crisis inherited by the Hawke government in 1983.

In its first Budget, the Hawke government announced a 30% tax on superannuation payouts from deducted contributions. Thus the tax on deducted contributions became a DET, and both undeducted and deducted contributions were taxed only once—on entry and exit respectively. This tax also brought superannuation into line with other investments, including the family home, which were bought with after-tax income and untaxed on sale—i.e. also taxed only once. But there the good news ends. The pension assets test, announced in 1984 with effect from 1985, combined with the super tax to produce a double tax on saving. It was a virtual gift duty inasmuch it could not be avoided by giving away assets. It also gave preferential treatment to home owners and thereby, for the first time in Australia, encouraged diversion of investment from productive enterprises to unproductive real estate.

With the assets test began the sport of harassing the elderly over their financial affairs: hundreds of thousands of aged pensioners, some of whom were ill, and some of whom were no longer in possession of their faculties, were subjected to the inquisitions of the DSS. In the campaign for the Federal election of December 1984, Opposition leader Andrew Peacock waxed indignant on television, leafing through the assets-test questionnaire and declaring "Labor wants to know." Opposition commercials depicted a tearful old woman on the telephone saying "What do all these questions mean, son?"

The Government survived with a reduced majority. In 1985 it introduced the capital gains tax, which plugged some leaks in the double tax on saving, but again granted an exemption to the family home, causing the diversion of yet more capital out of job-creating enterprises and into static real estate.

When the Liberals returned to government in 1996, they forgot their indignation over the pension assets test and attempted to impose huge up-front "accommodation bonds" on entrants to nursing homes. The policy was changed four times, eventually giving way to a system of means-tested daily and annual fees. This means test was yet another tax on saving, equivalent to an income tax or a wealth tax. Thus the double tax on saving became a triple tax on saving.

All these measures—the super tax, the assets test, the CGT and the nursing-home fiasco—are intended to run down the assets of elderly people *before* they die, because governments no longer have the moral fibre to tax those same assets in the hands of their heirs *after* they die. Better to annoy old people in their twilight years than to annoy their heirs who will live to vote in future elections.

A DET is only a single tax on savings, and applies only when those savings are spent. It treats all investments as favourably as the family home, and consequently does not divert capital from job-creating investments to real estate. It does not require vexatious investigation into the affairs of the elderly, and does not tax their assets unless they decide to consume the assets rather than bequeath them. It taxes an inherited asset in the hands of the heir only if the asset is spent on consumption. In so doing, it avoids the need to tax the asset (with a means test) at any earlier time.

6.5.9 Government by example

The DET treatment of superannuation was short-lived, because the Hawke government could not wait for people to retire before helping itself to some of their savings. The 30% exit tax was replaced by a 15% entry tax and 15% exit tax. A 15% earnings tax was also introduced,[15] ostensibly to compensate for the effects of franked dividends. Thus the Government can access your superannuation immediately, but expects you to keep your hands off it until your retire.

Under a DET, you make your superannuation contributions out of pre-tax income, and do not pay tax on your super until you withdraw it. As long as you leave your super alone, the Government also leaves it alone; that is, the Government exercises the same discipline that it demands of its citizens.

Setting an example is one way in which governments can encourage saving. The other is to refrain from penalising savers. There are three reasons[16] why the Federal Government wants to encourage saving:

1. Savings are invested in wealth-creating and job-creating industries;

2. The resulting economic growth expands the tax base and increases revenue;

3. Savers provide for their own retirement and reduce expenditure on pensions.

The third effect is achieved through a means test, which is an additional tax on saving. Those who neglect to save do not incur this additional tax. Putting it another way, those who neglect to save are rewarded with a pension, while those who save miss out. *If the Government really wants to encourage saving, the rewards for saving must be in addition to—not instead of—the rewards for*

[15] N. Whittaker, *Making Money Made Simple*, 8th Ed. (Sydney: Simon & Schuster, 1993), pp. 134–5.

[16] To the list of benefits I could add "Saving reduces our reliance on foreign capital and reduces the current account deficit." I refrain because this benefit is in competition with the increase in investment. To the extent that savings replace foreign capital, they displace foreign investment rather than adding to total investment.

not saving. Therefore the third item on the above list must be repudiated: the Government must be content with the employment growth and the growth in the tax base, and must not also demand a reduction in welfare expenditure. That is another reason why the GR and supplementary benefits must not be means-tested.

6.5.10 Transitional provisions on superannuation?

When the Hawke government changed the rules on superannuation, it distinguished between pre-1983 and post-1983 contributions in order to avoid any suggestion of retrospectivity. No such courtesy was extended to the victims of the assets test or the nursing-home charges; the privileges that they thought they had earned by a lifetime of paying taxes were simply taken away. Moreover, whenever a change is made to the superannuation tax, any attempt to avoid retrospectivity adds another layer of complexity to the final tax calculation, making work for accountants and destroying real jobs. Under an FDET, the present entry tax, earnings tax and exit tax would be replaced by a single exit tax at the full FDET rate. If this were done without any special treatment of past contributions, retirees would pay a higher exit tax than expected. But they would be more than compensated by the abolition of that other super tax: the means test on pensions (Step 2). So there would be no cause for complaint, and no need to avoid retrospectivity: the rules that have accumulated from previous attempts to avoid retrospectivity can simply be swept away.

6.6 Federal-State financial relations

At suburban railway stations in Brisbane, women are raped because the State Government apparently cannot afford to employ night staff or security guards. If a woman catches a night train at a suburban station, she must buy a ticket from a vending machine because the ticket office will be closed. If she discovers that she does not have suitable change for the machine, she must walk away in the dark in search of change; if she boards a train in the hope of buying a ticket from a conductor, she will be fined for fare-dodging. Apparently the State Government can only afford to employ enough conductors to *check* tickets—not to sell them. For reasons like these, women prefer to travel by car. In so doing, they increase their chances of being involved in accidents; hence an unknown fraction of female road-accident victims are actually indirect victims of underfunded, understaffed, State-run public transport systems.

Because the Federal Government does not allow citizens to insure themselves against the full costs of private medical treatment, an increasing percentage of Australians rely on State-run public hospitals, which cannot cope with the demand. Casualties wait on trolleys in the corridors because there are not enough beds. Nurses are so overworked and underpaid that some are driven to strike, while others abandon the profession altogether. Doctors, exhausted by 30-hour shifts, make mistakes on the job and have accidents on the way home. The unemployed go without dental treatment. Surgery waiting lists grow. Governments respond to waiting lists, not by increasing funding, but by threatening to remove funding from hospitals that fail to meet government targets. Hospital staff, realising that they can neither meet the targets nor afford to lose funding, are tempted to give the *appearance* of meeting targets by preventing patients from being placed on waiting lists in the first place.

Legal aid for civil cases is virtually unavailable, with the result that the average citizen does not enjoy the protection of the law, while unscrupulous dealers can breach warranties and contracts with impunity. Prisons are overcrowded and understaffed, forcing inappropriate classifications of prisoners and inviting breaches of security. Victims of violent crime receive less compensation than victims of defamation who are rich enough to sue. If you are found *not guilty* of a criminal offence, you get no refund of your legal expenses, no compensation for any time spent in prison awaiting trial, no compensation for lost income, no compensation for having been defamed by the Crown, and no apology—to be accused is to be punished. So much for the presumption of innocence.

Constitutionally, the States are partly or fully responsible for the above matters. However, while State and local governments spend about 50% of all tax revenue raised in Australia, they raise only 20% of it [1, p. 11]; for the rest, they depend on Federal grants. This mismatch between taxing and spending, known as *vertical fiscal imbalance*, is a standing invitation to mischief. The Federal Government likes to reduce its expenditure by gradually cutting grants to the States, while the States, for base political reasons, are reluctant to compensate by increasing their own taxes. As a result, State services are chronically underfunded. The States blame the Commonwealth, citing cuts in Federal grants, while the Commonwealth blames the States, citing their constitutional responsibilities. To put an end to these games, *the States must be made responsible for raising the revenue that they spend*.

Under s. 90 of the Constitution, the States cannot impose customs or excise duties. The High Court has interpreted this prohibition has applying to all indirect taxes on goods. Hence the States cannot impose sales taxes or a GST. While the Constitution does not of itself prevent the States from imposing income taxes, ss. 94 and 96 give the Commonwealth sweeping financial powers, which the Commonwealth uses as bargaining chips to restrict the taxing options of the States. As a result of one such "agreement", the States lost the right to impose income tax in 1942. They regained it between 1977 and 1983 [1, p. 95] but did not use it, partly because the Commonwealth did not "make room" by cutting its own income tax. Payroll tax, which was introduced by the Commonwealth in 1941 and passed to the States in 1971 [6, p. 23], is potentially simple, efficient and lucrative—and, contrary to popular opinion, less damaging to employment than income tax—but has been frittered away by vote-grubbing thresholds and exemptions. Land tax, which is constitutionally available to both the Commonwealth and the States, is potentially the simplest, fairest and most efficient of all taxes [7, 8, 11, 12]. Unfortunately, no government has yet been able to work out how to introduce a broad-based land tax in such a way as to gain the political advantage (which is considerable) before paying the political price.[17] The end result of these machinations is that the States do not have access to a broad-based tax that can yield sufficient revenue to fund their spending responsibilities.

Reserving GST revenue for the States, as proposed by the Howard government, is no solution, because the GST would still be a Federal tax and its revenue would be distributed according to a Federal formula. The mechanism for setting the GST rate might allow the States *collectively* to determine how much Federal revenue they get, but it would not make the States *individually* responsible for raising their own revenue, and therefore would not prevent one State government from blaming some other government for its fiscal problems. Although the GST does not yet exist, the States are already brawling over the carve-up of GST revenue.

Under Steps 11 and 12, the States gain access to the broadest tax base of all: consumption—including both personal consumption and corporate consumption. The Commonwealth cuts grants to the States, then cuts its FDET rate to "make room" for the States to impose their own FDET surcharge. When they have done so, the following proposals are put to a referendum as a single question:

(a). that the States cannot impose any taxes except land taxes, mining royalties on existing mines, and surcharges on personal and corporate FDET,

(b). that each State may determine the rate of its FDET surcharge, but must impose the same rate on personal and corporate FDET, and must impose the surcharge on the same range of transactions as are subject to the corresponding Federal tax.

[17] I have suggested a solution in reference [21].

Part (a) prevents the introduction of any new State taxes, and abolishes most existing State taxes including payroll tax, financial institutions duty (FID), bank account debit (BAD) tax, stamp duties and gambling taxes. In other words, part (a) guarantees the success of the referendum. Part (b) makes the States fully responsible for their own revenue-raising, but prevents them from complicating the tax system in any way, and prevents them from bribing international investors with tax concessions not available to ordinary citizens.

In the proposed scheme, casinos and licensed clubs pay FDET like all other businesses, and the States get their usual surcharge. As the States are no longer dependent on specific gambling taxes, and stand to benefit from taxes on other business activities that decline in the presence of gambling houses, they have an incentive to do something about compulsive gambling. Banning the use of credit cards in gambling houses would be a good start.

The additional compliance cost caused by a State FDET surcharge is negligible, because the Federal and State components are calculated on the same tax base. In practice, the agent who calculates and remits the tax (usually the bank) would send the *total* tax to the appropriate State branch of the ATO, which would divide the tax between the State and Federal governments. The ATO might reasonably charge the State a small fee or commission for this service.

The only objection to a State FDET surcharge is that it would allow the total FDET rate to vary from State to State. The States might engage in competitive rate cuts in their efforts to attract investment, and those States with less developed infrastructure would be unable to compete. The most savage cuts in State expenditure would be in areas where expenditure in one State could result in benefits to other States (positive externalities); the most obvious example is education. If significant differences in FDET rates were to become entrenched, corporations with branches in several States would be tempted to adopt transfer-pricing strategies designed to shift their taxable consumption from high-FDET States to low-FDET States. For these reasons, Step 11 calls for the retention of *matching grants*, by which the Federal Government encourages the States to spend in ways that lead to positive externalities, and also for the retention of *fiscal equalisation grants* from the Federal Government to poorer States, so that those States do not need to raise their FDET rates too far above the rates in richer States. Of course the retention of some Federal grants implies the retention of some scope for disputes over which government is to blame for fiscal difficulties. However, if Federal grants are restricted to matching and fiscal equalisation, the scope for disputes is correspondingly restricted, and can be restricted further by tying the fiscal equalisation grants to a clear formula which takes account of mining royalties (Subsection 6.4.4). That, I suggest, is as close as one can get to the elimination of buck-passing in a federal system of government.

6.7 Conclusion

Subsection 6.1.1 ended with a list of reasons why income tax is often inequitable. We can now list the corresponding improvements brought about by an FDET.

1. Most so-called work-related expenses are consumption and consequently are not deductible under an FDET. As these expenses disappear from the calculation, so do the associated inequities.

2. A flat rate with no income threshold (excluding the GR and supplementary benefits) removes any possibility of anomalies caused by single or multiple application of the threshold, and ensures that any shuffling of income from one person to another has no effect on the total tax bill.

3. The PAYE procedures for FDET require no input from the employer and are not a deterrent to employment.

Furthermore, an FDET is simpler than the present income tax system (by about two orders of magnitude) and avoids double taxation of capital, giving more encouragement to saving and investment. For these reasons an FDET is guaranteed to have a lower deadweight cost than an income tax system that raises the same amount of revenue.

Chapter 7

GST: a simplified indirect tax

Myth: There is no tax on bread.

Fact: About half the cost of making a loaf of bread is hidden tax,[1] including:

- excise on the diesel fuel used in transporting the ingredients,
- wholesale sales tax (WST) on vehicles, machinery and baking equipment,
- payroll tax paid by the various businesses between the farmer and the consumer,
- stamp duties on the leasing, purchasing and insurance of premises used by the participating businesses, and
- financial institutions duty (FID) and bank account debit tax (BAD tax) paid on the bank accounts of the participating businesses,

not to mention the compliance costs which are incurred in calculating and paying all the above taxes, and which are also passed on to the consumer in the price of the loaf.

Those much-maligned folk who want to impose a new tax on bread—the Goods and Services Tax—also want to abolish most of the old ones; indeed, they want to introduce a GST *because* they want to abolish certain other taxes.

[1] *Courier-Mail*, Brisbane, June 21, 1997, p. 15. The information apparently comes from a speech delivered by Peter Costello on June 16, 1997.

Every GST proposal that has ever been put before the Australian people has involved massive reductions in diesel fuel excise and the total abolition of WST. The scheme proposed in this book also eliminates payroll tax, stamp duties and FID/BAD (Step 12), and cuts labour costs by subsidising wages (Steps 1 and 3).

All these facts merely defend the GST against suggestions that it will increase the price of bread. They do not touch on the real purpose of introducing a GST, which is to *limit inflation while maintaining low interest rates*. I want a GST because I want perpetual low interest rates. This benefit can be obtained only if the GST rate is *variable*, as we shall see in Section 7.2. But first it is necessary to explain what a GST is.

7.1 How it works

7.1.1 The value-added mechanism

"Goods and Services Tax" or "GST" is the name used in New Zealand, Canada and Australia for a *Value-Added Tax* (VAT). In theory a VAT can be levied on goods alone or services alone, but in practice it is levied on both. A VAT is not the only kind of tax that can be levied on both goods and services, but by convention the name "GST" is reserved for a VAT on goods and services. Hence, in practice, the names "GST" and "VAT" are almost synonymous. I say "almost" because the term "Goods and Services Tax", which was first used in New Zealand, emphasises the *uniformity* of the tax; New Zealand's GST is the most uniform VAT in the world, with the fewest exemptions and zero-ratings. When Australian reformers advocate a "GST" rather than a "VAT", they indicate a preference for the simplicity of the New Zealand model. Canada's "GST", which is less uniform than New Zealand's, is a departure from this convention; admirers of the New Zealand system might say that Canada's "GST" should have been called a VAT.

The value-added concept is well illustrated by an example given in the promotional literature for the Howard government's tax package. Suppose a timber yard sells some timber to a cabinetmaker, who works it up into a desk and sells it to a retailer, who sells it to the consumer. The exchanges of money and goods are shown in Table 7.1.

In the table, the timber yard, cabinetmaker, retailer and consumer are called *agents* (first column). The *value added* by each agent (second column) is the excess of the output value (fourth column, line below) over the input value (fourth column, line above). The flow of goods between agents (third column) is the output from the agent above and the input to the agent below. The *total*

Table 7.1: Example of the value-added mechanism for a 10% GST applied to goods. Single arrows show the flow of goods and sale prices. Double arrows show the flow of GST.

Agent	Value added	Goods	Total value	GST added	Sale price	Net GST remitted
Timber yard	\$100					\$10 ⇒
		↓ Timber	\$100	\$10 ⇑	\$110 ↑	
Cabinetmaker	\$50					\$5 ⇒
		↓ Desk	\$150	\$15 ⇑	\$165 ↑	
Retailer	\$100					\$10 ⇒
		↓ Desk	\$250	\$25 ⇑	\$275 ↑	
Consumer						

value (fourth column) is the sum of the values added on previous (higher) rows of the table; the total value is the output value for the agent above and the input value for the agent below. To this total value, we add 10% tax (fifth column) to obtain the sale price (sixth column). *Each agent collects the GST from the customer (below) and claims a refund for GST paid to the supplier (above).* Hence the GST *remitted* by each agent to the ATO (seventh column) is the GST received in the sale price of the output (fifth column, line below) minus the GST paid in the sale price of the input (fifth column, line above). Notice that the GST remitted is 10% of the value added (second column); hence the name "value-added tax". To show that this relationship holds in general, let the GST rate, expressed as a fraction, be r ; for example, a 10% GST has $r = 0.1$. Then the GST remitted by each agent is

$$\begin{aligned} &\text{GST remitted} \\ &\quad = r \times \text{output value} - r \times \text{input value} && (7.1) \\ &\quad = r \times (\text{output value} - \text{input value}) && (7.2) \\ &\quad = r \times \text{value added}\,. && (7.3) \end{aligned}$$

7.1.2 Simplification: GST-inclusive prices

In the system used in New Zealand—and proposed by the Howard government and preferred in this book—nobody adds GST to a tax-free price in order to work out a tax-inclusive price, because *all* prices are tax-inclusive. In the language of Table 7.1,

$$\text{GST added} = r \times \text{Total value} \tag{7.4}$$

and

$$\begin{aligned} &\text{Sale price} \\ &\quad = \text{Total value } + \text{ GST added} \\ &\quad = \text{Total value } + r \times \text{Total value} \\ &\quad = (1+r) \times \text{Total value}\,. \end{aligned} \tag{7.5}$$

Dividing Eq. (7.4) by Eq. (7.5) gives

$$\text{GST added} = \frac{r}{1+r} \times \text{Sale price}\,. \tag{7.6}$$

In the terminology of Section 6.2, the rate r is *tax-exclusive*, while the fraction $r/(1+r)$ is the *tax-inclusive* rate, which we may call r_i.

For each agent,

$$\begin{aligned} &\text{GST remitted} \\ &\quad = \text{GST on output } - \text{ GST on input} &(7.7) \\ &\quad = r_i \times \text{output price } - r_i \times \text{input price}\,. &(7.8) \end{aligned}$$

Using Eq. (7.8), we can eliminate all references to "value" from Table 7.1 and calculate solely in terms of prices. For a 10% GST, we have $r = 0.1$, whence

$$r_i = \frac{r}{1+r} = 1/11\,;$$

that is, to calculate the GST included in a sale price, one divides the price by 11. To calculated the GST remitted, each agent subtracts the GST included in the input price from the GST included in the output price. The result is Table 7.2.

A further simplification is to allow each business to claim refunds of GST on its inputs *as they are purchased*, without waiting until the inputs are incorporated in outputs. To calculate the GST to be remitted at the end of each accounting period, one subtracts the GST paid on one's inputs from the GST collected on one's outputs, and sends the difference to the ATO. For example, suppose you are running a small business under the Howard government's proposed GST. The rate is 10% and, as a small business, you are required to remit GST quarterly. At the end of each quarter, the procedure for submitting the *GST return* is:

1. Add up all your sales on which GST is payable and divide by 11;

Table 7.2: Example of a 10% GST applied to goods, with the GST included in prices. Single arrows show the flow of goods and sale prices. Double arrows show the flow of GST.

Agent	Goods	Sale price	incl. GST	Net GST remitted
Timber yard				$10 ⇒
	↓ Timber	$110 ↑	$10 ⇑	
Cabinetmaker				$5 ⇒
	↓ Desk	$165 ↑	$15 ⇑	
Retailer				$10 ⇒
	↓ Desk	$275 ↑	$25 ⇑	
Consumer				

2. Add up all your purchases on which GST is payable and divide by 11;
3. Subtract the second result from the first and send the difference to the ATO.

That is the procedure which, according to the opponents of a GST, is too complicated and time-consuming to impose on small business.

If you are running your business properly, you will already know how much you have sold and how much you have bought during the quarter. Hence, if the GST applies indiscriminately to all inputs and outputs, you will already have the figures to be used in the first two steps of the above procedure. But if the GST makes exceptions for certain inputs and outputs, you will need to separate taxable and non-taxable items and apply the above procedure to taxable items only, requiring substantial extra work. The possible types of exceptions are explained in the next subsection.

7.1.3 Exemptions and zero ratings

At the beginning of the 1997–8 GST debate, it seemed that every lobby group in the country was prepared to support a GST as long as its own business was exempt. Just before the Government released its tax policy, it seemed that every lobby group in the country was prepared to support a GST as long as its own business was zero-rated. This transformation occurred, not because the debate changed any attitudes, but because a few influential people eventually learned the difference between *exempt* and *zero-rated*. What exempt and zero-

Table 7.3: Example of an exempt business (a bank) under a 10% GST.

Agent	Goods/ services	Sale price	incl. GST	Net GST remitted
Timber yard				\$10 ⇒
	↓ Timber	\$110 ↑	\$10 ⇑	
Cabinetmaker				\$5 ⇒
	↓ Desk	\$165 ↑	\$15 ⇑	
Bank				
	↓ Account	Fees ↑		
Customer				

rated businesses have in common is that they do *not* collect GST from their customers; but there the similarity ends.

In Table 7.2, notice that the consumer does not remit GST. She pays GST on her "input" (the desk), but does not collect GST from anyone, and therefore cannot claim a refund for the GST paid on the input. If a business pays GST on its inputs but does not collect GST on its outputs or claim refunds for GST paid on its inputs, it is said to be *exempt*.

Financial services (such as banking services) and residential rents are normally exempt from GST because it is too difficult to quantify all the inputs and outputs; even the New Zealand GST, which has the fewest exemptions of any GST in the world, exempts financial services and residential rents. So, as an illustration, let us adapt Table 7.2 by supposing that the desk is bought by a bank. As the bank is exempt, it pays GST in the price of the desk, but does not collect GST in its account-keeping fees and does not claim a refund for the GST paid on the desk. The result is shown in Table 7.3.

Notice that if your business is "exempt", this does *not* mean that you do not pay GST. It means that you do not *collect* GST from your customers, and therefore do not remit GST or perform any GST-related paperwork. But you still *pay* GST in the prices of your inputs, and this inevitably affects the prices that you charge to your customers. For this reason, an "exempt" business is alternatively and more accurately described as an *input-taxed* business.

Because an input-taxed business avoids all GST compliance costs, businesses whose turnover is below a certain threshold are not required to *register* as GST collectors, with the result that they are input-taxed. In New Zealand, the threshold is \$30 000 per annum. Under the Howard government's tax policy, the threshold is \$50 000 per annum. The registration threshold avoids inconve-

Table 7.4: Example of a zero-rated business (an exporter) under a 10% GST.

Agent	Goods	Sale price	incl. GST	Net GST remitted
Timber yard				$10 ⇒
	↓ Timber	$110 ↑	$10 ⇑	
Cabinetmaker				$5 ⇒
	↓ Desk	$165 ↑	$15 ⇑	
Exporter				⇐ $15
	↓ Desk	$250 ↑	$0 ⇑	
Customer				

nience for people who pursue very small informal businesses, such as private tutoring or casual lawn mowing.

If a business does not collect GST on its outputs but is still allowed to claim refunds for GST paid on its inputs, it is said to be *zero-rated*.

For logical and economic reasons, exports are zero-rated under a GST. The logical reason is that the exported goods or services will be taxed in the country of destination; to tax them also in the country of origin would be double taxation. The economic reason is that the removal of GST from exports minimises their price and maximises their competitiveness. Even the New Zealand GST, which does not zero-rate anything else, zero-rates exports. So, as an illustration, let us adapt Table 7.2 by supposing that the "retailer" is in the business of exporting office furniture to Japan. As the exporter is zero-rated, it pays GST in the price of the desk, does not collect GST from its customer, and still claims a refund for the GST paid on the desk. The result is shown in Table 7.4, in which the export price is estimated by subtracting the GST from the retail price in Table 7.2.

Notice that if your business is zero-rated, you pay zero GST, but you do *not* have zero compliance costs. Although you do not collect GST from your customers, you still need to keep records of purchases on which GST was paid, so that you can claim the refund. Because the prices charged by a zero-rated business do not contain GST and are not affected by GST paid on inputs, such a business is described as "GST-free" in the Howard government's tax reform package.[2]

[2]Since the Government coined the term "GST-free", too many journalists have resumed the

In summary: If your business is fully taxed, you claim a refund for GST paid on your inputs and collect GST on your outputs. If your business is *exempt* (input-taxed), you pay GST on your inputs but do not collect GST on your outputs. If your business is *zero-rated*, you claim a refund for GST paid on your inputs and do not collect GST on your outputs. Hence, if your are exempt, you pay GST but do not do the paperwork; but if you are zero-rated, you do the paperwork but do not pay GST.

7.1.4 Complications to be avoided

If some of your outputs are zero-rated, you exclude these from the calculation of the GST collected on your outputs; for example, if some of your outputs are exported and some are sold locally, you exclude the exports from the calculation of GST payable, but claim refunds on inputs as usual. Hence you can export at a lower price than you can sell locally. Excluding exports from your taxable sales is not too difficult, because you know where your orders are coming from.

If some of your inputs are zero-rated or exempt, you exclude these from the calculation of the GST paid on inputs. Hence you need to know the GST status of all your inputs and all your suppliers. This not only makes work, but also creates a risk of mistakes. To minimise the workload and the risk, the classes of products that are exempt and zero rated should be as small as possible, and should *not* include products that are likely to constitute business inputs. Exports, by definition, are not inputs and may therefore be safely zero-rated. Health and nursing services, education and childcare services, financial services (other than those offered on a fee-for-service basis) and residential rents are not quantifiable business inputs, and may therefore be safely exempted.[3] One does not intuitively regard taxes as consumption expenses, and therefore does not expect taxes to include GST; hence State and local taxes may be safely zero-rated. The choice *between* exemption and zero rating is debated in Section 7.5.

If a registered business purchases inputs from an unregistered business whose turnover is below the registration threshold, it cannot claim GST refunds for those inputs. For this reason, most registered businesses purchase inputs only from other registered businesses. Hence some small businesses

habit of saying “exempt” when they mean “zero-rated” or “GST-free”. Thus the terms “exempt” and “zero-rated”, which the media seemed to have sorted out before the release of the Government’s policy, have now been confused again.

[3] Some of these items, although not business inputs, could be fringe benefits provided by employers for employees, in which case the associated expenses would be treated as consumption under the FDET.

choose to register even if their turnover is below the registration threshold, so that they can sell to registered businesses.

If some of your outputs are exempt, you exclude these from the calculation of the GST collected on your outputs, and also exclude the associated inputs from the calculation of the GST paid on inputs. Identifying the “associated inputs” is problematic. Perhaps the simplest solution is to compute the fraction of your output value that is fully taxed, and claim the same fraction of the GST paid on your inputs; but even this procedure invites tax minimisation by manipulation of output prices. It is therefore highly desirable that exemptions apply to whole businesses rather than individual products. A possible exception concerns banks and financial institutions that give advice on a fee-for-service basis. Because such advice is likely to be a business input, it arguably should be fully taxed so that the GST can be reclaimed by business customers.

7.2 No more high interest rates

7.2.1 The cause and the cure

Question 1: Why does the Reserve Bank of Australia (RBA) act independently of the Government in setting official interest rates?

Answer: Actually it doesn’t—the Treasurer has a statutory right of veto over any change in rates. But the RBA must be *seen* to be independent, because if interest rates were openly decided by the Government, the decision would be dictated by political expediency rather than economic prudence. High interest rates are always unpopular, but sometimes necessary.

Question 2: If it is such a good idea to eliminate politics from the formulation of public policy, why stop at interest rates? Why not do the same with every other politically sensitive issue?

Answer: This is a democracy. Policy must be debated and decided by the people’s representatives in Parliament, who periodically submit themselves to the judgement of the people.

Q3: Right. So why shouldn’t interest rates also be debated and decided by the people’s representatives in Parliament? What distinguishes interest rates from any other political football?

A: … The people are less likely to understand the need for high interest rates than the need for other unpopular policies.

Q4: And what is this need that the people don't understand? Why are high interest rates sometimes necessary?

A: If there is too much demand in the economy—too much money chasing too few goods and services—prices rise and the flow of imports increases. Price rises lead to demands for higher wages, which feed further price rises, and so on—that is, an inflationary spiral begins. Increased imports cause a blowout in the Current Account Deficit (CAD) which must be balanced by an increased rate of foreign investment. This in turn requires either a depreciation in the Australian dollar (so that it becomes cheaper to invest in Australia) or an increase in Australian interest rates (encouraging foreign investors to buy Australian dollars and invest them in interest-bearing Australian securities). If the RBA allows the dollar (A$) to fall, import prices rise, adding to inflationary pressure, and the total A$ value of foreign debt increases. But if the RBA raises interest rates, it avoids these problems by raising demand for the A$. Higher interest payments also cut into the purchasing power of individuals and corporations, reducing the excessive demand that caused the problem in the first place.

Q5: For the purpose of reducing spending power—and hence reducing demand, inflation and the rate of imports—wouldn't a tax rise be just as effective as an interest rate rise?

A: Yes; in fact, if the tax rise were manifested as a price rise, it would be *more* effective. A rise in interest rates tends to cause a slump in prices, which counteracts the desired reduction in demand. But if the desired reduction in demand is caused by a tax-induced price rise, there is no counteracting influence.

Q6: If a tax rise causes a price rise, doesn't that conflict with the goal of reducing inflation?

A: No. We need to distinguish between *one-off* inflation and *underlying* inflation. An increase in indirect taxation causes a one-off increase in prices, but this in turn causes a fall in demand, which reduces underlying inflationary pressures. A mechanical analogy might help. If you want to make a left turn on a bicycle, you must develop a lean to the left. You do this by briefly turning the handlebars to the *right*, so that the front wheel is to the right of your body—that is, so that your body is to the left of the front wheel, leaning to the left. Hence the initial turn of the handlebars must be in the *opposite* direction to that in which you want to turn—which is why you fell of the bike so many times before you got the hang of it. Similarly, if you use an indirect tax to control inflation, the initial price movement is in the opposite direction to the desired trend.

Q7: Wouldn't a tax rise be more equitable than an interest rate rise?

A: Very much so. Bank interest is money flowing from borrowers to depositors. As depositors tend to be richer than borrowers, interest is more regressive than any tax. A GST, which is often attacked for being regressive, collects more tax from the rich than from the poor, albeit not in proportion to income. Even a poll tax makes the rich pay something. But interest is money paid *to* the rich by the poor.

Q8: Wouldn't a tax rise be a better long-term investment than an interest rate rise?

A: Of course. If taxes are raised higher than is necessary to meet current expenditure, the excess can be used for debt reduction, or invested to cover future expenses (e.g. pensions).[4] But if interest rates are raised in a deliberate attempt to stifle demand, the resulting reduction in economic growth is a dead loss. If an enterprise is to go ahead, it must be at least profitable enough to pay the interest on its borrowings, and its profitability depends on its customers' spending power, which is also inversely related to interest rates. Hence a rise in interest rates reduces the number of new enterprises that can proceed. Worse still, it reduces the number of existing enterprises that can survive: a business that has borrowed

[4] All else being equal, the price level is proportional to the money supply, i.e. the amount of money in circulation [24, pp. 17–26]. The money supply includes at-call deposits. Hence, if a temporary increase in taxation is intended to act as a brake on inflation, the extra revenue should be invested in such a way as not to create new deposits. Spending on goods and services (even for infrastructure) not only adds to the already excessive demand, but also swells deposits and increases the money supply. So extra spending is not appropriate. Borrowing from banks increases the money supply because the borrowed money swells deposits when it is spent (and the banks must have deposits to finance their loans). Hence, if such borrowings have been made in the past, repaying them reduces the money supply and is anti-inflationary. Borrowing from the public by selling bonds does not increase the money supply, because the initial withdrawal of money from the public cancels any subsequent increase in deposits. Therefore buying back the bonds is not in itself anti-inflationary. In conclusion, if a government increases taxation as an anti-inflationary measure, the repayment of past bank loans should have first claim on the additional revenue.

money in the past may find that last year's sound investment is this year's unserviceable debt, in which case it goes bankrupt and its employees are thrown out of work. In summary, high interest rates have a deadweight cost which, unlike the deadweight cost of a tax, cannot be offset by any benefit.

Furthermore, although a rise in interest rates encourages foreign investment, it also raises the value of the A$ and makes our exports less competitive, with the result that most of the investment flows into the *non-traded* sector of the economy, e.g. real estate, so that it does not help the balance of trade.

Q9: If taxation were increased in order to restrain demand, could some of the extra revenue be used to increase welfare payments and ease the pain on low income earners, without negating the effect on demand?

A: Yes. While any policy that succeeds in restraining demand must obviously cause some pain, a suitable combination of tax and welfare increases can concentrate the pain on the rich. It is much harder to compensate low income earners for the effects of an increase in interest rates, because the reduction in economic growth causes a reduction in revenue growth.

Q10: What sort of tax is most suitable for controlling demand?

A: A GST. When the tax rises, you want people to spend less and save more. An income tax is equivalent to a tax on spending plus a tax on saving, whereas a consumption tax is a tax on spending alone. Hence an increase in a consumption tax is more likely to divert income from spending to saving than an increase in income tax. The remaining question is whether the consumption tax should be direct (like an FDET) or indirect (like a GST). To exert the appropriate influence on demand, the tax may need to be adjusted quite frequently, e.g. quarterly. But, to minimise compliance costs, the tax rate should remain constant during each accounting period. Hence we need a tax with a short accounting period. A quarterly settlement of accounts is quite reasonable for a GST, whereas most taxpayers would prefer an annual settlement for the more complex FDET. Moreover, a GST rise causes a price rise—which, as I said before, is the most effective means of reducing demand—while an FDET rise does not. So a variable GST looks like the answer.

Q11: Does a “variable” GST mean a forever-rising GST?

A: Of course not. Next time the Government encounters an economic slowdown or recession, it needs to speed up the economy by stimulating demand. If it has kept interest rates at rock bottom by raising the GST, it cannot drop interest rates any further, so it has to lower the GST. And the resulting deficit can be funded from the excess revenue that was collected while the GST was high. The reason why the GST never falls in other countries is that they don’t use a GST to control demand—they use interest rates instead!

Q12: If, as you seem to be saying, a variable GST is more effective, more equitable, more fiscally responsible and less damaging to employment than variable interest rates, why does the Government prefer variable interest rates?

A: If the Government were to use a variable GST to keep inflation under control, it would have to take some responsibility for adjusting the GST rate, and pay the political price. But if it uses variable interest rates, the responsibility for setting interest rates can be “delegated” to the RBA, which draws the political flak away from the Government.

Q13: So, while the independence of the RBA is ostensibly designed to prevent politically motivated decisions, the decision to use variable interest rates instead of a variable GST is itself politically motivated?

A: . . . Yes.

Q14: And when pro-GST politicians promise that the rate will be set in concrete, they are throwing away the biggest single advantage of a GST for the sake of political expediency?

A: Right. And anti-GST politicians silently concur in this, because if they were to acknowledge that a variable GST can serve as a substitute for variable interest rates, they would make a GST look too respectable.

7.2.2 Social, environmental and international effects

At an interest rate of 5% per annum, you would need to deposit \$7835 now in order to have \$10 000 after five years. At an interest rate of 15% per annum, you would need to deposit \$4972 now in order to have \$10 000 after five years. In other words, at 5% interest, \$10 000 in five years' time is worth \$7835 today; but at 15% interest, \$10 000 in five years' time is worth only \$4972 today. In general, the higher the interest rate, the more a future cash flow must be *discounted* when comparing it with an immediate cash flow; hence the interest rate is also called the *discounting rate* applicable to future cash flows.

Suppose you borrow money to start a business. If the interest rate is 5%, your business needs to make a margin of 5% of its start-up capital per year, just to pay the interest. If the interest rate rise to 15%, your minimum survival margin also rises to 15%—while your maximum achievable margin *decreases* because your customers have less money to spend. If you have not already started a business, a rise in interest rates may prevent you from doing so and consequently prevent you from employing anyone. If you have already started, a rise in interest rates may sink your business and throw you and your employees out of work. In either case, the link between interest rates and unemployment is clear.

Even if your business is very robust, a rise in interest rates may dissuade you from taking on new employees. When you hire a new recruit, salary and training costs begin immediately; but the benefits do not accrue until later, after the employee has learned the job. A higher interest rate means a higher discounting rate applicable to those future benefits, so that the investment in new staff takes longer to pay off and is less likely to pay off at all.

In the long term, the survival of the economy is totally dependent on the survival of the natural environment that supports all life. It is also in the long term that the effects of high discounting rates are most pronounced. For example, at 5% interest, \$10 000 in 30 years' time is worth \$2314 today; but at 15% interest, \$10 000 in 30 years' time is worth only \$151 today. The lower the long-term interest rate, the lower the discounting rate applicable to the economic costs of future environmental damage, and the higher the probability that today's economists—whether they work for national governments, giant corporations or small local councils—will be influenced by future environmental consequences when making today's decisions. To my knowledge, the best thing that national governments can do for the environment is to promise continuous low interest rates throughout the booms and busts of the economic cycle. They can do this by using the GST rate to control demand, so that their central banks are free to maintain low interest rates. Interest rates must be sufficient to compensate lenders for the alternative uses of their money (opportunity cost) and for the risk of losing their money (risk premium). In a free financial market, competition between borrowers maintains the necessary minimum interest rate, while competition between lenders prevents exorbitant interest. Any intervention by a government or central bank to raise interest rates above the levels demanded by free competition is to be condemned not only as usury, but also as environmental vandalism.

The use of variable interest rates to control demand is entirely responsible for the third-world debt crisis: poor countries borrowed when interest rates were low, only to find that interest rates were unilaterally increased by the lending banks in response to increases in official rates by their respective central banks. Highly-indebted poor countries have already paid back far more than they initially expected to pay. If a corporation were in such a situation, it would be declared bankrupt, and its shareholders' losses would be limited to the values of their shareholdings; this is called *limited liability*. Shareholders in a company have bought their shares by choice. Citizens of third-world countries are citizens not by choice, but by birth. But when a country is technically bankrupt, its citizens get no limited liability. They must pay taxes and go without essential services in a hopeless attempt to repay their Government's debts, plus any corporate debts guaranteed by the Government. If insolvent countries were treated the same way as insolvent companies, banks that have lent to insolvent countries would suffer the same fate as those that have lent to insolvent companies: they would lose their money. Logically and morally, that is precisely what should happen. Against this, it is argued that if a poor country were to default on it debts, its citizens would suffer further because of the damage to their Government's credit rating. But the damage would be minimal if there were good reason to believe that the default would not recur, as there would be if the governments of rich countries were to agree that it is better to increase taxes than to increase interest rates.

7.3 Faults of existing indirect taxes

Subsection 7.2.1 has established that the maintenance of low interest rates requires a variable indirect consumption tax—a tax that is passed on in the prices of goods and services, so that a variation in the tax rate causes a variation in the general level of prices, hence the general level of demand. A GST is one such tax. It remains to explain why a GST is preferable to other indirect consumption taxes.

Before discussing the faults of individual taxes, I should mention one fault that is common to them all: *every indirect consumption tax is a tax on employment*. An indirect consumption tax, by definition, is ultimately paid by consumers in the prices of goods or services. If some of a price of a consumable item is tax, it follows that not all of the price is available to pay the wages, profits and rents that are involved in the production of the item. The higher the tax, the more difficult it is to pay the wages of the necessary labour, pay enough rent to secure the necessary premises, and make enough profit to attract the necessary capital; hence the harder it is to employ people in the production of that item. How the tax finds its way into the final price is irrelevant, except to the extent that it affects compliance costs and distortionary costs.

7.3.1 Wholesale Sales Tax (WST)

Wholesale Sales Tax is a tax paid by producers and wholesalers on sales made to retailers, and is built into the wholesale prices paid by retailers for their stock. The retailers then add their margins to the tax-inflated wholesale prices, so that their customers pay tax-inflated retail prices. A few retailers choose to pay WST separately, so that they can deal with tax-exempt customers; in so doing, they incur additional compliance costs which are also passed on to customers.

WST is unsuitable for controlling overall demand because its base is too narrow: it does not apply to services, and even some goods—notably basic food and clothing—are exempt. It is also too complicated. In effect it is not one tax, but six taxes, because it applies at six different rates: 12% (some foods and household goods), 22% (the default rate), 32% ("luxuries", including TVs and VCRs—and engagement rings, but not wedding rings[5]), 37% (beer and spirits), 41% (wine and cider), and 45% for cars above the luxury threshold; this threshold is an additional complication and an exception to the usual method of calculation. Multiple rates were first introduced during the Second World War in order to discourage non-essential consumption, but persisted after the war [6, p. 5].

WST is inefficient. The multiple rates generate compliance costs for business, cause products to be modified so as to qualify for lower tax rates, and encourage businesses to divert resources into lobbying—and even litigation—in an effort to have their products reclassified [6, pp. 15–17, 21]. Ice cream, for example, is taxed at 12%, while frozen yoghurt is tax-free—unless it tastes like ice cream.[6] It has taken two years of litigation to reach this result. Stand by for further court cases concerning the taste qualities of particular brands of frozen yoghurt. In November 1998, a Federal Court judge ruled that 43% of the information on a music CD is a computer program and consequently tax-free, while the rest is taxed at 22%. The applicant had sought a ruling that the entire contents of music CDs were computer programs.[7] Stand by for more court

[5] *Australian Financial Review*, May 25, 1998, p. 16.
[6] *Australian Financial Review*, November 5, 1998, p. 5.
[7] *Australian Financial Review*, November 7–8, 1998, p. 6.

cases on the WST applicable to the next generation of digital audio and video disks.

WST causes difficulties with *cash flow* because businesses may be required to pay tax on their sales before they have received the proceeds of those sales. For example, a small manufacturer selling to a retailer will need to pay WST immediately on each month's sales, even if it does not receive payment from the retailer until some months later. In accounting jargon, we say that WST applies to *accruals* rather than *realisations* of sales revenue—it is a tax on an IOU.

WST is *cumulative*—it is tax on tax. For example, the prices of equipment purchased by a manufacturer include WST, which is then built into the price charged by the manufacturer for a finished product. A wholesaler might buy this product and add its own margin, plus WST, to calculate the wholesale price. Thus the price on which the final WST is calculated already includes some WST. This process can be repeated over and over, so that it is difficult for a consumer to determine how much of the final retail price is tax. The six official tax rates are not the full story.

Exporters also pay WST on their inputs, and they have to compete with firms in other countries where there is no tax on inputs—in other words, the WST tilts the playing field against Australian exporters.

7.3.2 Payroll tax

Payroll tax is a tax paid by employers on their wage/salary expenses, wherefore it is simplistically labelled a tax on employment. As explained in the introduction to this section and in Subsection 6.1.2, payroll tax is not the only tax on employment and is certainly not the worst. In particular, it is no worse than other indirect consumption taxes for discouraging employment. It does, however, have the ignoble distinction of having been introduced for that specific purpose: it was introduced by the Commonwealth in 1941 in order to discourage civilian employment of labour that was needed for the war effort [8, s. 1(6)]. It was retained as pure revenue measure after the war, and was handed over to the States in 1971.

Nowadays payroll tax applies to businesses whose payroll is above a certain threshold, which varies from State to State; some jurisdictions even have multiple thresholds and progressive rates. Various other exemptions and concessions are given. If a business operates in several States, each threshold in each State is adjusted according to the fraction of the total payroll in that State. The thresholds usually include fringe benefits and superannuation contributions, causing unpleasant surprises for many small business operators who think they are below the lowest threshold. While the thresholds exclude most small businesses from tax liability, they also constitute a disincentive to growth.

Payroll tax is an indirect tax because the employers who initially pay the tax pass it on to their customers. It is also a consumption tax because it is ultimately paid by consumers of goods and services that are produced using the labour on which the tax is imposed. It is broad-based in the sense that it applies to both goods and services. But it is narrow-based in the sense that it is paid in proportion to the local labour content that fell foul of the thresholds and exemptions. Hence its effect on prices is not uniform or easily predictable, which is one reason why payroll tax is not a suitable instrument for controlling demand. Another reason is that payroll tax is imposed by the States, whereas the control of demand—especially for imports—requires Federal action.

Payroll tax has most of the other disadvantages of the WST. It is inefficient because it has been complicated by thresholds and exemptions, and because employers must deal with a different set of rules in every State in which they operate. It causes difficulties with cash flow because it must paid on top of wage and salary expenses regardless of whether the employer is earning sufficient revenue. Because it is a tax on an essential input (labour), it reduces the competitiveness of exporters. By itself it is not a tax on tax, although it is cumulative in a weaker sense: an employer not only pays payroll tax but also buys inputs whose prices have been inflated by payroll tax. However, the combination of payroll tax and WST leads to tax on tax: payroll tax adds to production costs and inflates prices, and these inflated prices are used in the computation of WST.

7.3.3 FID and BAD tax

Financial Institutions Duty (FID) is a tax imposed by most States on the receipts of financial institutions. Bank Account Debit tax (BAD tax) is the tax that causes the balance of your cheque account to be lower than you think; it is a tax imposed by the States on withdrawals from cheque accounts and other accounts with cheque access. FID and BAD tax are direct taxes when paid by consumers, but indirect when paid by businesses. Both taxes fall on consumption to the extent that they are built into the prices of consumable products, but they also fall on savings and investments to the extent that these activities involve taxable banking transactions.

Because FID and BAD tax are not pure consumption taxes, and because they are imposed by the States, they are unsuitable for controlling overall demand. Moreover, because FID and BAD tax are business costs, the prospect that Australian governments might raise and lower FID and BAD tax would encourage businesses to deal with foreign banks instead of Australian banks, thus avoiding the variable taxes.

FID and BAD tax are inefficient because they are affect an astronomical number of *individual* transactions, collecting a minuscule amount of revenue from each. As they apply to realised transactions, they cause minimal difficulties with cash flow. As they are a business expense which must be recovered through prices, they reduce the competitiveness of exporters. To the extent that they apply to transactions required for tax purposes, they are taxes on tax. They are also cumulative in the weak sense: each business not only pays its own FID/BAD, but also buys inputs whose prices are affected by FID/BAD.

7.3.4 Stamp duties

Stamp duties are taxes imposed by the States on a bewildering range of transactions including share purchases, credit cards (both contracts and individual purchases), hire purchase agreements, rent/lease agreements, mortgages, bonds, debentures, cheques, bills of exchange and promissory notes, car purchases, insurance premiums, and real estate conveyancing. Stamp duties are mostly indirect because they add to the costs of doing business and must therefore be recovered in prices, and because they inflate the prices of consumer durables that are destined to be resold on the second-hand market.

Stamp duties include the “contract duty” and “transactions duty” that litter your credit card statements. Stamp duty eats into your account balance every time you are issued with a new cheque book. Stamp duty is one of those diplomatically-named “on-road costs” that you must add to the price of a new or used car before you drive it away. Stamp duty is added to your premium every time you renew the insurance on your house or car.

Stamp duty is one reason why real estate prices rise faster than other prices. If you sell your residence, you want to recover not only the purchase price adjusted for improvements and inflation, but also the stamp duty that you paid when you bought it. The same applies to the next buyer and the one after—every time the residence changes hands, stamp duty is added to the price. The stamp duty on real estate varies from State to State and is highest in New South Wales. That is part of the reason why ordinary mortals can no longer afford to buy a house in Sydney—it is not just because the city is fenced in by mountains and watercourses and is preparing to host the Olympics.

The Howard government’s tax package reserves all of the GST revenue for the States on the condition that the States to abolish most of their stamp duties. But, apparently because of large variations from State to State, the package allows stamp duties on *residential* real estate to continue. This exception, combined with the GST on new houses, will price Sydney real estate further out of reach. If a GST is to be acceptable, it must be accompanied by the abolition of *all* stamp duties, as I propose in Step 12.

Because stamp duties fall on investments as well as consumption, and because they are imposed by the States, they are unsuitable for controlling overall demand. Because stamp duties, like FID/BAD, are a business cost, the prospect that Australian governments might raise and lower stamp duties would drive business offshore.

Stamp duties are more inefficient than FID/BAD because they affect a similarly astronomical number of transactions but cannot always be automated. The high compliance cost implies that for each dollar of revenue raised, *stamp duties are more damaging to employment than payroll taxes*. Stamp duties paid by buyers are cash expenses on top of the purchase prices and may therefore cause difficulties with cash flow. Like FID/BAD, stamp duties are a business expense which must be recovered through prices, and therefore reduce the competitiveness of exporters. To the extent that they apply to transactions required for tax purposes, they are taxes on tax. They are also cumulative in the sense that each business not only pays its own stamp duties, but also buys inputs whose prices are affected by stamp duties; if the former stamp duties are *ad valorem*, they are taxes on tax.

7.3.5 Customs and excise duties

Customs and excise duties are exclusive to the Commonwealth under s. 90 of the Constitution. The founding fathers clearly envisaged that the revenue raised by these duties would be sufficient to defray the entire expenditure of the Federal Government and leave a surplus for distribution to the States. That hope was dashed by the First World War.

Customs duties, commonly called *tariffs*, are taxes on imports. Like the WST and some stamp duties, tariffs are *ad valorem* taxes; that is, the tax is a percentage of the price. Tariffs are relatively unimportant in fiscal terms, raising about a quarter of the revenue of the WST [6, p. 11]. Their main purpose is political: to protect inefficient local industries against competition from imports, at the expense of consumers (who do not realise that they are being fleeced) and of more efficient local industries (who do realise it). In fairness, tariffs also compensate employers who must compensate employees for the tax surcharge masquerading as the income test on the dole; but the masquerade is also politically motivated. These issues were canvassed in Chapter 2.

Excises are taxes on sales of specific goods. They differ from wholesale sales taxes in that (a) they are imposed on a narrower range of goods and (b) they are *specific* rather than *ad valorem*; that is, they are levied on the quantity (e.g. weight or volume) rather than the price. Excises apply whether the goods are locally produced or imported; in the case of imported goods, excises make up part or all of the *import duties* [6, p. 22]. Excises are major revenue sources, comparable in importance with wholesale sales taxes [6, p. 11]. They may also serve as policy instruments. The tobacco excise, for example, is intended to discourage smoking (which it does) and to cover the expenditure caused by smoking-related illnesses (a more dubious claim, because in practice the revenue from excises is treated as general-purpose revenue). The excises on fossil fuels—coal, oil and gas—are intended in part to deter the production of greenhouse gases. They would do this more effectively if they were strictly based on carbon content (Step 8).

Tariffs and excises are obviously indirect consumption taxes; they are taxes on goods, paid by businesses and shifted onto consumers. Because of their narrow base, they are unsuitable for controlling overall demand. A general increase in tariffs reduces imports, but also makes exports less competitive because it increases the value of the A$ and because tariffs affect the prices of some business inputs.

Imports subject to tariffs may also be subject to WST, in which case the WST is tax on tax. Fuel excise adds to production costs and inflates prices, and these inflated prices are used in the computation of WST, again causing tax on tax. Fuel excise is built into the prices of exports, making them less competitive. Exporters who manufacture goods from imported components may pay tariffs on those components, in which case the tariffs are built into the prices of their finished products, making them less competitive [4, p. 196].

Tariffs are taxes on the poor inasmuch as they protect local producers by raising the prices of cheap imports, which would otherwise be bought preferentially by the poor. Among the greatest hypocrites in Australian politics are those who demand tariffs to protect their own interests, but oppose a GST because it is so inequitable!

7.3.6 The RST option

A Retail Sales Tax (RST), also known as a cash register tax, is a tax on the sales of retail businesses. Usually it applies to both goods and services, but it is simpler than a GST in that there are no refunds for RST paid on inputs. Hence, under an RST, there is no distinction between "exempt" and "zero-rated". Usually inputs are purchased at wholesale level, in which case no RST is paid on them; but if inputs are purchased from a retailer, there is no refund for the RST.

Australia does not have a broad-based RST, although it has toyed with the idea. The “broad-based consumption tax” proposed and abandoned by the Hawke government in 1985 was an RST. So is the new luxury car tax proposed by the Howard government to replace the existing WST on luxury cars. In the USA, however, broad-based RSTs are essential revenue sources for state governments. At state level, an RST is easier to administer than a GST: under a state GST system, it would be difficult to calculate how much GST should be claimed on inputs, because a business is likely to receive inputs from different states having different GST rates; an RST avoids this problem because it is not refundable. In the USA, the state RSTs leave no room for broad-based consumption taxes at the federal level (although of course there are federal customs and excise duties). Thus the USA is, and is likely to remain, one of the few developed countries without a GST.

In Australia, while s. 90 of the Constitution apparently prevents the States from imposing indirect taxes on goods, there is nothing to stop the States from taxing services. The New South Wales “bed tax” is the most infamous example to date, but need not be the last. At present, the Commonwealth has two major indirect taxes—WST and excise—that apply only to goods. Hence, if the Commonwealth does not extend its indirect tax base to services, and if the States are still denied access to any part of the existing Commonwealth tax base, the States will be heavily tempted to impose broad-based RSTs on services. For example, the States have to power to tax car repairs, plumbing and electrical services, haircuts, tickets to the cinema or theatre, accommodation, residential and commercial rents, rates, water, gas, electricity, telephone calls, internet access, bus and train fares, school fees, childcare, weddings, funerals, visits to the doctor or dentist . . . You name it: as long as it does not involve a change of ownership of goods, the States can tax it. Of course the tax rates and rules would vary from State to State, causing an administrative nightmare for employers and reducing their ability to employ.

As an instrument for controlling demand, a broad-based Federal RST is just as effective as a GST, provided that it is not watered down by exemptions and concessional rates. But it probably would be. Because RST is non-refundable, so that businesses do not need to distinguish between multiple RST rates on inputs, the temptation to grant exemptions for certain businesses and concessions for certain goods would be greater for an RST than for a GST. A multi-rate RST, like the present multi-rate WST, would influence business structures and product designs, and would lead to disputes over classifications of businesses and products.

An RST causes fewer cash-flow difficulties than a WST because most inputs are free of RST, and because the RST collected on the sales of a business can be retained in the business until the end of the accounting period. But an RST can still be a tax on tax: if a business buys some inputs at retail level, the RST paid on its inputs inflates the prices of its products, and the RST collected on its products is computed from those inflated prices. If the business is an exporter, any RST paid on its inputs reduces the competitiveness of its exports.

7.3.7 Advantages of a GST

As explained in Subsection 7.2.1, a broad-based GST is an eminently suitable instrument for controlling demand, provided of course that it remains broad-based. And it would. When businesses claim refunds of GST paid on inputs, they do not want to deal with exceptions or multiple rates. This, together with the large number of businesses that need to collect GST, gives governments a political incentive to maintain a single rate of GST. (A problem arises if there are too many zero-rated industries when the GST is introduced; see Subsection 7.5.2.)

The risk that a business may have to remit tax on its sales before receiving the proceeds is lower for a GST than for a WST, and can be entirely eliminated by calculating the tax on receipts instead of invoices. Overall, the cash-flow benefit of a GST is greater than that of an RST, because a GST is more thorough in eliminating taxes on business inputs. However, the cash-flow benefit of a GST is also more widely and thinly distributed than that of an RST. Under a GST, every profitable business collects more GST on its outputs than it reclaims on its inputs, and retains this excess until the end of the accounting period. Under an RST, only retail businesses collect RST on their outputs and benefit from the temporary retention of this tax.

The cash-flow benefit of a GST assists the establishment of new enterprises, which can claim refunds for GST paid on their inputs even before they start collecting GST on their sales. In this context an RST is slightly superior to a GST because, if all start-up purchases are made at wholesale level, no up-front RST is payable, and one does not need to wait for a refund. It should also be noted, however, that the replacement of the income tax system with an FDET would enable new investments to be made out of pre-tax income, and would therefore give much greater encouragement to new enterprises than would the replacement of existing indirect taxes with a GST or RST.

Under other *ad valorem* indirect taxes, the tax paid a business's inputs is included in the pre-tax prices of its outputs, to which more tax is added. As this process is repeated for each business in the supply chain, the tax paid by the consumer can be much higher than the tax rate suggests. Under a GST, however, each business in the supply chain gets a refund for GST paid on its inputs and therefore does not need to build this tax into the prices of its outputs. In the final price paid by the consumer, the fraction of tax is the tax-inclusive rate

$$r_i = \frac{r}{1+r}\ , \tag{7.9}$$

where r is the nominal (tax-exclusive) rate; for example, under a 10% GST ($r = 1/10$), retail prices are 9.09% GST ($r_i = 1/11$).

If a GST is understood as a tax on value added, it is cumulative in the weak sense: each business in the supply chain pays GST on its inputs and remits tax on its own value added. But if a GST is understood as a tax on final consumption, as it is usually portrayed in political debate, then it is *non-cumulative* because the tax on inputs is refunded. In either case, a GST by itself is *not* cumulative in the strong sense—the purpose of the multistage value-added procedure is to *avoid tax on tax*.

However, a GST combined with other taxes can still lead to tax on tax; for example, a GST may be imposed on prices that have already been inflated by tariffs, excises, payroll tax, stamp duties, or FID/BAD. Because the Howard government is not proposing a GR, it is not in a position to abolish tariffs. Excises cannot be abolished, because they serve purposes other than raising revenue. Neither is it practical for excisable goods to be exempt or zero-rated under a GST, because this increases compliance costs for businesses that sell or consume excisable goods along with other products. If the combination of GST and excise leads to excessive taxation, it is better to reduce the excise than to remove the GST. Payroll tax, stamp duties and FID/BAD, however, are purely revenue taxes; to avoid unnecessary cases of tax on tax, they should be abolished when a GST is introduced. Hence the business lobby was not impressed when it heard that the Howard government's GST package would not force the States to abolish payroll tax.

Furthermore, a GST can become a tax on tax if there are too many exemptions. If a business purchases inputs from an exempt business, the prices of those inputs are inflated somewhat by GST, but no refund is available. Hence the GST that the business pays on the inputs is built into the prices of its outputs, and the business calculates its own GST on those inflated prices. In other words, exemptions turn a GST into a cumulative tax on inputs, like a WST. For this reason, any GST exemptions must be confined to products that are not likely to constitute business inputs.

Under a value-added GST, exports are always zero-rated: a business that exports part of its output does not collect GST on its exports, but still reclaims the GST paid on all its inputs, whether those inputs came from wholesale or retail sources. In this respect a GST is superior to an RST; under an RST, an

Table 7.5: Tax compliance costs incurred by Australian business in 1994–5, compared with a GST for 2000–1.

Tax	Revenue ($ million)	Compliance cost ($ million)	Compliance cost (% revenue)
PAYE	51 238	688	1.3 %
WST	11 100	519	4.7 %
Company	31 000	2106	6.8 %
FBT	2 736	286	10.5 %
PPS	2 169	477	22.0 %
GST	27 000	1026	3.8 %

exporter who purchases some inputs at retail level cannot reclaim the RST paid.

A GST is highly efficient provided that it is imposed at a single rate, with minimal exemptions and zero-ratings. If there is only one rate, there is no point in lobbying to have one's products reclassified to qualify for a lower rate. A single rate also minimises compliance costs; indeed, although the number of businesses incurring compliance costs would be many times greater for a GST than for a WST, the New Zealand experience indicates that a GST can have a lower compliance cost per dollar of revenue raised. New Zealand introduced a 10% GST in 1986, and increased it to 12.5% in 1989. In its review of tax simplification in 1989, the New Zealand Government estimated that the compliance cost of the GST was 3.8% of the revenue raised.[8] (I assume that this figure was based on the old 10% rate.) For comparison, I have added this figure to Table 5.1 and combined it with the revenue that the Howard government plans to raise from the GST in 2000–1. The result is shown in Table 7.5. Notice that the compliance cost of a GST is lower than that of a WST when expressed as a fraction of the revenue raised, but higher in total. One must remember, however, that the WST is not the only tax that would be abolished on the introduction of a GST. When comparing compliance costs, the relevant comparison is not between the GST and the WST, but rather between the GST and *all* the taxes to be abolished. Hence it is unlikely that the introduction of a GST would increase total compliance costs. In any case, the compliance cost of a GST would be offset somewhat by cash-flow advantages.

New Zealand has the world's simplest GST, with no zero ratings except for exports, and no exemptions except for financial services and residential rents. The Howard government's tax policy proposes additional zero ratings, which

[8] *Australian Financial Review*, August 18, 1998, p. 25.

would cut revenue without a commensurate reduction in compliance costs. Under that policy, Australia could expect a compliance costs somewhat greater than 3.8% of revenue. Because the policy described in this book calls for additional exemptions rather than additional zero ratings, it would sacrifice less revenue, but achieve a greater reduction in compliance costs, than the Howard government's policy. Hence the bottom line of the table is a plausible estimate of the compliance cost of the GST proposed in this book. Of course, when the GST rate varies, the total compliance cost (third column) remains constant, while the percentage compliance cost (fourth column) varies in inverse proportion to the rate.

7.4 Why food must be taxed

7.4.1 Prices need not rise.

Imposing a tax on basic foods is a sure way to kindle the wrath of the welfare lobby. But, as the introduction to this chapter suggests, the emotional response is largely caused by ignorance: people do not realise that basic food prices are already inflated by numerous taxes, most of which would be abolished or reduced by the introduction of a GST. Whether a GST would cause food prices to rise or fall depends on the GST rate and on which other taxes were abolished. I suggest that the GST should be introduced at such a rate that the one-off change in the CPI is slightly but clearly *negative*, so that there is no adverse effect on low income earners.

7.4.2 Price vs. affordability

The affordability of food does not only depend on food prices. For low income earners, the food budget is what is left over after other non-negotiable expenses have been paid, so that the food budget decreases if non-food expenses increase. The average pensioner, for instance, spends about 28% of his income on food. If the *volume* of his non-food purchases remains constant, a 1% increase in the price of food reduces his food-purchasing power by 1%, whereas a 1% increase in other prices reduces his food-purchasing power by 2.57%, and a 1% increase in his pension increases his food-purchasing power by 3.57%. The obsession with food prices is a relic of former times in which people spent most of their income on food. As the economy progresses, the fraction of income spent on food decreases, so that the affordability of food depends less on food prices and more on other factors. Under these conditions, zero-rating food and shifting the GST load from food to other products does not necessarily improve the affordability of food.

7.4.3 The domino effect

If the GST is to serve its purpose, any narrowing of the tax base must be compensated by an increase in the rate; this applies regardless of whether the purpose is to raise revenue or to control demand. If food is zero-rated because it is considered unacceptable to tax the poor on their food, the tax rate on other goods and services must rise. Then the rate of tax on (say) children's clothing, which was acceptable when food was in the base, becomes unacceptable, so that children's clothing must also be zero-rated, and the tax rate on other goods and services must rise again. Then the tax rate on something else becomes unacceptable, and so on. So the question becomes "Where do you draw the line?" I submit that there is only one sensible place to draw it: tax everything—and, if necessary, use the social security system to alleviate hardship (see Q9 in Subsection 7.2.1).

It has also been noted that concessional rates for selected "essentials of life" are a moral hazard because they make it too easy for governments to increase the standard rate—to the detriment of low income earners.[9] Similarly, concessional rates make it too easy for governments to treat the GST as a pure revenue tax rather than an instrument for controlling demand.

7.4.4 Compliance costs hurt the poor.

If food is zero-rated, the GST system becomes a two-rate system: wholesalers and retailers must keep separate accounts for food and non-food items, so that they collect GST only on non-food sales and reclaim GST only on non-food purchases. The additional cost of this exercise inflates prices. Avoiding multiple rates is much more important for a GST than for a WST because of the larger number of businesses involved in the GST system. The definition of food also leads to wasteful disputes; in the UK, where food receives concessional treatment under the VAT, the legal definition of food runs to 20 pages.[10] Moreover, concessions for food obviously should not be extended to restaurant meals, which are luxuries rather than necessities and which include an element of service. This requires a legal distinction between food and food services. In the UK, a cold pie is food but a hot pie is a service, the distinction depending

[9] G. Lehmann, "Exemptions, zero ratings bad for poor", *The Australian*, March 27, 1998, p. 22.
[10] *Australian Financial Review*, July 7, 1998, p. 44.

on the temperature of the pie! How does the Inland Revenue enforce this rule? By raiding take-away bars and sticking thermometers in the pies? The burden of all these compliance costs—including increased unemployment—falls preferentially on the poor (Section 5.6).[11]

Compliance costs cause deadweight costs, which are a dead loss to the economy. One cannot compensate the poor for deadweight costs, because there is nothing to compensate them with! But one *can* compensate the poor for the effect of a GST on food, because this is a redistributive effect and can be compensated by an equal and opposite redistributive effect.

7.4.5 Concessions help the rich.

In absolute terms, the top 20% of income earners spend three times as much on food as the bottom 20% [4, p. 167]. If food is zero-rated, the top 20% of earners get three times as much benefit as the bottom 20%. If food is taxed, and if the revenue raised from food is spent on a *non-means-tested* income support payment (Steps 1 and 2), the benefit goes equally to the top 20% and the bottom 20% of earners, and is therefore *better targeted* than the benefit of zero-rating food. If the income-support is means-tested, the targeting can be tighter, as the revenue raised from the top 20% is three times what is needed to compensate the bottom 20%. But because a means test is a highly distortionary hidden tax, I would not recommend that option; rather, if it were necessary to ease the burden on the bottom 20%, I would suggest increasing the GR and increasing the FDET so as to transfer income from the top 20% to the bottom 20% in a revenue-neutral manner.

These observations illustrate the general principle that assistance to the poor can be delivered more efficiently by social security adjustments than by tax concessions. The more efficiently we help the poor, the more we can help them. Inefficiency is a crime against the poor.

7.4.6 Reductio ad absurdum

If we take the view that food should be zero-rated under a GST, why stop at the GST? Why not argue—using exactly the same logic—that employees of giant supermarket chains should be exempt from income tax, and that their gross wages should be reduced to their former after-tax wages, enabling their employers to pass on the savings in the form of lower food prices? Why not argue

[11] *The Australian* recently published a table of GST rates in 22 countries (October 8, 1998, p. 2). I cannot help noticing that in the six countries where food is taxed like any other product, unemployment is lower than in Australia.

that all firms involved in the food supply, including some of the largest firms in the country, should be exempt from sales tax, payroll tax, FID/BAD, stamp duties, tariffs, excises, rates and land tax, so that they can pass on the savings to consumers? And because income tax is equivalent to a tax on consumption plus a tax on saving, why not argue that food expenses should be tax-deductible so that the consumption component does not apply to food? Again the question becomes "Where do you draw the line?" Again the answer is the same: tax everything—and, if necessary, use the social security system to alleviate hardship.

7.5 What should be exempt/zero-rated?

There is nearly universal agreement that if a GST is introduced, financial services and residential rents should be exempt (input-taxed), and exports should be zero-rated. This section discusses what other concessions should be given.

7.5.1 Once exempt, always exempt.

If your business is exempt, you have no GST compliance costs, but you still pay GST in the prices of your inputs. If the Government were to change your status to zero-rated, it would give some tax relief to your customers (good politics), but would increase your compliance costs (bad policy, bad politics) and narrow the tax base (bad policy). If the Government were to change your status to fully-taxed, it would tax your customers more (bad politics), increase your compliance costs (bad policy, bad politics) and slightly broaden the tax base by taxing your outputs instead of your inputs (good policy). On balance, neither change is attractive to the Government; if your class of business is exempt when a GST is introduced, it will stay exempt.

7.5.2 Once zero-rated, always guessing.

If your business is zero-rated, you still have GST compliance costs, but you are outside the GST base. If the Government were to change your status to exempt, it would slightly increase costs for your customers (bad politics), reduce your GST compliance costs to zero (good policy, good politics) and slightly broaden the tax base by including your inputs (probably good policy). If the Government were to change your status to fully-taxed, it would tax your customers (bad politics) without greatly adding to your compliance costs (neutral policy, neutral politics) and would substantially broaden the tax base (good policy). On balance, the change to exemption is more attractive to the Government. But the Government will eventually notice that the fully-taxed option can be made more politically acceptable by introducing a concessional rate. This would soften the blow for your customers (better politics) without greatly adding to your compliance costs (neutral policy, neutral politics), and would establish a precedent whereby GST can be levied at multiple rates, just like the old WST (disastrous policy, but tolerable politics). As a coin standing on edge will eventually topple over, so a future government will eventually yield to the temptation to tax a previously zero-rated industry at a concessional rate. The only sure exception is exports, for which the need for zero rating is too obvious.

Why are multiple rates so disastrous? In the first place, there will be disputes over whether the rates apply to business types or product types. When they apply to business types, there will be disputes over classification of businesses; when they apply to product types, there will be disputes over classification of products. Some of the disputes will be played out in the courts. The outcomes will cause distortion as businesses redesign themselves and their product lines in pursuit of lower tax rates. In the second place, as business structures change over time, the same business will be forced to sell products taxed at different rates, and will need to separate these products for the purpose of calculating tax on outputs and inputs, causing a multiplication of compliance costs. As usual, the burden of all this waste will fall preferentially on the weakest members of society.

If a blowout in compliance costs is to be avoided, it is essential that the GST is not repeatedly amended by future governments and, in particular, is not ruined by multiple rates. Accordingly, I am not proposing any zero-ratings except for governments and exports (see Step 14). I am concerned at the numerous zero-ratings in the Howard government's tax package.

7.5.3 Health and nursing services

It is easy to argue that health and nursing services are essentials and as such should be free of tax. However, this argument tacitly assumes that people pay for their own health care, which assumption I find unacceptable.

In Australia, what is called health insurance is not insurance, and what is called a health insurance excess is not an excess. If you insure your house, you accept a known small expense (the premium) in return for a guarantee that you will not suffer a large expense (the repair or replacement of the house). Your worst-case out-of-pocket expense is the premium plus the excess (if any). But if you take out private health insurance, you do not get any guaranteed limit on your out-of-pocket expenses. All you get is a schedule of particular benefits for particular procedures, which do not cover the costs; even if your insurer has agreements with particular hospitals for “100%” cover, this applies only to hospital bills, not doctors’ bills. If your policy has an excess, it means that the excess is subtracted from the benefits payable; it does not mean that your out-of-pocket expenses are limited to the premium plus the excess.

If this country had a *real* health insurance system, every citizen would get a guaranteed limit on out-of-pocket expenses incurred in a single year. Such a system would *not* be a blank cheque for overservicing, because at any time most patients would still be under their annual limits and would meet their own expenses—and carefully scrutinise their bills. It would, however, eliminate most trips to the local Medicare office.

Given that every patient has a ceiling on annual health expenses, the equity of the system depends mainly on the height of the ceiling. Whether you pay tax on your way up to the ceiling is of little importance; indeed, the revenue from such a tax might be used to fund a lowering of the ceiling. Hence the treatment of health and nursing services under a GST can be decided on grounds of efficiency and simplicity, not equity. Because health and nursing services are not likely to be business inputs, there is little point in allowing GST refunds on them, indicating that such services can be exempted or zero-rated. Exemption is the simpler and more stable option, and minimises compliance costs for service providers.

Of course, the ceiling on annual health expenses would include prescribed medicines, so the tax treatment of such medicines would have little effect on equity. The simplest arrangement is to exempt medicines administered in hospitals (so that the hospital has no compliance costs) and tax medicines dispensed by pharmacists (so that everything in the pharmacy receives the same tax treatment).

The ceiling should also include travel costs and accommodation costs incurred in the course of receiving medical treatment; these costs are considerable for rural patents who must travel to the cities for treatment. Hence the normal taxation of travel and accommodation should not have serious implications for equity.

7.5.4 Education and childcare services

Education and childcare—including private school education—are heavily subsidised by governments. Hence the treatment of education and childcare under a GST has little to do with equity; if these services are taxed, the resulting revenue can be used to increase the subsidies so that parents are no worse off. So again the decision can be made on grounds of efficiency and simplicity. As education and childcare are not likely to be business inputs, there is little point in allowing GST refunds on them, indicating that such services can be exempted or zero-rated. Again, exemption is the simpler and more stable option, and minimises compliance costs.

7.5.5 Rates and land tax

If rates and land tax are calculated on unimproved capital values, they are taxes on economic rents. If they are calculated on improved capital values, they are also taxes on wealth. In either case, they are not taxes on consumption and should not be taxable or deductible under a GST. The question is whether the governments that impose these taxes should be exempt or zero-rated. The general rule is that governments do not pay tax. If this rule is applied to a GST, the result is that governments are zero-rated and must claim refunds on their inputs. This is pointless in the case of the Federal Government, as it would be claiming refunds from itself. One could also argue that local governments should not claim GST refunds, because this exercise would involve compliance costs and would merely transfer revenue from the Federal Government to the local Council, resulting in lower rates and higher Federal taxes, and leaving the ratepayers no better off overall; hence it is simpler to exempt local governments and let them pay GST on their inputs. The same argument can be applied to State governments. Politically, however, it is obviously impossible for a Federal government to tax State and local governments; the combined campaigning power of State and local governments is so great that it can shout down a Federal government regardless of the merits of the case. Accordingly, State and local governments would be zero-rated.

7.6 Adjusting the GST rate

Step 15 proposes that the GST rate be used as a substitute for monetary policy. *Monetary policy* is the standard euphemism for the efforts of governments and central banks to control credit. In a regulated banking system, such as Australia once had, control can be exercised on the *supply side* by requiring private banks to deposit a certain percentage of their funds with the central bank (the RBA). When this percentage is increased, the private banks have less money to lend; this situation is called a *credit squeeze*. In a deregulated banking system, such as Australia now has, control must be exercised on the *demand side* by varying official interest rates, such as the rates paid on government bonds. Because of the dominance of the central bank in the national financial market, changes in official interest rates affect most other variable interest rates in the system. When interest rates rise, borrowers reduce their demand for new loans (the desired result) and find it more difficult to pay back old loans (the unacceptable side-effect, amounting to a retrospective penalty for past borrowings).

The one advantage of using variable interest rates to control demand is a political one: the Government can hide behind the decision of the "independent" RBA. If a variable GST is to be politically acceptable, the Government must also be able to hide behind recommendations of the RBA on the tax rate. That the RBA should make such recommendations is perfectly reasonable because the purpose of varying the GST rate is to control demand, inflation and the balance of payments, which are traditional concerns of the RBA. Hence Step 15 proposes that the GST rate be adjusted by the Treasurer on the recommendation of the RBA, and that the recommendation be published at the same time as the Treasurer's decision. The reason for using the GST to control demand is that it avoids high interest rates; hence Step 15 also proposes that the maintenance of low interest rates be added to the RBA's brief. If the GST rises, some of the extra revenue can be used to increase the GR and supplementary benefits so that the burden of the increased GST is concentrated on the rich. Benefits are traditionally indexed to the CPI. But if the CPI were to change suddenly because of a GST change, the old indexation system would not adjust benefits until the *next* quarter (assuming quarterly adjustments). To avoid this delay, the expected CPI change due to the GST change should be added to the latest measured quarterly CPI change, and the GST-induced change for the previous quarter (if any) should be subtracted.

If the GST rate is increased/decreased at the beginning of a quarter, every business collects more/less GST on sales during that quarter, and pays and reclaims more/less GST on purchases during that quarter. For a GST reduction, each business would immediately cut prices of existing stock. The prices paid for that stock during the previous quarter would stand, but all new stock would be cheaper, so that no cash-flow difficulties would result. For a GST increase, a business might increase all prices immediately in order to compensate for higher input prices, or it might confine the price increases to new stock in order to encourage the clearance of old stock; a business with electronic price storage would probably choose the former option, while a business with price tags on individual articles would probably choose the latter.

There remains the question of what standard increments should be used when adjusting the GST rate. When GST is included in the displayed prices of goods and services, the computation of GST returns involves the tax-inclusive rate, given by Eq. (7.9). Hence it is convenient that the tax-inclusive rate r_i, rather than the nominal or tax-exclusive rate r, should be a round figure. A

Table 7.6: Tax-inclusive GST rate (r_i) vs. nominal or tax-exclusive rate (r).

r (%)	r_i (%)
2.04	2
3.09	3
4.17	4
5.26	5
6.38	6
7.53	7
8.70	8
9.89	9
11.11	10
12.36	11
13.64	12
14.94	13
16.28	14
17.65	15

sample of rates is shown in Table 7.6.

7.7 A weapon against tax evasion?

Every new tax produces an initial improvement in the level of compliance with tax laws. People who have been evading old taxes are not sure whether they can get away with evading the new one, so they play safe: they identify themselves to the tax authorities for the purpose of paying or collecting the new tax. Having identified themselves, they are then obliged to be more honest about the old taxes as well as the new one.

If a business fails to register as a GST collector, it does not entirely escape GST, but pays GST on its inputs instead of remitting GST on its outputs; in other words, it becomes input-taxed, and only escapes the tax on its own value added. It also runs a high risk of detection: if it sells to a registered business that claims GST refunds on its inputs, an audit of the registered business will expose the unregistered one. The unregistered business cannot prevent this outcome by warning that it only accepts cash or that it does not give receipts, because such warnings draw attention its unregistered status. Because the risk of detection is out of all proportion to the amount of tax evaded, failure to register is not an attractive option to a seasoned tax-evader. For example, when the New Zealand Government introduced a GST, it expected 180 000 businesses to register as GST collectors. It got 280 000 registrations.[12]

A more likely method of evading GST is to register, claim refunds on one's inputs, but fail to declare all of one's sales. Records of sales can be avoided by failing to use the cash register, or having two cash registers with a tape in only one of them, or offering discounts for cash in hand.[13] But the registration of the business makes these tactics more dangerous than they would otherwise be. When a business is registered, the tax authorities can apply various benchmarks to see whether a full audit is likely to bear fruit; for example, for any type of business, the authorities may know typical ratios of sales to inputs and sales to stock losses. Hence, while a GST is not impossible to evade, it is more difficult to evade than the alternatives.

Under a GST, the detection of unregistered businesses is made possible, not by the vigilance of the tax authorities, but by the desire of registered businesses to reclaim GST paid on their inputs. No other indirect tax has this self-enforcing feature. The only one that comes close is the RST, for which non-retail businesses must keep accurate records of their sales in order to show that they are not dealing directly with the public; hence, if a wholesaler sells to an unregistered retailer, an audit of the wholesaler will expose the retailer.

Whereas a GST or RST invites cooperative enforcement, a WST invites cooperative evasion. Under a WST, the tax office is a middleman between the wholesaler and retailer, both of whom stand to gain by cutting out the middleman. Old techniques include the "split invoice" (by which a consignment of goods is divided into small parts which are individually below the WST threshold) and the bogus sales-tax-paid certificate.

A new technique by which individual purchasers can avoid WST, and which I believe is not even illegal, is the Internet mail-order. As I understand it, if you order goods worth less than A$200 from an overseas supplier, the ATO does not want to know. Moreover, the calculation of WST on an Internet transaction would be problematic because there is no wholesaler between the seller and the buyer. This logical problem does not arise under a GST or RST, because these taxes are collected at the retail level. If the ATO were keen to collect GST on Internet purchases, it could require the credit provider or account provider to remit the tax.

[12] *Courier-Mail*, Brisbane, August 22, 1998, p. 27.
[13] ibid.

7.8 Answers to objections

Numerous objections to a GST are based on the assumption that the introduction of a GST would increase the cost of living. In the system proposed in this book, the GST is introduced at such a rate that the cost of living falls, because the price effect of the GST is not sufficient to compensate for the elimination of other indirect taxes—let alone the introduction of the GR. Accordingly, objections alleging general price rises are not prominent on the following list.

1. *If a variable GST maintains low interest rates, it restricts the income from the savings of self-funded retirees.*

   Response: The objection assumes that the savings are invested in interest-bearing deposits. That is not the only option. When interest rates fall, fixed-interest deposits become less profitable, but shares become more profitable and more secure. The onus is on the fund manager to invest in such a way as to obtain acceptable returns and acceptable security.

2. *Taxing essential consumption is unfair to the poor, whose consumption is not discretionary.*

   Response: And exempting essential consumption feathers the beds of the rich, who spend more money on "essentials" than the poor.

   The tax system is an unsuitable instrument for dispensing social justice. To help the poor, it is necessary to *give*; but the tax system, by definition, can only *take*! Helping the poor is the purpose of the social security system. The purpose of the tax system is to raise revenue—including the revenue needed by the social security system.

   In the system proposed in this book, the GR and supplementary benefits provide a basic income to cover non-discretionary consumption.

   Even if the objection were valid, it would apply to numerous other taxes which inflate the prices of life's essentials, and which this book proposes to abolish.

3. *If prices include GST, the GST is a hidden tax.*

   Response: If a GST is imposed at a single rate, and if this rate is adjusted and advertised at the beginning of each quarter as a demand-control measure, no consumer will have any excuse for not knowing what the rate is, or what fraction of the prices of goods and services is GST; see Eq. (7.9).

Contrast this with the multi-rate WST, or payroll tax, or financial taxes and stamp duties, all of which inflate prices in ways that the consumer cannot predict.

4. *People who cannot travel to large shopping centres pay higher prices, hence more GST. For example, elderly or disabled people may be forced to shop at local corner stores, and people in remote areas pay high prices* [9, p. 32].

   Response: In other words, a GST does not change the ratio of prices paid in one location to prices paid in another. The problem of regional variations in the cost of living is not likely to be solved by any kind of tax reform. This book argues that the elderly and the disabled should qualify for non-means-tested supplementary benefits. Subsidising the provision of goods and services in remote areas is a separate issue and can be debated on its merits.

   Besides, the WST suffers from a similar problem because it is calculated on the last sale before the retail sale.

5. *Elderly and disabled people are forced to engage paid domestic help and would pay GST on such services* [9, p. 32].

   Response: Domestic servants now pay hidden taxes on their inputs, and these taxes are passed on to customers. A major reason for introducing a GST is to remove such taxes. In any case, carer pensions minimise the need for domestic services, and the remaining need can be taken into account when setting the rates of the GR and supplementary benefits. As always, it is better to help the needy through the social security system than to complicate the tax system and narrow the base. After all, millionaires are more likely than the elderly and disabled to employ domestic servants.

6. *People with particular illnesses or disabilities incur associated expenses, e.g. for equipment or special diets, on which they would pay GST* [9, p. 104].

   Response: That's why we have sickness and disability allowances. If these allowances are not sufficient, the simplest and most direct solution is to increase them. Of course the payment of such allowances requires revenue, which has to come from somewhere.

7. *A GST would apply to funerals* [9, p. 104].

Response: Emotive stuff, but nothing new. Undertakers now pay sales tax, stamp duties, FID/BAD and payroll tax, and pass on all these expenses in the prices of funerals. This book proposes to remove those hidden taxes.

8. *Students would pay GST on books.*

   Response: So would non-students. The effect on students must be taken into account when setting the rates of study and training allowances.

9. *If anyone is adversely affected by the GST and compensated through the social security system, that compensation can be taken away at a later date.*

   Response: Tax concessions can also be taken away at a later date. Taxes can even be increased. There is no reason to suppose that fairness delivered through the tax system is any more permanent than fairness delivered through the social security system.

10. *The GST compliance cost for a small business would be greater, as a fraction of turnover, than for a large business.*

    Response: The same is true of stamp duties, financial taxes, PAYE income tax, FBT, company tax and (for producers and wholesalers) WST. Moreover, the compliance cost of a GST is not a total waste, because it enforces the sound practice of keeping records of purchases and sales (but if businesses were required to separate food and non-food merchandise in GST calculations, the additional compliance cost *would* be a total waste). Computation of GST also serves as a periodic check on the solvency of a business: if you owe GST at the end of the quarter, you are making a profit on those transactions on which GST is computed; if you are owed a refund, you are in trouble. Concern about compliance costs is well placed, but not if it focuses on a GST (see also Table 7.5).

11. *Introduction of a GST would be a bonanza for accountants and lawyers.*

    Response: Only during the transition phase. All GST proposals, including the one in this book, involve the elimination of numerous other taxes, resulting in an overall simplification of the tax system and leaving *less* work for accountants and lawyers in the long term. In New Zealand, small businesses do not need accountants to prepare their GST returns, and the same returns reduce the amount of accounting to be done at the end of the financial year.[14]

12. *Canada's GST was introduced in 1991 and is still unpopular.*

    Response: New Zealand's GST was introduced in 1986, and the Government was re-elected in 1987. Canada's VAT has too many concessions, is added to displayed prices rather than included in prices, and—most ridiculous of all—is imposed on top of sales taxes. And the Government tainted it forever by stacking the Senate in order to pass the enabling legislation. Australian advocates of a GST cite the Canadian experience as an example of how *not* to do it.

13. *Replacing a WST with a GST reduces the prices of luxuries and encourages inappropriate expenditure* [9, p. 55].

    Response: Many items that were regarded as luxuries in the 1930s, when the WST was introduced, are no longer regarded as such. If the Government wants to impose a tax surcharge on *real* luxuries, such as prestige cars, yachts and private aircraft, it can impose an RST on those items. Because only a small number of businesses would remit such a tax, and because the tax would be imposed on a small number of large transactions, the additional compliance cost would be small; furthermore, the industries on which the compliance cost would fall are not major domestic employers. My only concern is that if such a tax were initially imposed on a small class of goods, the class of taxable goods might be expanded in a series of revenue-driven steps, eventually leading to a mess like the old WST. On that point I am open to persuasion.

14. *If a GST were to replace excises, it would lead to excessive consumption of alcohol, tobacco and fossil fuels* [9, p. 55].

    Response: You don't have to eliminate excises. The Howard government's GST proposal does not abolish excises, although it does reduce the diesel fuel excise in order to avoid excessive increases in food prices.

15. *The mere fact that a GST requires compensation proves that it is unfair* [9, p. 55].

    Response: If other indirect taxes are abolished, it is possible to introduce a GST at such a rate that no compensation is required. But let us take up the objection supposing that some compensation is required.

[14] A. D. Spence, "GST debate gets some input from New Zealand", *The Australian*, March 16, 1998, p. 21.

The objection assumes that if a reform is to be fair, it must produce winners but no losers. This requirement is called the *Pareto criterion*. But if the gains of the winners outweigh the losses of the losers, the winners could afford to compensate the losers and still have some of their gains left over. If this compensation is paid, the end result satisfies the Pareto criterion. Hence a reform in which the gains of the winners outweigh the losses of the losers is said to satisfy the *potential Pareto criterion* (also called the Hicks-Kaldor criterion). Critics of the potential Pareto criterion point out that compensation may not be paid to every loser. Whether this is a problem involves a value judgement which may vary from case to case; one may well take the view that certain persons *should* be losers. It is perfectly clear, however, that the Pareto criterion is a higher hurdle than the potential Pareto criterion. Hence the opponents of any particular reform always choose the Pareto criterion, while supporters always prefer the potential Pareto criterion. That the GST debate follows the same pattern says something about human nature, but nothing about the GST.

16. *A GST is too complicated.*

    Response: A GST is as simple or as complicated as the politicians decide to make it. In the end, its complexity is proportional to the amount of political opposition that must be overcome in order to introduce it. Such opposition leads to inappropriate exemptions and zero ratings, which not only complicate the GST, but also reduce its revenue and increase the number of old taxes that need to be retained. The complexity of any remaining old taxes comes on top of the complexity of the GST. If the GST has sufficiently few exemptions and zero ratings, so that it can replace a sufficient number of old taxes, it leads to an overall simplification of the tax system.

17. *Savings due to the elimination of other indirect taxes may not be fully passed on to consumers, because businesses with tight margins may take the opportunity to restore their margins to more normal levels.*

    Response: If a business has serious competitors, it will be forced to retain tight margins; it not, it will already have comfortable margins. In any case, a restoration of more normal margins would help the restoration of more normal levels of employment. Wages come from margins.

18. *A GST will devalue the savings of retirees.*

    Response: Only if it causes a rise in the cost of living—in spite of the GR and the abolition of other indirect taxes. If that happens, the removal of means tests on pensions (Step 2) is generous compensation.

19. *The sales tax system can be modified so as to remove taxes on inputs.*

    Response: If you do that job thoroughly, you turn the sales tax into a VAT—which is fine, as long as you admit what you're doing.

20. *Overseas experience shows that once a GST is introduced, it is never abolished.*

    Response: Could that be because there is some merit in a GST? If a government introduces a GST in order to abolish half a dozen nuisance taxes on business inputs, what future government is going to reintroduce half a dozen nuisance taxes on business inputs in order to abolish the GST?

21. *Consumption is not a reliable measure of capacity to pay.*

    Response: Neither is income; see Subsection 6.1.1. The combination of an FDET, a GST and a non-means-tested social security system assumes that capacity to pay can be measured not by overall consumption, but by consumption in excess of a basic level which depends on the circumstances of the consumer.

22. *Small businesses will incur massive set-up costs in the transition to a GST. A GST-capable cash register can cost $7000.*

    Response: If the accounts of a business are in order, and if the GST is not complicated with inappropriate exemptions and zero-ratings (like food), the submission of a GST return does not require any information that is not available from the accounts. This applies regardless of whether the accounts are computerised. If they are, most small-business accounting software sold in Australia is already GST-aware. The ability to handle possible future changes in tax laws is obviously a strong selling point for an accounting package, and vendors design their packages accordingly. If GST is included in prices, the cash register does not need to know about it.

23. *A GST is inevitably more complex than income tax* [9, p. 63].

    Response: That one takes the cake. GST involves sales and purchases. Income tax involves sales, purchases, payroll, interest, depreciation, fringe benefits, capital gains, business structures carefully chosen to minimise tax, and (sometimes) a good measure of creative accounting.

Chapter 8

Constitutional reform

8.1 Difficulty of the task

Constitutions are overrated. New Zealand hasn't got one. Britain never had one. Canada's is scattered among so many documents that it is barely recognisable. The US Constitution, with its comprehensive Bill of Rights, did not end slavery until 1865, did not give women the vote until 1920, and did not prevent American citizens of Japanese parentage from being interned in concentration camps and stripped of their property during World War Two; but it did give organised crime a monopoly on the manufacture and sale of liquor from January 1919 until December 1933. Neither does the US Constitution require the popular election of state delegates to the Electoral College that elects the President.[1] Rather, the US Constitution allows the legislature of each state to determine the manner in which its delegates are appointed, and the legislatures have chosen popular elections; thus the Presidential election—the most familiar feature of the US political system—is not constitutionally entrenched.

The Australian Constitution, although it is a single written document, does not attempt to codify the conventions of the Westminster system within which it was born, and consequently gives a grossly misleading description of the political process. It portrays the Governor-General as a chief executive appointed by the Queen and vested with powers that considerably exceed those of the President of the United States. It does not mention the Prime Minister. It does

[1] Contrary to widespread belief outside the United States, the American people do not directly elect their President. Suggestions that the President of the Australian Republic should be directly elected by the people are not based on any American model.

not mention political parties except in connection with the filling of casual vacancies in the Senate, which it otherwise assumes to be a house for the States, not for the parties. More seriously, the Constitution debars immigrants from standing for Parliament if their former countries will not let them renounce their former citizenship (s. 44(1)), places financial barriers in the way of government employees who wish to stand for Parliament (s. 44(4)), contains very little protection for basic rights, generates endless red tape and litigation by leaving too many areas of overlap between Federal and State responsibilities, and allows the Federal Government to extend the overlap through its power to make conditional grants (s. 96).

The inadequacies of the Australian Constitution are widely acknowledged on both sides of the political divide. But as soon as a government draws up a specific proposal for Constitutional reform and puts it to a referendum, political opponents turn on it and tear it to pieces. It matters not what these same opponents have said about the same proposal in recent years: as soon as the proposal is put, the Constitution becomes Holy Writ, the founding fathers become Prophets, and the would-be reformers become heretics and apostates who must be silenced, lest the land be smitten with plagues.

Why does this happen? Because politics is about winning, and every win counts. If you win a referendum campaign, you shore up your own leadership, destabilise the leadership of the opposing party, and gain an advantage in credibility that will help you in the next election. And your chances of winning a referendum campaign are much better if you campaign against another party's proposal than if you put up a proposal of your own. There are four reasons for this:

- Section 128 of the Constitution is deliberately biased in favour of the "No" case. If a bill to amend the Constitution is to become law, it must be passed by at least one house of the Federal Parliament and must be submitted to a referendum, in which it must be approved not only by an overall majority of voters, but also by majorities of voters in at least four States. Hence, to defeat the referendum, you only need to secure majority "No" votes in three States, and you can afford to confine your campaign to the three States in which you are most likely to succeed.

- Superficially, a "No" campaign seems more patriotic than a "Yes" campaign. A "No" campaign expresses support for the country as it is, while a "Yes" campaign tries to change it. A "No" campaign expresses unqualified reverence for the founding fathers, while a "Yes" campaign has the effrontery to suggest that the founding fathers lived in different times, or—blasphemy of blasphemies—that they were only politicians.

Of course a true patriot, as opposed to a superficial patriot, will want to improve anything that can be improved for the benefit of the people. So the argument from patriotism does stand up to scrutiny; but as long as the argument is not made explicit, it escapes scrutiny.

- A “No” campaign allows you to take advantage of a basic human instinct: fear of the unknown. Although the proposed changes to the text of the Constitution are set out in the back of the referendum booklet distributed to every household, they qualify as unknowns because most voters don’t bother to read them. So the instinct prevails, and its effect is to place to onus of proof on the “Yes” case. To get people to vote “Yes”, you have to prove that the proposed amendment is desirable. To get them to vote “No”, you only have to generate enough FUD (Fear, Uncertainty and Doubt) to cause indecision; in a referendum, an undecided voter is a “No” voter.

- Under the Referendum (Machinery Provisions) Act, voting in referenda is compulsory. Hence undecided voters do not have the option of staying home. They must go out and vote; and when they vote, they vote “No.”

In the 18 referenda since federation, 42 separate proposals have been put to the voters. Only eight proposals have been carried. None of the successful proposals encountered substantial organised opposition, while all of the unsuccessful ones did [16, p. 29]. In other words, 81% of referendum questions have attracted organised “No” campaigns, and the success rate of such campaigns has been 100%. So the rival politicians, preferring to back a winner, back the “No” case. Having made that decision, they then look for arguments to justify it. Any arguments will do—valid or invalid, honest or dishonest, consistent or inconsistent—as long as they are plausible enough to scare a majority of voters in each of three States.

Of course, once you have committed yourself to the “No” case, you cannot afford to lose; if the amendment is adopted and your predicted plagues fail to materialise, your credibility will be irreparably damaged. So you have to go for broke. And it is safe to do so because you are campaigning, not against people, but against *ideas*, and ideas cannot sue you for libel or challenge you in the Court of Disputed Returns. As a result, campaigns against referendum proposals are the dirtiest political campaigns waged in Australia. The process reached its nadir on September 3, 1988, when the Australian people, by a record margin, voted down a proposal that would have compelled the States to recognise freedom of religion, the right to trial by jury, and the right to fair compensation for property acquired by the Crown.[2]

8.2 Solution: optional voting in referenda

Because a referendum proposal can be defeated by a scare campaign in three States, any major political party, or any other organisation capable of mounting a saturation advertising campaign in three States, has a virtual veto on Constitutional change. This is not democracy; this is government by political parties and vested interests. To restore some semblance of democracy, the opponents of Constitutional change must be forced to produce something more that FUD. There is obviously no hope of amending s. 128 so as to make the Constitution easier to change, because that would require a referendum under the existing s. 128, and there is no more radical change to a constitution than a change in the mechanism by which it is changed. Neither is it possible to alter human nature so that the mug voter is more willing to consider change, or to read the referendum booklet from cover to cover—or, for that matter, to read the Constitution! But it is a simple matter to amend the Referendum (Machinery Provisions) Act to introduce non-compulsory voting in referenda that are not held simultaneously with general elections (Step 9). The minor parties in the Senate are not noted for dogmatic Constitutional conservatism and would not block the amendment. In a voluntary referendum, an undecided voter might have the decency to stay home rather than vote "No."

8.3 Means tests

The behaviour of undecided voters would be critical to the success of my first referendum proposal (Step 10), which is designed to stamp out the pretence that there is any difference between a means test and a tax. I am confident that any voter who could understand the proposal would support it. But, remembering the 1988 debacle, I am not altogether confident that a majority of eligible voters would understand it, and I am even less confident that all political parties would want the voters to understand it. Optional voting might therefore be critical to the success of the proposal. Because Australian voters are notoriously suspicious of any referendum proposal that appears to give more power to governments, the wording of the question would need to make it clear that

[2] For an assessment of the campaign against the four 1988 referendum proposals, see Paul Kelly, "Myths and bogeys", *The Australian*, September 2, 1988.

the intention is to *reduce* the power of the Federal Government, albeit only in respect of the reporting of its Budget. I suggest something like this:

> A Proposed Law: To alter the Constitution so that the Federal Government cannot impose a means test on any social security payment unless the money withheld as a result of the means test is counted as taxation in the Budget.

Note that the suggested wording gives a specific and complete description of the proposal; if the money withheld is counted as taxation, it follows that the full value of the benefit must be counted as expenditure in order to reconcile the books, and it is to be presumed that the rule applies "even in cases where the means test causes the full value to be withheld." Concerning the amendment to the text of the Constitution, I suggest that the proposal as worded in Step 10 be inserted in the Constitution as Section 82A.

In view of the unpopularity of means tests—not only because of the resulting withdrawal of benefits, but also because of the intrusion, inconvenience and temptation to which applicants are subjected—the question as framed above would stand a reasonable chance.

8.4 State taxes

If my second referendum proposal (Step 12) is to succeed, the question must clearly explain that the intention is to *reduce* the taxing powers of State governments. I suggest the following wording:

> A Proposed Law: To alter the Constitution so that
>
> - State governments cannot impose any new taxes;
> - State governments must abolish all existing State taxes except fees and charges, land taxes, mining royalties on existing mines, and surcharges on the Flat Direct Expenditure Tax (FDET); and
> - State governments must not complicate the FDET—each State may determine the rate of its own FDET surcharge, but must impose the same rate on personal and corporate FDET, and must impose the surcharge on the same range of transactions as are subject to the corresponding Federal tax.

In the text of the Constitution, I suggest a new Section:

> 112A. The States shall not impose any taxes except land taxes, mining royalties under agreements which exist when this section comes into effect, and surcharges on the Commonwealth direct expenditure tax. Each State may determine the rate of its direct expenditure tax surcharge, but must impose only a single rate, and must impose this rate on the same range of transactions as are subject to the Commonwealth tax.
>
> For the purposes of this section, “taxes” do not include freight charges as permitted by Section 104, inspection charges as permitted by Section 112, vehicle registration fees, or other fee-for-service charges, but do include payroll taxes, financial institutions duties, debit taxes, stamp duties, gambling taxes, income taxes, capital taxes, transaction taxes, turnover taxes, sales taxes and value-added taxes.

Comparing the question with the proposed addition to the Constitution, one may reasonably allege that the question puts a positive spin on the proposal, but not that the question is vague or misleading, although for brevity it assumes familiarity with fees and charges. One of the lessons of the 1988 referendum is that if the wording of a question is vague, opponents will seize upon its vagueness as evidence that the proponents of change have something to hide.

I have suggested in Step 11 that all Commonwealth grants to the States, except matching grants and fiscal equalisation grants, should cease. I refrain from suggesting that this step be entrenched in the Constitution, for two reasons. First, the necessary referendum would be a waste of time, because the States would campaign against it and sink it. Second, even if the step were not Constitutionally entrenched, it would be politically entrenched: if the States were once made to stand on their own fiscal feet, no subsequent Federal government would again accept the political odium of raising taxes on behalf of mendicant States.

8.5 Politicians’ pay and perks

Politics is a full-time occupation, leaving no time for income-earning activities outside politics. A part-time politician would not be able to compete with full-time rivals, and in any case the voters expect full-time service from their representatives. Therefore, if politicians were not paid for being politicians, you would not be able to afford to enter politics unless you had already accumulated a large amount of wealth—or received a large inheritance. Parliamentary salaries make it possible for a poor person to become a politician. Without parliamentary salaries, the political system would not be truly democratic, because the greater part of the population would be financially ineligible to enter politics.

Parliamentary salaries have changed politics, which was once the exclusive preserve of the upper classes, into the most open of all professions. To enter politics, you do not need to be high-born. You do not need a formal qualification. You do not need the financial means of getting through a full-time course leading to such a qualification. You do not need the looks of a film star. You do not even need to be exceptionally intelligent or articulate. Therefore I am not about to join the chorus of back-seat drivers alleging that politicians are overpaid. The mug voter might reasonably object to the high earnings of a profession which puts up financial or other barriers to entry. But he cannot reasonably object to the high earnings of a profession which he himself is free to join, especially as he imagines himself more fit to join it than those who have already done so. "If you want to pay peanuts, hire a monkey," says the proverb. If the mug voter would make such a fine politician as he claims, and if he has not been persuaded to enter politics, it is obvious that the salaries of politicians need to be increased in order to attract more capable candidates like himself.

My concern is not that politicians are paid too much, but that they are paid in the wrong way and rewarded for the wrong kinds of behaviour:

> **Problem 1:** During election campaigns, politicians use arguments that are demonstrably invalid and make statements that are demonstrably false. This is election rigging—less likely to attract international condemnation than stealing ballot boxes or intimidating voters, but equally effective.
>
> *Cause:* Ministers are paid more than Shadow Ministers, giving too much incentive to win elections and creating too much temptation to cheat.
>
> *Solution:* Pay all MPs the same salary whether they are in government or opposition.
>
> **Problem 2:** Back-benchers seem incapable of independent thought. They are rounded up like sheep by the party whips, and whichever party or coalition has the most sheep wins every vote.
>
> *Cause:* Ministers are paid more than back-benchers. If you want to be a Minister, you have to toe the party line.

Solution: Pay all MPs the same salary whether they are Minister or not. When they become Ministers, give them extra staff and a crash course in delegation. Back-benchers who become Ministers will still have toed the party line, but only because they drew it.

Problem 3: On the few occasions when back-benchers speak out, they seem to be advocating populist and irresponsible policies in order to hold on to marginal seats. They still seem incapable of independent thought.

Cause: Parliamentary superannuation entitlements depend on length of service. In particular, you must serve three terms to qualify for a life pension.

Solution: Get rid of the Parliamentary super scheme. Let MPs continue contributing to whatever super schemes they were in before they entered Parliament. Pay them sufficiently high Parliamentary salaries to compensate for the lack of employer-funded super.

Problem 4: Parliamentary allowances seems too generous and too easily abused.

Cause: The allowance system is not sufficiently transparent and is different from the expense systems used by most employers in the public and private sectors.

Solution: Get rid of the allowance system. If MPs need to purchase goods or services in connection with their work, let them fill in standard forms and submit them to a common purchasing office. If that is too slow, let them make their own purchases, keep receipts, and apply for reimbursement.

Problem 5: Federal MPs seem to be able to vote themselves pay rises in mid term.

Cause: Section 48 of the Constitution allows them to do exactly that. Even if the decisions on Parliamentary remuneration are made by an “independent” tribunal, that tribunal owes its existence to a decision of the Parliament under s. 48.

Solution: Amend s. 48 so that if the MPs are awarded a pay rise, they must face the people before collecting it.

The solutions described above can be put into effect at the Federal level by amending Sections 48 and 66 of the Constitution as follows:

> 48. The Parliament may provide for the remuneration of the members of each house. But the remuneration shall be the same for all members, whether they are Minister or not, and shall be entirely in the form of salary; and any law or decision altering the salary of members shall not take effect until a general election for the House of Representatives, preceded by a public announcement of the salary alteration, has intervened.
>
> **Transitional provisions:** This section, when it has received the Queen's assent, shall come into effect from the beginning of the next term of the House of Representatives. The annual salary of each member of Parliament during that term shall be A\$.... .
>
> 66. A Minister shall receive the same remuneration as any senator or member of the House of Representatives.

The new s. 66 is not redundant; it is made necessary by the clause in s. 64 which allows a person to be a Minister for up to three months before becoming a member of Parliament.

The referendum question would be worded along these lines:

> A Proposed Law: To alter the Constitution so that
>
> - Members of Federal Parliament receive only a salary, with no "allowances" or employer-funded superannuation;
> - Ministers and back-benchers receive the same salary; and
> - Any change in the salary shall not take effect until a general election for the House of Representatives, preceded by a public announcement of the salary alteration, has intervened.

While the historical success rate of "No" campaigns is 100%, this proposal would surely blemish the record. A "No" campaign could only come from politicians, in which case it would be so obviously self-serving that it would backfire. The only plausible strategy for a "No" campaign is to ignore what the proposal does and focus exclusively on what it does *not* do: it does not altogether prevent Parliamentary pay rises. But that is no basis for a scare campaign when the electorate is already accustomed to such rises. The real question is whether the Parliament would put the question to the people at all.

As to what the Parliamentary salary should be, I offer only this observation: because the purpose of the amendment is to allow MPs to behave with quasi-judicial independence, it would not be unreasonable if their salaries were similarly judicial.

8.5.1 Epilogue

If an amendment to the US Constitution is approved by a 2/3 majority in each house of Congress, or by a convention called by Congress at the request of the legislatures of 2/3 of the states, the amendment is said to be formally *proposed*, and is then submitted to the states for ratification. If the proposal is approved by the legislatures of 3/4 of the states, or by conventions called in 3/4 of the states by the legislatures thereof, the amendment is *ratified* and becomes law; the Congress decides which of the two methods of ratification shall be used.

The Congress may also determine a time limit for ratification (usually seven years, and usually specified in the text of the proposed amendment). But in the absence of any such determination, there is no limit on the time which may elapse between proposal and ratification. The record, held by the 27th Amendment, is 202 years and 225 days. On September 25, 1789, twelve amendments were proposed. Ten of those were ratified by December 15, 1791, and became the Bill of Rights. One of the remainder eventually became the 27th Amendment when it was approved by the legislature of the state of Michigan on May 7, 1992. The 27th Amendment reads:

> No law, varying the compensation for the services of the Senators and Representatives, shall take effect, until an election of Representatives shall have intervened.

In the USA, constitutional amendments are ratified by politicians. In Australia, they are ratified by voters.

8.6 Chronic election fever

> Permanent electioneering, the automatic consequence of almost yearly major elections, encourages and entrenches the systematic “murder of reputations” which the great Victorian radical George Higinbotham identified more than a century ago as the bane of party politics and which drove him to seek refuge in the Supreme Court. Politicians can hardly complain of their low public standing when the public simply takes them at their own valuation. Fewer elections would mean better debate, better parties, better government and better democracy.

— E. G. Whitlam [25, p. 249].

8.6.1 Causes and consequences

The three-year Federal election cycle is too short. Of the three Budgets that a Government can deliver in one term, the first is wasted on the keeping of irresponsible election promises and the third is wasted on irresponsible pre-election pork-barrelling, leaving only the second Budget for hard but necessary decisions. An exception arises when an election results in a change of government, in which case the incoming government suddenly discovers that the outgoing government has grossly understated the seriousness of the fiscal situation, and that therefore—alas—it will not be possible for the new government to keep its promises, which—it goes without saying—were conditional on the old government's budget forecasts. So a new government can do all its dastardly deeds in the first Budget instead of the second, gaining an extra year for the hard decisions to pay dividends—and an extra year for the voters to forget.

Moreover, it has become rare for the House of Representatives to run its full term. The elections of 1972, 1993 and 1996 were full-term or nearly so; those of 1974, 1975, 1977, 1980, 1983, 1984, 1987 and 1990 were at least seven weeks early. The average term of the House between the elections of 1972 and 1998 was two years and four months,[3] indicating that it is more usual for a government to deliver two Budgets—a post-election Clayton's Budget and a pre-election Clayton's Budget—rather than three. Early elections not only increase the frequency of elections, but cause each election to be preceded by months of public speculation about the election date.

The usual reason for an early election is political opportunism: the Prime Minister judges that the political climate is deteriorating and that the Government has a better chance of winning an early election than a full-term election. Even double dissolutions are open to abuse. Under s. 57 of the Constitution, a double-dissolution is always an early dissolution—at least six months earlier that the expiry of the term of the House of Representative—and can take place only if the Senate twice rejects a bill passed by the House of Representatives. If the two houses remain deadlocked after the election, the disputed bill can be voted upon by a joint sitting of the houses. Therefore, if the incumbent party wins a double-dissolution election, one may reasonably expect the bill or bills that triggered the election to be reintroduced; but this is not obligatory.

Another common reason for an early election is the lack of synchronism

[3] Whitlam [25, pp. 301–2] gives a table showing the dates of all Federal and State elections from 1945 to 1996.

between the terms of the House of Representatives and the Senate. To avoid a doubling of the frequency of Federal elections, general elections for the House are normally held simultaneously with half-Senate elections. But the *terms* of the two houses are not simultaneous. Under s. 28 of the Constitution, the term of the House is a *maximum* of three years from its first sitting after an election. Under s. 13, each State Senator serves a *fixed* six-year term. After a half-Senate election, the term is reckoned from the first day of July *following* the election, and new Senators do not take their seats until then. But after a double-dissolution election, the term is reckoned from the first day of July *preceding* the election, and new Senators take their seats immediately. As a result of this backdating, the next half-Senate election after a double dissolution is early, and the Prime Minister often calls an early House election to coincide with it; this was the excuse for the early elections of 1977 and 1984. Thus a double-dissolution election, as well as being an early election itself, tends to precipitate another early election.

The budgetary decisions of Federal governments are further constrained by the political exigencies of State elections, which are not synchronised with Federal elections or with each other. There has been at least one Federal or State election in every calendar year from 1945 to 1993 inclusive. As if to make up for the drought in 1994, there were two elections in 1995, four in 1996, one in 1997, and three in 1998. Like Federal elections, State elections can be called early for the convenience of incumbent governments, and their timing is subject to speculation.

The result is that the entire political and economic system suffers from perpetual partial paralysis. When the Federal Government is not in election mode itself, it is under pressure from State colleagues in election mode. Financial markets are always affected to some extent by pre-election uncertainty. It is all but impossible to secure inter-State cooperation or Federal-State cooperation on any issue of long-term importance to the nation, because there is always at least one government with its attention fixed on short-term political point-scoring. This problem is especially serious in Australia because of the large number of matters on which the Constitution gives power to both Federal and State Parliaments; these matters include taxation, communications, railways, meteorology, fisheries, census and statistics, weights and measures, bills of exchange and promissory notes, bankruptcy and insolvency, corporations, banking and insurance, copyrights, patents and trademarks, matrimonial causes, social security, indigenous affairs, industrial relations—not to mention the numerous State responsibilities, such as roads, health, education and legal aid, in which the Commonwealth interferes by means of its power to make conditional grants under s. 96 of the Constitution.[4]

8.6.2 The remedy

If the term of the House of Representatives were extended to four years, as suggested in Step 21(a), two in four Budgets—instead of one in three—could be sufficiently far removed from elections to allow responsible decisions.

A four-year term for the House should have little difficulty gaining approval at a referendum, because every State except Queensland already has four-year terms; in 1991 a referendum for four-year terms in Queensland was narrowly defeated after the National Party objected to the absence of any provision for a minimum term. Most Parliaments in the world have terms of four or five years, with five years being more common [25, p. 252]. The two-year term of the U.S. House of Representatives is not comparable with the Australian situation, because the Australian cabinet is drawn from the membership of Parliament while the U.S. cabinet is not.

The only likely objection to a four-year term for the House is that, if half-Senate elections were held simultaneously with general elections for the House, Senators would serve for eight years. In 1984 and 1988, the Hawke government held referenda proposing simultaneous elections and four-year terms for the House. In the 1984 version, Senators were to serve for eight years. The conservative parties campaigned against the proposal, saying (among other things) that eight years was too long. In the 1988 version, Senators were to serve for four years—that is, every election was to be a double dissolution. The conservatives campaigned against the proposal, saying (among other things) that abolition of staggered Senate terms would reduce the independence of the Senate, but that there was nothing wrong with a four-year term for the House. Their acceptance of four-year terms for the House and staggered terms for the Senate seems to imply acceptance of an eight-year Senate term, in contradiction of their 1984 position. If the conservatives knew that a referendum for an eight-year Senate term, if defeated, would be immediately followed by a referendum for a four-year Senate term (Step 21), they would be forced to adopt a consistent position. (When I say "immediately", I means as soon as s. 128 will allow;

[4]Of course the power of the Commonwealth to interfere in State affairs would be substantially reduced if the Commonwealth were to abolish all grants to the States other than matching grants and fiscal equalisation grants (Step 11). If the Commonwealth were to hand some exclusive State responsibilities back to the States—to the point of abolishing the associated Commonwealth departments—the States might reciprocate by referring some of their other joint or exclusive responsibilities to the Commonwealth under s. 51(37) of the Constitution. If the responsibilities to be exchanged were well chosen, the result would be more uniform laws and less red tape. But such an exchange would be unlikely to occur in an atmosphere of permanent electioneering.

in practice at least three months would elapse between the two referenda.)

The proposal for synchronised terms of the House of Representatives and the Senate—usually but inadequately described as the "simultaneous elections" proposal—has been put to the Australian people on four occasions: in 1974, 1977, 1984 and 1988. In its simplest form, the proposal is that the term of Senators shall be two consecutive terms of the House, and that elections for the House and half the Senate shall be held simultaneously. The Labor Party has consistently supported the proposal. The conservative parties, at the Federal level, have consistently supported it when in government and opposed it when in opposition. In 1984 the proposal was combined with four-year terms for the House of Representatives. In 1988 it was modified to give four-year terms for both houses. On no occasion, however, was the proposal accompanied by any measure to discourage the Prime Minister from calling early elections. Whereas the PM can now take the House of Representatives to an election at a convenient time, the standard "simultaneous elections" proposal would allow the PM to take the House *and half the Senate* (or, in the 1988 version, the full Senate) to an election at a convenient time. In other words, the proposal strengthens the hand of the incumbent Government—which explains the changing attitude of the conservative parties.

The motive for calling an early election is to avoid an election at the scheduled time. The simplest way to prevent unnecessary early elections is to take away the motive: require any early election to be in *addition* to the election at the normal time, as suggested in Step 21(b), so that an early election becomes an *additional* occasion on which the Government could lose office. Then a Prime Minister would not call an early election except under the most extreme circumstances, such as a deadlock between the two houses on a critical issue, or the inability of any party or coalition to command the confidence of the House of Representatives. It is not necessary to codify the conditions under which an early election is permissible; indeed, codification would be dangerous because it might fail to foresee some eventuality under which an election is absolutely necessary, leaving the nation without a functioning Government. To avoid unnecessary early elections, it suffices to ensure that the Prime Minister cannot avoid the scheduled election by calling an early one.

Opponents of synchronised terms for the House and the Senate also claim that synchronisation would diminish the independence of the Senate and hence the influence of the States. This is nonsense. Although the Constitution assumes that the Senate is a forum for State representation, in practice the Senate votes along party lines, not along State lines. If the Senate is controlled by Government parties, it is a rubber stamp. If it is controlled by Opposition parties, it is a stone wall. Only when minor parties hold the balance of power can the

Senate be an genuine house of review or amendment—although amendments proposed by minority parties with no experience of government are liable to be impractical. Even if party loyalties were weakened by Step 20, State loyalties would not take their place; the factions of major parties are for the most part divided along policy lines, not State lines. Since the introduction of proportional voting in the Senate in 1949, the main difference between the two houses has been the presence of minor parties in the Senate, usually holding the balance of power. If the two houses had synchronised terms, the essential difference between them would remain. The power of the States, being already negligible, would not be diminished further. The only power that would be diminished is the power of the Opposition, which would no longer have any hope of throttling the Government in mid term through a change in the composition of the Senate.

As to whether the term of Senators should be eight years or four years, I make two observations. First, an eight-year term would ensure that at least half of the Senators continue serving through each scheduled election. This would give some continuity to the Senate committee process. Second, under the proportional voting system, a four-year term would reduce the quota of votes needed to elect each Senator, making it easier for minor parties and independents to win Senate seats. It should be noted, however, that the proportional voting system is *not* prescribed by the Constitution; it is prescribed by the Commonwealth Electoral Act, and can be amended or repealed by the Federal Parliament under s. 9 of the Constitution. Abolition of the proportional system would obviously not be supported by the minor parties in the Senate, but could be forced through by collusion between the major parties.

The frequency of elections can be further reduced, without compromising the sovereignty of voters, by synchronising State and local elections with Federal elections, as is the norm in the United States [25, p. 249]. It is sometimes said that simultaneous elections for different levels of government would lead to confusion between Federal and State issues [16, p. 269]. In fact the reverse is the case. A political party facing simultaneous elections for three levels of government must coordinate and harmonise its policies at Federal, State and local levels, and in so doing must explain which policy is for which level. But when an election is held for just one level of government, the contestants can openly invite voters to take other levels of government into account, or deliberately confuse the responsibilities of different levels of government. When a State government of the same political colour as the Federal government is facing an election, the State opposition routinely invites voters to "send a message to Canberra" concerning the least popular policies of its Federal opponents. In 1989 the Liberals almost won the unwinnable South Australian election by campaigning on the Federal issue of high interest rates. If Federal and State elections were held simultaneously, voters wishing to send a message to Canberra would write their message on the Federal ballot papers, not the State ones.

After a round of simultaneous Federal, State and local elections, the whole country would be election-free for the next four years, which is enough time for new policies to pay dividends. Therefore the best re-election strategy for every government would be to implement the best possible policies—in cooperation with other governments if necessary—and consequently go to the next election with the best possible record.

Another proposed method for reducing the frequency of elections is to have a maximum term of four years and a *minimum* of three years. This system would be a standing invitation for a Prime Minister or Premier to call an election at any time during the fourth year of the Government's term. It would institutionalise a full year of speculation about the election date—or force the PM or Premier to call an early election just to end the speculation. Furthermore, a mandatory minimum term would require exceptions to allow for the resolution of deadlocks, and the failure to allow for a particular kind of deadlock could paralyse a government for the remainder of its term. It is a stupid idea.

8.6.3 Implementation of the remedy

The relevant sections of the Constitution, in the plain English version given in Appendix D, are as follows (words in *italics* are quoted verbatim from the Constitution):

> 5. The Governor-General may appoint the times of Parliamentary sessions, may prorogue the Parliament, and may dissolve the House of Representatives. After any general election, the Parliament shall meet within 30 days of the day appointed for the return of the writs. . . .
>
> 7. *The Senate shall be composed of senators for each State, directly chosen by the people of the State* for a term of six years. The names of the senators elected for each State shall be certified by the State Governor to the Governor-General. The Federal Parliament may determine the number of senators for each State, but each Original State shall have the same number of senators and shall not have fewer than six senators.
>
> 9. The Federal Parliament *may make laws prescribing the method of choosing senators, but so that the method shall be uniform for*

all the States. Subject to any such law, the Parliament of each State may make laws prescribing the method of choosing the senators for that State.

The Parliament of a State may determine the times and places of elections of senators for the State.

13. **Staggered Senate elections:** After a double-dissolution election [Section 57], the Senate shall divide the senators for each State into two groups of equal size. The places of the first group shall become vacant after three years and the places of the second group shall become vacant after six years. The places of senators elected thereafter [in a half-Senate election] shall become vacant after six years.

The election to fill vacant places shall be made within one year before the places are to become vacant.

For the purposes of this section, the term of a senator elected in a half-Senate election shall be reckoned from the first day of July *following* the election, and the term of a senator elected in a double-dissolution election shall be reckoned from the first day of July *preceding* the election.

28. *Every House of Representatives shall continue for three years from the first meeting of the House, and no longer, but may be sooner dissolved by the Governor-General.*

32. Within ten days from the expiry of a House of Representatives or from the proclamation of a dissolution thereof, the Governor-General shall issue writs for a general election of members of the House.

Under my proposed amendments (Step 21), the above sections would be altered to the following effect:

5. The Parliament shall meet on the 44th day after any general election of the House of Representatives. Otherwise the Governor-General may appoint the times of Parliamentary sessions, may prorogue the Parliament, and may dissolve the House of Representatives.

7. The Senate shall be composed of senators for each State, directly chosen by the people of the State for a term of eight years. The names of the senators elected for each State shall be certified

by the State Governor to the Governor-General. The Federal Parliament may determine the number of senators for each State, but each Original State shall have the same number of senators and shall not have fewer than six senators.

9. The Federal Parliament may make laws prescribing the method of choosing senators, but so that the method shall be uniform for all the States. Subject to any such law, the Parliament of each State may make laws prescribing the method of choosing the senators for that State.

13. **Staggered Senate elections:** After a double-dissolution election [Section 57], the Senate shall divide the senators for each State into two groups of equal size. The places of the first group shall become vacant at the next half-Senate election, and the places of the second group shall become vacant at the half-Senate election after the next. The places of senators elected in a half-Senate election shall become vacant eight years after the election.

A half-Senate election shall be held on the fourth Saturday in November in the year 2001 and in every 4th year thereafter.

28. A general election of the House of Representatives shall be held on every day on which a half-Senate election is held under Section 13. Every House of Representatives shall continue until the next half-Senate election, and no longer, but may be sooner dissolved by the Governor-General.

32. Thirty days before the expiry of a House of Representatives or within ten days from the proclamation of an early dissolution thereof, the Governor-General shall issue writs for a general election of members of the House.

106A. An election for every house of every State Parliament and for every local government council shall be held on every day on which a half-Senate election is held under Section 13, and every such house or council shall have a maximum term of four years, commencing on the 44th day after the election. This section does not prevent eight-year terms for members of a State Legislative Council, provided that half of the members are elected every four years.

Transitional provision: For the purpose of bringing State and local elections into synchronism with half-Senate elections, the term

> of a local council or of a house of a State Parliament may be extended by up to six months or shortened by up to forty-two months.

The rules on double dissolutions would stay the same. In consequence of the above changes, a Prime Minister could call a double dissolution under the conditions of Section 57, and could call an early election for the House of Representatives only, but could *not* call an early election for the House plus half the Senate. The requirement that an early election shall be an extra election is implicit in the fixed quadrennial election dates; in no case could a Prime Minister or Premier avoid the next scheduled quadrennial election by calling an early one. Thus the power of Prime Ministers and Premiers to manipulate the political process for their own advantage would be *reduced*.

Under the alternative form of Step 21, involving four-year terms for the Senate, Sections 5, 9 and 32 would remain as above, while Sections 7, 13, 28 and 106A would be altered to the following effect:

> 7. The Senate shall be composed of senators for each State, directly chosen by the people of the State for a term of four years. The names of the senators elected for each State shall be certified by the State Governor to the Governor-General. The Federal Parliament may determine the number of senators for each State, but each Original State shall have the same number of senators and shall not have fewer than six senators.
>
> 13. A general election for the Senate shall be held on the fourth Saturday in November in the year 2001 and in every 4th year thereafter.
>
> 28. A general election of the House of Representatives shall be held on every day on which an election of the Senate is held under Section 13. Every House of Representatives shall continue until the next Senate election, and no longer, but may be sooner dissolved by the Governor-General.
>
> 106A. An election for every house of every State Parliament and for every local government council shall be held on every day on which a Senate election is held under Section 13, and every such house or council shall have a maximum term of four years, commencing on the 44th day after the election. This section does not prevent eight-year terms for members of a State Legislative Council, provided that half of the members are elected every four years.
>
> **Transitional provision:** For the purpose of bringing State and local elections into synchronism with Senate elections, the term of a

> local council or of a house of a State Parliament may be extended by up to six months or shortened by up to forty-two months.

Again the rules on double dissolutions would stay the same. In consequence of the above changes, a Prime Minister could call a double dissolution under the conditions of Section 57—but only under those conditions—and could call an early election for the House of Representatives only. In no case could a Prime Minister or Premier avoid the next scheduled quadrennial election by calling an early one. Again, the power of Prime Ministers and Premiers to manipulate the political process for their own advantage would be *reduced*.

The first simultaneous election of all legislatures would cut short the terms of State legislatures in violation of the constitutions of some of the States. However, s. 106 of the Federal Constitution makes it clear that State constitutions continue *subject to the Federal Constitution.* So any provisions of State constitutions that were inconsistent with the above amendments would, to the extent of the inconsistency, become void.

Section 394(1) of the Commonwealth Electoral Act forbids the States from holding State or local elections or State referenda on the same day as a Senate election or general election for the House of Representatives, “without the authority of the Governor-General” [25, p. 250]. This provision would also automatically become void under the above amendments. But, for the sake of strict and tidy legality, the Federal Parliament could repeal s. 394(1) of the Electoral Act before passing the Constitutional amendment bill and submitting it to the people.

The referendum question can be worded exactly as shown in parts (a) to (c) of Step 21. The wording emphasises simultaneous elections and synchronised terms for the two houses of Federal Parliament, which the people have rejected four times before, and four-year terms, which the people have rejected twice before. But it also emphasises fixed election dates and a disincentive to hold early elections—essential elements which have been missing from previous “simultaneous elections” questions. When the politicians deign to ask the right question, they will get the right answer.

Chapter 9

Political considerations

9.1 Thimble and pea

In the absence of means tests on social security payments, effective tax rates are the same as nominal tax rates. In the presence of means tests, effective tax rates are usually much higher than nominal tax rates; for example, the means test on Newstart allowance, by itself, increases the EMTR on earned income by up to 70 cents in the dollar. The abolition of means tests, as advocated in Chapter 2 for the dole and in Chapter 5 for all other benefits, necessarily reduces maximum EMTRs, because the equivalent tax surcharges are spread over broader bases, allowing lower rates. The only possible strategy by which a political party could defend means tests is to compare the effective tax rates under a non-means-tested system with the *nominal* tax rates under a means-tested system—as if the means test in the latter system did not exist. The fraudulence of such a campaign would be easily exposed by drawing graphs of the nominal tax rate, effective tax rate and after-tax income vs. earned income for the competing systems.

On October 26, 1998, the news broke that five leading academic economists had written a letter to the Prime Minister suggesting that safety-net wage increases should be replaced by tax cuts and tax credits for low income earners.[1] The letter brought swift condemnation from trade union leaders, who apparently did not trust the Government to keep its side of whatever bargain might be struck. The implication of the union position is that the responsibility for wage justice should rest entirely on employers. Why employers should be thought

[1] *The Australian*, October 26, 1998, p. 13.

any more reliable than the Government is not apparent to me. In any case, the union attitude bodes ill for my first proposal for reducing unemployment, which is to *cut* award wages and rely on a non-means-tested income support scheme (the GR) to protect the living standards of the working poor (Steps 1 and 3). It is certain that such a policy would be universally supported *after* its introduction, because it would restore full employment, and because the resulting competition between employers to attract labour would lead to improved overall income and conditions for the lowest-paid workers. The problem is how to introduce the policy in the first place. Making the reasonable assumption that the unions would be more willing to trust a Labor government with such a policy than a Coalition government, I predict as follows:

- If the Labor Party were to fight an election on a platform of implementing Steps 1 and 3, it would win;
- If the Coalition were to fight an election on the same platform, it would lose;
- If an incumbent government of either political colour were to implement Steps 1 and 3 without warning, it would win the next election and the one after.

If workers are suspicious of a trade-off between wages and tax credits, would they be any less suspicious of a trade-off between tariffs and wage subsidies (Steps 3 and 4)? For workers in protected industries, it should be obvious that their competitiveness can be as well protected by subsidising their wages as by raising the prices of imported competition. But whether this point is obvious or not, these workers and their dependants constitute a small minority of voters. For workers in all other industries and for their dependants, it *is* obvious that the maintenance of tariffs requires them to pay inflated prices for necessities of life—such as children's clothing—and that the replacement of tariffs with wage subsidies would cut prices. Therefore, even if workers in protected industries wrongly believe that their jobs are under threat, a policy of replacing tariffs with wage subsidies is good politics, because the real winners from the policy would greatly outnumber the imaginary losers.

9.2 Downward envy

Resentment of welfare recipients is caused by means tests. Those who do not work receive the dole, while those who work hard for a meagre income are deprived of the dole, leaving them with little to show for their work. The taking of a second job may cause a loss of family allowance, again leaving little to show for the extra work. A lifetime of saving may cause a loss of pension entitlements, leaving the saver with no reward for thrift. Long hours and unpaid overtime also contribute to resentment of the unemployed, who are seen to have an abundance of leisure. But long hours are caused partly by unemployment (Section 3.2), which in turn is largely caused by the means test on the dole (Section 2.4); long hours cannot be blamed independently of means tests. Moreover, in the absence of means tests, a worker or saver could not fail to be better off than a non-worker or non-saver in otherwise similar circumstances, would receive the same benefits as the non-worker or non-saver, and consequently would have no reason to complain about the comparative treatment of the non-worker or non-saver. Therefore, whatever else may contribute to downward envy, means tests are the *sine qua non*. No means tests: no downward envy.

Of course the abolition of means tests could be seen as an extension of "welfare" to the rich, and might therefore give occasion to *upward* envy. To this I answer that to abolish "welfare" for the rich is to create a poverty trap for the less rich. My proposed GR-FDET regime gives job opportunities to the poor and allows them to keep a reasonable fraction of the fruits of their labour, whereas the present system destroys jobs and creates poverty traps—as if to keep the poor in their place. Moreover, the GR-FDET regime forces the rich to pay the same EMTR as the poor, whereas the present system of means tests and "progressive" taxation generally gives the rich a lower EMTR. Therefore my proposals give less scope for upward envy than the present system.

The removal of means tests may embarrass some people who have hitherto taken pride in not burdening the taxpayer. These people need a reality check. Have they never been to school? Do they never use the roads? Do they not want the protection of a defence force and a system of law and order? Do they never use a public hospital or make a claim on Medicare? If they want to donate their GR and supplementary benefits to charity, they are free to do so. But let them first receive the payments into their bank accounts, lest they delude themselves that they are not burdening the taxpayer.

9.3 The red tape industry

> Some European economies have done away with personal income tax returns completely while others, such as Hong Kong, have returns that take only a few minutes to complete. Can you imagine

> our accountancy profession supporting such moves here?
>
> — David Clark [2, p. 102].

Yes, I can, because accountants are not economically illiterate; they understand that if their clients can afford to employ a certain number of accountants in unproductive tax calculations, they could afford to employ more accountants in more profitable roles. Besides, if clients see accountants simply as a compliance cost, the profession gets a bad name. A reduction in compliance costs would produce an economic expansion and an increased demand for accountants in support of wealth-creating projects. This would improve the morale and social status of the profession and allow it to command higher fees. To suggest that accountants want a complex tax system is an affront not so much to their integrity as to their intelligence.

Possible tax reforms floated by the Australian Society of Certified Practising Accountants include the following:[2]

- elimination of tax returns for most individuals,
- presumptive tax for small businesses,
- using a single set of company accounts for both the ASX and the ATO,
- moving FBT into the PAYE system and reducing the range of taxable benefits,
- reducing the number of rules on CGT,
- simplifying superannuation rules,
- elimination of "nuisance taxes".

While some of these proposals are at variance with my own, what they all have in common is that they would reduce the demand for accountants as tax agents. I have read numerous newspaper articles by accountants calling for simplification of the tax system and warning that any new tax, such as a GST, must be kept simple. I have not seen a single article by an accountant in defence of complexity.

[2] Australian Society of CPAs, *Tax Reform Agenda*, http://www.cpaonline.com.au/html/taxreform/pg_taxreform_agendadraft1997.htm (accessed April 8, 1998).

9.4 The GST ritual

The 1993 election result supported the political adage that an old tax is no tax—that the electorate will never vote for a new tax, no matter how many old taxes are to be abolished. That wisdom was overturned by the 1998 result, partly because the Democrats gave the popular but irresponsible assurance that they would not allow a GST to apply to food. The result is that the Government has been returned with a mandate to introduce a GST, but does not have the numbers to get it through the Senate unless food is excluded. The stupidity of excluding food has been amply explained by numerous commentators (see Chapter 7). But such arguments, however logical they may be, count for nothing with politicians who have already declared their positions and whose pride is at stake. The Senate will go through the motions of debating the GST, but the result will be decided on the numbers.

The Government has promised not to compromise; but it will, because it will have no choice, and because it will be pointedly reminded of the Coalition's politically-motivated decision to exclude food from the GST proposed in 1993. So the GST will be introduced with food zero-rated, and a million small businesses will scream about the new compliance costs. Unemployment will rise as some businesses go under and others are forced to downsize. The courts will be called upon to determine whether certain goods and services constitute food for GST purposes. The resulting uncertainty will increase costs for retailers and try the patience of consumers. The Government will loudly proclaim that none of this mess would have occurred if the Democrats had passed the Government's GST without amendment, and will go to the next election seeking a mandate to simplify the GST. As a political sweetener, the inclusion of food on a revenue-neutral basis will allow a reduction of about 2 percentage points in the GST rate.

When the food fight is over, it will be possible to offer the carrot of perpetual low interest rates in exchange for a variable GST rate.

I note with interest that the Labor Party is threatening to vote against any attempt by the Democrats to zero-rate food under the GST, in which case such an amendment could only be made by the Government itself. Bearing in mind that New Zealand's ultra-pure and well-accepted GST is the creation of a Labor government, I wonder whether the next Australian Labor government, if it inherited a GST with food zero-rated, would simplify the tax along the lines suggested in this book. The dries in the party would certainly understand the need for such a move.

9.5 Fair Dinkum Exemplary Tax

The GST debate is boring. It is not about anything new. It is about reforming our indirect tax system so as to catch up with the rest of the world—or rather to catch up with Europe; the Government's package, for political reasons, falls short of international best practice (New Zealand), and will fall even further short by the time the present Senate has finished with it. A debate about the FDET would be different, because no other country has a direct expenditure tax. The goal would be not merely to catch up with the rest of the world, but to move ahead of it.

The FDET is less politically dangerous than a GST, because it is not so much a new tax as an adjustment—and massive simplification—of the existing income tax in its various guises (PIT, company tax, FBT, CGT, super tax). For a typical wage/salary earner—that is, for the kind of taxpayer who decides the results of elections—the adjustments to the income tax system are as follows:

- No need to submit a tax return,
- Replacement of the tax-free threshold by a more generous tax-free GR,
- Full deductibility for superannuation contributions (and full taxation of withdrawals, offset by removal of the means test on the pension),
- Full deductibility of health insurance premiums (with *no* tax on benefits),
- Full deductibility of life insurance premiums (offset by full taxation of payouts), and
- No nuisance deductions (and a taxpayer-funded subsidy of donations to registered charities).

The first four items on the list are gains. The fifth is neutral. The last is a small monetary loss in exchange for a large saving of time. The additional deductions on the list can be expected to be popular. Tax deductions are often considered inequitable because they give greater benefit to higher income earners in higher tax brackets; but the FDET, being a flat-rate tax, is not subject to this objection.

The most obvious manner in which the FDET might be neutered on its way through the Senate—or on its way to an election—is by exempting life insurance payouts. Because a life premium can include a superannuation component plus an insurance component, and because the division of the premium between the two components can vary rapidly in response to fluctuations in the value of the investment portfolio, it is not practical to compensate for the exemption of insurance payouts by removing the deduction for premiums. Therefore the exemption of life insurance payouts would amount to a taxpayer-funded subsidy of the life insurance industry. Because high income earners tend to be insured for larger amounts than low income earners, and are more likely to be insured at all, the subsidy would be regressive. But if that were the price of getting the FDET through the Senate, one would have to take it on the chin.

Business, including small business, would unreservedly welcome the FDET because it allows investments to be made out of pre-tax income. In the case of depreciating assets, this treatment is more favourable than any accelerated depreciation regime; it is equivalent to instant depreciation. Small businesses would be especially pleased because of the reduction in compliance costs, not only for their own tax, but also for their employees' PAYE tax, for which the entire administrative burden would be offloaded onto the banks. Making the banks work for their fees is a perfectly safe political strategy.

Under the FDET, cash bequests and declared cash gifts are taxable for the recipient and tax deductible for the donor (or the donor's estate). The recipient can delay the tax by investing the cash. A non-cash bequest or gift is neither deductible for the donor nor taxable for the recipient, unless the recipient sells the asset and consumes the proceeds. In Australian politics, these facts are enough to invite the accusation that the FDET is a death duty and a gift duty. The accusation may be answered as follows:

- A death duty or gift duty can require the recipient to sell the inheritance or gift in order to pay the duty. The FDET does not apply to a non-cash inheritance or gift unless it is sold; therefore the FDET cannot force the sale, and indeed actively discourages the sale.

- The FDET does not make special cases of inheritances and gifts. It merely treats cash inheritances and gifts, and the proceeds of sales of non-cash inheritances and gifts, for what they are: income. It is the opponents of the FDET who are guilty of making special cases of inheritances and gifts.

- The architect of the FDET is absolutely opposed to means tests. History and arithmetic indicate that if inheritances and gifts are completely outside the tax net, the Government is forced to impose a means test on pensions. Such a means test is worse than a full-blown system of death duties and gift duties, because it causes vexation and anxiety for elderly people and erodes their assets *before* death, not after.

On balance, the mild taxation of inheritances and gifts is probably a political asset, because it counteracts any suggestion that the FDET is excessively generous in its treatment of capital; even so, any such suggestion is misguided because it overlooks the importance of capital in creating employment.

9.6 Rubbery figures

The amount of revenue raised by any proposed tax depends not only on the tax rate, but also on the size of the tax base, which in turn depends on the size of the economy. Hence, when a political party goes to an election promising a particular set of tax rates, its ability to keep its promises depends on a certain minimum rate of economic growth. Because each side wants to promise lower taxes than the other, both sides tend to make excessively optimistic assumptions about economic growth, so that whichever party wins government is likely to find itself unable to keep its promises.

Economic growth depends to a large extent on government policy; indeed, most of this book is concerned with the effects of policy on employment growth, which is virtually synonymous with economic growth. But economic growth also depends on factors which governments cannot predict, let alone control; such factors include the weather at home and abroad, political events in foreign countries, and the psychology of foreign financial markets and share markets. Consequently, *political parties cannot predict what tax rates will be necessary during the next Parliamentary term, and any promise to maintain a particular set of tax bases and tax rates throughout the next term is not to be believed*. Even if the letter of such a promise is kept, the spirit of it will be broken; for example, the first Howard government did not increase group tax rates in its first term, but it did increase the frequency with which group tax must be remitted, causing increased compliance costs and increased difficulties with cash flow.

If a promised tax system is to be believable, it must include at least one tax rate that is allowed to vary in response to unforeseen events. If voters do not want broken promises, they must learn to be content with promises about the *structure* of the tax system, without insisting that every rate be specified, and they must learn to demand promises on interest rates; governments can credibly promise to maintain low interest rates throughout the economic cycle, provided that they are prepared to use tax rates rather than interest rates as a means of controlling demand. If a political party wins government by promising to change the structure of the tax system with a view to reducing deadweight, unfavourable events may force adjustments in the tax rates, but they will not force the abandonment of the new structure; on the contrary, unfavourable events make it all the more necessary to reduce deadweight.

Readers will be inclined to criticise this book for failing to specify the rates of the proposed taxes. But it is precisely the lack of such specifications that makes the proposed tax system believable. The system includes one tax that is allowed to vary as a means of controlling inflation (the GST), and several others that are allowed to vary in response to fiscal exigencies (such as Federal and State FDET and municipal rates). While I have not specified the numbers, it is a cast-iron certainty that for a given set of economic conditions, there exists a set of numbers that will make the system work! Two other cast-iron certainties should be mentioned. First, because the proposed tax system is designed to minimise deadweight—i.e. maximise economic growth—it would increase the size of the tax base and hence reduce the tax rates required to raise a given amount of revenue. Second, because the proposed system abolishes means tests, it reduces maximum EMTRs; to abolish an income test is to eliminate a high tax surcharge on a narrow range of income and replace it with a lower tax surcharge on a broad range of income. These observations are sufficient to guarantee that the system proposed in this book can only give lower effective tax rates than the present system. If the book generates any public interest, numerous economic modelling groups around the country will tweak their proprietary computer models and produce estimates of the necessary tax rates.

9.6.1 The race to the bottom

To the suggestion that a party's election platform should include at least one tax whose rate is not specified, the mug Australian voter will say "If they don't specify the rate, they have a licence to make it as high as they like!" And how high will that be, considering that the next election will follow within four years? It is precisely because the mug voter equates the tax burden with the amount of tax collected—having never heard of deadweight—that governments and oppositions are constantly fighting for the low ground on tax, each wanting to be seen as the low-tax party at the expense of the other. On top of that, every nation minimises its tax rates in an effort to attract investment away from other nations, and every state of a federation minimises its tax rates in an effort to attract investment away from other states. In Australia, because the States are partly dependent on the Commonwealth for their revenue, each level of government raises insufficient revenue and blames the other for the consequent underfunding of essential services. Therefore, contrary to the ravings of the mug voter—and partly because of them—the natural tendency of governments is to raise too *little* revenue to meet their social obligations. This competitive cutting of taxes has been called "the race to the bottom".

When governments break election promises by increasing taxes or failing to cut taxes, they do so not because governments tend to raise taxes above the socially optimal level, but because competing political parties promise to cut taxes *below* the socially optimal level, and then find themselves unable to deliver.

In summary, the determination of governments to minimise taxes is revealed by inadequate funding of essential services, arguments over the carve-up of revenue, and election promises that cannot be kept. Politicians can be trusted to minimise taxes because they can be trusted to play politics. The mug voter who does not understand this is not necessarily representative of the majority.

9.7 The buck stops in the mirror.

Totalitarian states are badly governed for two reasons. First, when power depends on fear rather than merit, the most unscrupulous politicians rise to the top. Second, because dictators prefer loyalty and flattery to sound advice, they tend to fill key positions with cronies and sycophants instead of experts. In a totalitarian state, government failure is entirely the fault of the regime, and it is perfectly reasonable—albeit dangerous—for the citizens to complain about their leaders.

In a democracy, in the place of the all-powerful ruler, we have the all-powerful voters; and in the place of the flatterers competing for favours, we have the politicians competing for votes. The voters are not as evil as dictators, but neither are they saints. They do not necessarily suffer from delusions of grandeur, but neither are they immune to flattery or prejudice. The voters constitute the pool of talent from which politicians are drawn. They decide whether to offer themselves for election to public office. They decide whether to join political parties. If they join, they decide which members are endorsed as candidates. Whether they join or not, they decide which candidates are elected. Collectively, the voters hire and fire every politician in the country, determine the criteria on which politicians are hired and fired, and decide the degree of care and attention with which those criteria are applied. Politicians are completely at the mercy of this process. Therefore, in a democracy, government failure is suborned and supervised by the voters, and it is perfectly unreasonable—albeit safe—for the voters to complain about the behaviour of the politicians who rise to the top. They get the politicians that they deserve.

As the voters are all-powerful, the quality of government necessarily reflects the quality of the voters. If the voters are ignorant, they get ignorant government. If the voters are misguided, they get misguided government. If the voters are fools, they get foolish government. This is not to say that the politicians are respectively ignorant or misguided or foolish, although they may be. Rather, it is to say that the politicians who win elections will be those who render themselves most acceptable to the voters, whether they privately agree with the voters or not. A leader who needs the support of a majority of voters cannot afford to tell a majority of voters that they are fools, even if they are—yea, especially if they are, for it is in the nature of fools that they resent correction.

If the voters take the trouble to make themselves economically and constitutionally literate, they will be able to discern which politicians, if any, are telling them what they need to hear. Thus they will create a demand for sound policy, and the competitiveness of the political market will ensure that the demand is met. But if they start reading the newspaper at the back page and never get to the op-ed page, if they treat politics as just another sport, if they prefer television to books, if their taste in "current affairs" is for sensationalism rather than analysis, if they would rather look for scapegoats than for new ideas, if they treat economics as an esoteric science that they will never understand—or worse, as a triviality that they already understand or an irrelevancy that they do not need to understand—then all they can look forward to is a lifetime of economic frustration, for which they will have themselves to blame.

Most politicians profess belief in the decency of the average voter. I don't. I believe in Original Sin—or, to express that ancient doctrine in modern terms, I believe that the average voter, being a product of natural selection, is genetically programmed to care about himself first, his family second, his associates third, and everyone else not at all. And I do not make any exception for myself. This is not to say that the voter is an automaton. Through a combination of free will and grace he is able, to a greater or lesser extent, to act contrary to his genetic program. But let us not delude ourselves as to what that program says.

Most politicians also profess belief in the intelligence of the average voter. Their debating tactics lead me to question their veracity. Nevertheless, it is more rational to believe in voters' intelligence than in their decency; while decency does not improve one's chances of passing on one's genes to the next generation, intelligence probably does. Hence the prescriptions in this book appeal more to voters' intelligence than to their decency. For the most part I have asked my readers, not to sacrifice their own interests for the sake of others, but to understand that the present structure of the tax/welfare system is damaging the interests of themselves and others alike. If I had appealed to altruism, I would have wasted my time. But as I have appealed to enlightened self-interest, my time may have been well spent.

Appendix A

Response to Latham's *Civilising Global Capital*

Mark Latham, the Federal member for Werriwa and former Shadow Minister for Education and Youth Affairs, attracted brief but intense publicity with his book *Civilising Global Capital: New thinking for Australian Labor* [15]. Most of the media coverage was confined to just two of Latham's suggestions, namely

- that most Federal taxes should be replaced by a progressive expenditure tax (PET), which as a form of *direct* consumption tax, and

- that recipients of social security payments should repay some of their benefits if they subsequently reach a certain threshold of affluence.

This emphasis is unfortunate, and perhaps symptomatic of the media's tendency to define news as conflict; I have relegated discussion of these two ideas to subsequent appendices, under the headings "Flawed concepts" and "Political stunts", respectively. The present appendix gives my appraisal of what I regard as Latham's more important ideas. My selection is influenced by the purposes of my book and is not meant to be a balanced summary or review of Latham's book, although it can hardly be as unbalanced as the media coverage.

A.1 National sovereignty vs. global capital

Modern communications and computerised trading have made it possible for colossal sums of money—sums that could make or break the Australian economy—to travel halfway around the world in the blink of an eye. Computer-controlled manufacturing has made production facilities smaller, more versatile, and more readily transportable from one country to another. Many valuable products are not "manufactured" at all, but comprise only information, in which case they can be produced anywhere and transmitted electronically to the point of use or consumption. These trends, as Latham explains, have increased the bargaining power of multinational corporations (MNCs) at the expense of nation states: the MNCs can invest their capital wherever the conditions are most favourable, and nations must bid against each other to offer the most favourable conditions. In federal political systems such as Australia's, the States also compete against each other, bidding down the national interest in their efforts to divert investment from rival States, and giving still more power to the MNCs.

Among the more obvious incentives that governments can offer to MNCs are low company taxes, low income taxes (so that the MNCs can more easily attract skilled labour), tax concessions, tax holidays, low wages for less-skilled local labour, tariff protection (demanded and received by *multinational* car makers in Australia), and all manner of taxpayer-funded subsidies. These incentives have led to the present "fiscal crisis of the state": they reduce tax receipts and increase expenditure, forcing governments to compensate by cutting expenditure in areas that are of little concern to the MNCs—such as health, welfare and legal aid. Hence the scramble for global capital widens the gap between rich and poor in the local economy. Adding insult to injury, a company can operate in one country for some years until another country offers a better deal, then relocate to that other country, taking its capital—augmented by the local taxpayers—with it.

According to Latham, these are the wrong ways to attract and hold global capital. The *right* way is to offer a highly educated workforce and thoroughly modern industrial infrastructure—in other words, to renew the national commitment to publicly-funded education, transport systems, communication networks and other reticulated services. Such measures reduce business costs while ensuring that the taxpayers retain a share of the benefits. Moreover, if a company moves offshore in search of more generous incentives, it cannot take away more than a small fraction of the local workforce, and cannot take away the national infrastructure; the taxpayers' investment stays at home, where is can continue to serve the taxpayers and attract more investment [15, pp. 46–7].

Federal expenditure on "industry welfare"—those tax concessions and subsidies by which Australia tries to preserve existing industries and attract new investment—is approximately equal to Federal expenditure on education. Total national expenditure on industry welfare is about 60% of total national expenditure on secondary and tertiary education. Therefore, says Latham, the logical way to pay for the desired investment in education and R&D is to cut industry welfare [15, pp. 55–6].

Without disputing Latham's observations, I wish to add the following:

- With regard to tax incentives, *low compliance costs* should be pursued more keenly than low rates (see Chapter 5). Whereas low rates result in reduced services to local taxpayers, low compliance costs are a direct benefit to MNCs and local taxpayers alike.

- My General Rebate would reduce the wage bill of MNCs employing local labour, while reducing—not increasing—the gap between rich and poor in the local economy (Chapter 2). Sovereignty allows the Australian Government to determine the conditions of residence and citizenship under which workers' wages can be subsidised by the GR, ensuring that the resulting pattern of employment is in the national interest.

- The profit motive is a sufficient incentive for industry to do almost everything we want it to do, with the notable exception of paying adequate wages. Therefore the payment of wages is the one of the few activities in which industry should receive any assistance from the taxpayer; the GR would reconcile industry welfare with personal and social welfare. Moreover, the GR would not be a free gift to industry, but would merely compensate employers for the social benefits of job creation, which are currently a cause of market failure (Chapter 2).

A.2 The "third deficit"

The two most highly publicised deficits of the Australian economy are the Federal Budget deficit and the current account deficit (CAD). The latter is equal to the public-sector borrowing requirement (of which the Federal Budget deficit is a large component) plus private investment minus private domestic saving. These relationships give rise to the so-called *twin deficit theory*: that a reduction in the Federal Budget deficit should contribute to a reduction in the CAD. Latham rejects this theory, citing historical evidence, and argues that cuts in government services tend to reduce private saving, offsetting the reduction in the public-sector borrowing requirement and leaving the CAD unchanged.[1] But the rejected theory provides the terminology that Latham applies to "a third, and more important, deficit issue: Australia's underinvestment in the skills and inventiveness of its people and institutions" [15, p. 50].

It is sufficiently clear that technological progress contributes to economic growth. However, contrary to the prevailing neo-classical economic theory, technological change is not an independent variable. Technology is the product of education, research and development, and the decision to invest in these activities is *economic*: if the investment does not offer an adequate return to the investor, it will not proceed. The words "to the investor" are crucial. An employee trained by one employer can resign and start working for another. An invention marketed by one manufacturer can give ideas to another. Business practices pioneered by one company can be emulated by another. In each case, the benefit of the investment *to the nation* may outweigh the cost; but, if the benefit does not flow entirely through the investor, the expected benefit *to the investor* may not justify the cost, in which case the investment does not proceed. In general, *a nation tends to underinvest in activities of which the benefits are not entirely captured by the investor.* This is an case of *market failure*: a situation in which the free market fails to uphold the public interest.

If the free market underinvests in education and R&D, a wise government will directly or indirectly attempt to make up the shortfall, says Latham. But the Howard government, in pursuit of a Budget surplus, has reduced public funding for higher education and increased student contributions through the Higher Education Contribution Scheme (HECS), and reduced the long-standing R&D tax deduction from 150% to 125%. Australia's participation in post-secondary education, measured by the number of full-time students per 1000 population, is in the bottom quarter of OECD countries. Australian investment in research and development (R&D) is about 1.5% of GDP, compared with 3% for Japan and 2% for the OECD average. Preoccupation with the twin deficit theory has exacerbated the third deficit [15, p. 55].

Without necessarily taking issue with Latham, I point out that governments can encourage more investment in education and R&D by helping investors to capture more of the benefits of such investment. To this end, I have suggested the transfer fee scheme for industry-funded education (Step 18) and assistance for patent applicants (Step 19). I also note that a wage subsidy in the form of a GR would greatly reduce the costs incurred by employers who offer scholarships, cadetships or apprenticeships.

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[1] Latham's contention is supported by Clark [4, p. 119], who gives a graph showing no apparent correlation between the public-sector borrowing requirement and the CAD.

A.3 Upstairs/downstairs employment

Knowledge workers (or "symbolic analysts") are *price setters*: they are in high demand and can use their bargaining power to secure generous salary packages. In-person service workers are *price takers*: they are in generally low demand, have little bargaining power, and must accept whatever work they can get. The knowledge workers ("upstairs") have money to spare but are short of time. So they literally buy time by outsourcing common household chores such as cooking, laundry, cleaning, gardening and maintenance, thereby creating employment for in-person service workers ("downstairs"). This mechanism transfers wealth from upstairs workers to downstairs workers and, when combined with adequate award wages, helps to "share the gain" in a reasonably equitable manner.

These observations lead Latham to endorse a "two-tier wages system" [15, p. 94], in which upstairs workers are left to fend for themselves while downstairs workers are protected by safety-net minimum wages.

I answer that the GR and the taxes that pay for it are a much more reliable mechanism of gain sharing than minimum wages, because minimum wages are of no use to the unemployed. Every citizen can be guaranteed a GR, but no citizen can be guaranteed a job.

Of course Latham anticipates the objection that generous minimum wages will price workers out of a job. To this, he offers three counter-arguments:

1. In-person service workers, like knowledge workers, are not readily displaced by capital.

2. All available estimates suggest that the wage falls required to restore full employment are politically and morally unacceptable.

3. Higher minimum wages increase the spending power of a community, stimulating demand for goods and services and increasing the wage-paying capacity of employers who produce those goods and services.

I respond to these arguments in order:

1. Latham seems to assume that an employer who cannot afford minimum wages for a particular type of work will use labour-displacing technology—in other words, that the work will be done somehow. But it is quite possible that the employer will do the work himself or that the work will not be done at all; the work will be done if and only if it is profitable to get it done.

2. My proposal to subsidise wages with the GR allows very large reductions in the wage liabilities of employers without adversely affecting the employees.

3. Supplementing wages with a GR also increases the spending power of the community.

A.4 Regional unemployment

Latham notes that the incidence of unemployment shows dramatic regional variations. Some districts and suburbs have almost full employment, while some public housing estates suffer unemployment of 40% or more [15, p. 105]. The reasons for such variations are clear. "Upstairs" workers tend to congregate in up-market communities or in communities near their places of work, creating job opportunities for "downstairs" workers in the *same* communities. The high spending power in those communities attracts more business, which in turn create more employment. The unemployed, in contrast, are obliged to live where accommodation is cheap—in other words, in uncongenial locations where upstairs workers do not want to live. The shortage of upstairs workers causes a shortage of downstairs employment, perpetuating the high unemployment and low spending power of the local population, and failing to present an attractive market for new employment-generating businesses. Thus the up-market regions enjoy ever-increasing prosperity, while the down-market regions descend into ever-increasing despair.

Debating what can be done to stimulate employment in down-market regions, Latham settles for two solutions. First, noting the connection between education and employability, he advocates special remedial support for schools in disadvantaged areas. Second, he calls for wage restraint in up-market communities (presumably by means of a new Accord), so that the benefits of economic growth have more time to spread to nearby down-market communities before inflationary pressures force the Reserve Bank to raise interest rates. To this, I answer that wage increases in up-market communities will *not* be inflationary, as long as they are strictly enterprise-based and not subject to automatic flow-ons (for the reasons set out in Subsection 3.3.1). Inasmuch as the lack of flow-ons can be described as a kind of wage restraint, my prescription is not necessarily at odds with Latham's.

Latham rejects subsidies in down-market regions because "subsidising the locational decision of investment simply socialises the costs of production while returns to investment remain privatised and increasingly globalised" [15,

p. 107]. In particular, he rejects wage subsidies because they suffer from the substitution effect, whereby employers have an incentive to replace full-cost employees with subsidised employees. Here I must disagree: if *all* employees were subsidised, as they would be under my GR proposal, there would be no substitution effect.

A.5 Employment creation

Having described the regional nature of unemployment, Latham addresses the problem of ensuring "that the demand for labour at a neighbourhood and regional level closely corresponds with the supply of labour force skills." He recommends five strategies [15, Chap. 13]:

1. Public investment in local infrastructure makes the area more attractive to private investors. While the small-government ideology of the political Right holds that public investment tends to "crowd out" private investment, the empirical evidence is to the contrary. While public borrowing is generally frowned upon for imposing a cost on future generations, it is an acceptable means of financing investment in infrastructure because *future generations benefit from the investment*. Taxing the resulting windfall gains in land values is an equitable means of repaying the loans. (Here Latham may have been influenced by the 1973 Else-Mitchell report, which recommended that increases in land values due to planning decisions, but not those due to inflation or community growth, should be appropriated by the Crown [10, pp. 23, 49–50].)

2. Public investment in urban and environmental maintenance, education, health, transport, childcare, sporting facilities and accommodation for the aged is socially useful, creates immediate employment, and seeds local economic growth. Adequate private investment in these services is unlikely to be profitable in depressed areas, and in any case it is inconsistent to welcome private investment in public services while regarding public investment in similar services as nothing but a drain on the taxpayer. We must make up our minds whether we want the services or not.

3. Grants to existing charitable organisations can generate further employment in services such as meals on wheels and transport for the aged.

4. Governments can reduce the dependence of local areas on footloose capital by providing advice and seed funds for cooperative ventures, such

as employee-owned enterprises. This, says Latham, could give new relevance to trade unions.

5. By attaching conditions to business licenses, including bank licences, governments can require large businesses to maintain adequate infrastructure and face-to-face service in local areas. If governments must grant assistance to industries, the continuation of assistance should at least be made contingent on satisfactory social outcomes (e.g. no forced redundancies and no branch closures).

Compared seriatim with Latham's strategies, a wage subsidy in the form of a GR would

1. reduce the cost of starting a business in a depressed area or elsewhere,
2. increase the profitability, and hence the likelihood, of private investment in community services,
3. reduce the wage bill faced by charitable organisations wishing to employ labour,
4. reduce the wage bill faced by new cooperatives, and
5. make business welfare contingent on employment outcomes: the GR paid to an individual as income support does not become a wage subsidy for a business unless the said business actually employs the said individual.

Because the GR is a universal, unconditional payment, it generates much less red tape than Latham's prescriptions. In other words, it does not make work. Hence I find it regrettable that Latham's chapter on employment creation is not accompanied by a chapter on employment destruction: *nowhere does Latham admit that making work destroys jobs.* Neither does Latham acknowledge that under the present means-tested welfare system, the creation of employment produces a positive externality—a reduction in welfare expenditure—with the result that jobs are undersupplied. The GR would remove the externality (see Chapter 2).

A.6 Reciprocal responsibility

Latham observes that the Howard government's "Work for the Dole" program, which purports to be an example of reciprocal responsibility, is in fact a cynical exercise in wedge politics (see Section C.2). Furthermore, the notion that welfare recipients owe something to the society that supports them is not the exclusive property of the political Right. One element of the Keating government's Working Nation program—which the Howard government abolished in its first Budget—was the Job Compact, under which long-term recipients of unemployment benefits were required to accept traineeships or subsidised jobs on pain of losing their benefits [15, p. 204]. Further opportunities for socially useful reciprocation are presented by a *case-managed* approach to the delivery of welfare; for example, to reduce the likelihood that educationally disadvantaged parents will bring up similarly disadvantaged children, parents on income support could be required, if necessary, to improve their own literacy and numeracy and to attend classes on their role as educators in the home [15, pp. 245–6].

Latham's much-publicised proposal that welfare recipients whose circumstances improve dramatically should repay some of their benefits is presented as an example of reciprocal responsibility [15, p. 227], although I have consigned it to the same category as Work for the Dole (see Section C.1). Latham also argues that partial repayment of welfare would improve intergenerational equity by reducing the extent to which one generation would fund the income support of another generation. In answer to this, I simply note that if most of the current welfare payments were replaced by a universal and lifelong entitlement—namely the GR—the welfare entitlements of different generations would become more equal.

The GR would also enforce a form of reciprocal responsibility, albeit one that differs from Latham's model in that the carrot and stick are interchanged. The GR is not intended to be an adequate income by itself; it is a supplement to earned income or other income tied to special circumstances. Hence an able-bodied person cannot live on the GR indefinitely, but must eventually either get a job or accept a studentship or traineeship attracting additional income. Under Latham's model of reciprocal responsibility, the individual must take certain actions in order to *retain* existing benefits. Under my model, the individual must take certain actions in order to *gain* additional benefits.

Setting the GR below the subsistence level would be unconscionable if there were any risk that a person could be required to live indefinitely with no income apart from the GR. But there would be no such risk because

- the GR would reduce unemployment to near-frictional levels, making it easy to find work;

- persons unable to work would qualify for additional benefits (Step 2);

- persons who remained unemployed for a certain period (perhaps two or three months) could be given paid traineeships.

Because the numbers of long-term unemployed would be small, the cost to the taxpayer of the guaranteed traineeship scheme would be minor—a small fraction of the cost of the Job Compact scheme introduced by the Keating government in a time of high unemployment.

A.7 Lifelong income support

Governments traditionally response to any new category of economic exclusion with a new category of transfer payment. As a result, the DSS handbook runs to 150 pages and covers 34 different benefits, each with its own eligibility criteria and its own means test [15, p. 223]. To prevent abuses and minimise expenditure, the criteria and tests are tight, with the result that large numbers of genuinely needy people fall through the cracks. And the means tests are poverty traps.

There are no cracks or traps in my General Rebate—every adult is eligible and there is no means test.

Acknowledging his indebtedness to his colleague Peter Baldwin (the former Minister for Higher Education), Latham sets out three elements of a reformed welfare system:

1. *A single category of payment with variations for age, experience, dependants, family responsibilities, housing costs and disabilities.*

   On leaving the education system, each person would apply for an Income Security Account (ISA), which would be a whole-of-life entitlement to replace the existing maze of benefits.

2. *Time-sequencing: the ability to bring forward or postpone income support, within prudential limits, according to changing circumstances.*

3. *Encouragement of self-provision, i.e. saving, to enhance intergenerational equity and protect the system against the small-government agenda of the political Right.*

   Initially, personal contributions to the ISA would be untaxed and withdrawals from personal contributions would be concessionally taxed. If this did not produce sufficient saving, contributions could be made compulsory. Contributions would be interchangeable with superannuation: contributions to superannuation could be redirected to the ISA for additional flexibility (time-sequencing), and final withdrawals from ISAs could be rolled over into superannuation. People might also be allowed to pool their ISA entitlements in cooperatives for the purpose of sharing risks.

Again, I respond to Latham's suggestions seriatim:

1. Notice that the factors affecting the rate of payment do not include income or assets; in other words, the ISA is not means-tested. Neither is my GR. Whereas Latham proposes to deal with special circumstances (such as age, dependants, disabilities) by varying the ISA rate, I propose payments in addition to the GR; but I could have called them variations to the GR. Also notice that the GR, like the ISA, is a fixed entitlement for a lifetime.

2. The GR by itself does not allow for time sequencing, but the additional benefits depend on circumstances which may vary with time. Latham does not tell us where he proposes to draw the line between time-sequencing of the ISA (funded internally) and time-dependent variations in the ISA rate (funded by the taxpayer).

3. I cannot see the difference between (a) redirecting superannuation contributions to the more flexible ISAs and (b) building more flexibility into superannuation itself, except that (a) is more complicated and makes more work. Latham also fails to address the fundamental problem with compulsory saving in Australia: if you have a mortgage, the best investment you can make is to pay it off, but compulsory saving limits your ability to do so. Any policy on compulsory saving must include a policy on home ownership.

A.8 Lifelong learning

Because knowledge drives economic growth, education should be treated not as just another expense competing for limited public funds, but as an "essential, universally provided service of the nation state," says Latham. "Clever nations have been able to succeed on a global scale, not by propping up routine production forms of work and slowing their economic development, but by increasing the proportion of their labour force engaged in knowledge work" [15, pp. 235, 236].

Accordingly, Latham declares that the number of years of compulsory education should be increased from 11 to 13 (i.e. to the Senior Certificate or equivalent trade qualification). He calls for more tertiary places, less onerous HECS, and post-secondary access strictly on the basis of merit; he rejects additional fee-paying places, which send “an appalling message to a generation of young Australians”: that if their parents are wealthy enough to purchase university places for them, they do not have to perform well at school [15, p. 247].

Again acknowledging his debt to Peter Baldwin, Latham proposes to extend the ISA system to include *Learning Accounts* [15, p. 238]. A Learning Account would entitle the holder to a certain monetary value of tuition, which could be spent on adult, vocational or recreational learning. The monetary value forces institutions to compete on price. The sovereignty of the consumer (the Learning Account holder) also promotes flexibility, including credit transfer and articulation (the ability to start a degree at one institution and complete it at another).

Latham explains that the integration of Learning Accounts with ISAs allows personal education expenditure to be given the same concessional tax treatment as personal contributions to ISAs. Again this strikes me as unnecessarily complicated, especially as there does not seem to be any such thing as a “withdrawal” from personal education expenditure. It is simpler to classify personal education expenses as tax-deductible investments under the PET (or, in my model, the FDET), and be done with it. Furthermore, in my model, the GR would act as a wage subsidy or allowance subsidy for employer-funded scholarships and traineeships, and the transfer fee scheme (Step 18) would encourage employer-funded education by ensuring that the graduates could not be poached with impunity by rival employers.

Latham does not explain how this personal education expenditure would arise—would the value of the Learning Accounts be insufficient to cover costs? Neither does he explain how Learning Accounts—with their emphasis on consumer sovereignty—would avoid the alleged evils of the voucher system: unpredictable student numbers at individual institutions, and a conflict between the short-term imperative of attracting students and the long-term imperative of upholding academic standards.

A.9 Place management, case management

The organisation of the post-war welfare state—where “welfare” is interpreted broadly to include not only transfers but also education, health and public works—expresses a philosophy that might be called *supply-side socialism*. Its characteristic features may be summarised as follows:

1. The Government is both the *funder* and the *provider* (or producer) of the services.

2. Services are standardised and mass-produced by “Fordist” production-

line methods: education is divided into primary, secondary and technical/higher; health is divided into primary, secondary and tertiary care; town planning is divided into zoning, development approval and building approval, and so on.

3. The flow of responsibility is *vertical*. Services are divided along the lines of ancient professional guilds: “Doctors run our hospitals, teachers run our schools, engineers control the roads system, town planners run urban affairs, and so on” [15, p. 214]. Each service is centrally planned and has a centrally determined budget. In a local area, there is little coordination between services or between Federal and State administrations. “In a typical public housing estate in Sydney, for instance, there are 17 different agencies providing 23 different programs and support mechanisms—each of them important in its own right, but none of them properly linked to address the diverse needs and circumstances of recipient families” [15, p. 215].

4. The individual citizen must deal with many government agencies.

Noting the regional nature of economic disadvantage, and noting that “disadvantaged people are not able to segment their problems into the discrete administrative units by which government has segmented its functions”, Latham calls for an alternative organisation that might be called *demand-side socialism*. Its features may be summarised, in the same order as the above list, as follows:

1. There is a clear separation of powers between the *funder* (the Government), the *purchaser* (the local *place manager*), and multiple *providers* (which may be publicly or privately owned, and which may compete with each other). Equity is protected by public funding. Quality and efficiency are protected by competition between providers.

2. Providers must be flexible in order to satisfy the local requirements of the place manager.

3. The flow of responsibility is *horizontal*. In each local area, public resources such as health, housing, education, training, employment agencies and community services are at the disposal of the place manager, who is empowered to buy in resources as needed. All purchases in the local area are funded by a local budget and coordinated by the place manager.

4. The individual citizen deals with a personal *case manager*, who assembles an appropriate package from the services purchased by the local

> place manager, and ensures that the citizen meets the required reciprocal responsibilities.

In summary, Latham would open the provision of services to competition while maintaining public funding. Providers would receive their funding from the Government via place management, and deliver their services to individuals via case management. This, according to Latham, is the most urgent reform required in the public sector [15, p. 220].

I should note that there is nothing partisan about the word “socialism”. Supply-side socialism in the organisation of the welfare state has been practised for decades by both conservative and Labor governments, and the Howard government’s Job Network is an example of demand-side socialism inasmuch as the employment agencies compete with each other for public funds.

My suggestions on tax reform and welfare reform are not incompatible with Latham’s “demand-side socialism”. The GR would save a great deal of work by transferring wealth from up-market regions to down-market regions *without* the intervention of place management or case management. The absence of means testing would save even more work. But services other than transfer payments would remain amenable to Latham’s suggestions.

Appendix B

Flawed concepts

B.1 A universal BAD tax

The great fiscal panacea, in the opinion of some contributors to the "Letters" page of the Brisbane *Courier-Mail*, is a debit tax on all monetary transactions. Calculations based on the present annual volume of transactions suggest that all Federal taxes could be replaced by a debit tax of about 0.33% . This seductively low rate is deceptive for the following reasons:

- According to the 1998 Budget and its forward estimates, Federal taxes amount to about 25% of GDP. The reason why the Government could collect 25% of GDP with a 0.33% tax rate is that goods and services change hands many times on their way to the final consumer, so that the tax rate would be applied many times over. In the end, if the Government collects 25% of GDP in tax, the final price paid by the consumer must on average contain at least 25% accumulated tax. A 10% GST would constitute only 9.1% of the final price of goods and services. Under a debit tax, because the number of transactions involved in getting a particular product to market is not widely known, the consumer cannot tell how much of the final price is tax. Under a GST, in the absence of complications due to exemptions, the value-added computation ensures that the tax content of the final price is precisely known. The proponents of a debit tax are invariably opposed to a GST, calling it a hidden tax, an unacceptable impost on the necessities of life, and a devaluation of the savings of retirees. Observe that a debit tax is worse on all three counts.
- The rate of 0.33% assumes that each transaction will be processed

through a bank or financial institution, resulting in a taxable debit. But if debits are taxed, merchants will have an incentive to deal in cash and avoid debits. Any reduction in the number of debits forces the Government to impose a higher rate of tax in order to collect a given amount of revenue.

- Even if *all* transactions can be caught in the tax net, businesses will streamline their procedures, minimising the number of transactions in order to minimise tax. Fewer taxable transactions mean a higher rate of tax.

- Merchants will avoid tax by processing transactions through offshore financial institutions. This can be done very cheaply via the Internet.

- Certain types of enterprises, which cannot avoid large numbers of transactions, may simply decide to do business somewhere else.

Further disadvantages of universal debit taxes include the following:

- The capital cost of starting a new business is inflated by accumulated debit tax plus compliance costs. As this inflated price must be paid before the business earns any income, it forms a barrier to job creation.

- Exporters must pay accumulated debit tax on their inputs, reducing their competitiveness. Importers have an advantage over local producers, because most of the debits in an importer's production chain take place offshore and escape tax.

- Debit taxes are distortionary because they encourage *vertical integration* at the expense of specialisation.

  Vertical integration means controlling the whole production process from the mine or farm to the finished product. This obviously minimises the number of transactions and hence the scope for taxable debits. The reward for vertical integration favours big business at the expense of small business, because a big business can more easily afford to establish in-house production units and to buy out its major suppliers and customers.

  Specialisation, on the other hand, facilitates *economies of scale*. Certain production costs, such as design and tooling up, are *fixed*, meaning that they do not depend on the volume of production. Other costs, such as raw materials and fuel, are *variable*, meaning that they are roughly proportional to production. If you produce a small range of products in large

> production runs, you spread your fixed costs over a large volume, thereby minimising the cost per unit volume.
>
> Because debit taxes reward vertical integration, they encourage the establishment of small (hence inefficient) in-house production units, and encourage corporate mergers and take-overs that are motivated by minimisation of tax rather than maximisation of efficiency. Thus they reduce the international competitiveness of the economy.

Debit taxes are not a new idea, and neither are credit taxes. The States already impose Bank Account Debit tax (BAD tax) on withdrawals from cheque accounts, and Financial Institutions Duty (FID) on the receipts of institutions. These taxes are already encouraging Australian businesses to deal with foreign banks instead of Australian banks.[1]

B.2 Not-So-Easytax

Easytax, invented by John McRobert's Tax Reform Ltd and endorsed by Pauline Hanson's One Nation Ltd, abolishes most Federal taxes plus payroll tax and introduces a 2% turnover tax on all transactions, including

- sales of goods and services,
- sales of real estate,
- wages and salaries,
- dividends and distributed profits,
- bank interest (but not deposits or withdrawals),
- contributions to and withdrawals from superannuation funds (withdrawals including pensions and annuities),
- sales of shares and derivatives, and
- foreign currency transactions.

The tax applies whether the transaction occurs within Australia or between Australia and another country; for example, both imports and exports are taxed.

Easytax, like a debit tax, is cumulative. As the 2% tax is applied at every link of the supply chain, the real rate of tax paid by the final consumer is much

[1] *Australian Financial Review*, November 17, 1997, p. 28.

greater than 2%. If Easytax is not to cause a reduction in government services, it must raise 25% of GDP in tax, and must therefore accumulate to such an extent that the final price paid by the consumer contains an average of at least 25% tax. A 10% GST, which One Nation opposes, would constitute only 9.1% of the final price of goods and services.

The policy document[2] proposes to avoid price rises by adjusting wages and salaries so as to preserve take-home pay rather than gross pay. Payroll expenses would fall because wages and salaries paid by employers would no longer include PAYE tax, and this saving would be passed on in the form of lower prices for goods and services. Achieving such a wage outcome would require the agreement of *all* the States, because s. 51(35) of the Constitution does not give the Commonwealth a general power over incomes.

But the policy is not satisfied with mere price stability. It claims that the reduction in prices caused by the removal of other taxes outweighs the increase in prices due to the accumulation of Easytax, causing a 17% reduction in the cost of living. This is a mathematical impossibility if the total tax collection remains the same, because the tax component of prices is merely converted from other taxes into Easytax. The policy claims that the total tax collection is allowed to fall because the payroll expenses of governments no longer include PAYE tax. But the inclusion of PAYE in government payroll expenses, when combined with the compensating portions of intergovernment grants, is a circular transfer of funds within and between governments, *the elimination of which has no effect outside the circle*. The pretence that this circular flow affects prices outside the circle is the fallacy on which the policy's optimistic forecasts are founded.

Under Easytax, the capital cost of starting a new business is inflated by accumulated tax plus compliance costs. As this cost must be paid before the business earns any income, it forms a barrier to job creation. Australian exporters also pay accumulated Easytax on their inputs and, for good measure, pay another 2% on their final sales. They compete with exporters in countries that have a GST, which does not tax inputs and zero-rates exports. Importers have an advantage over local producers, because most transactions in the production of imported goods take place overseas and escape Easytax. Local manufacturers will respond wherever possible by moving their operations offshore, exporting Australian jobs. The explanatory document[3] claims that the one-off deflationary effect will improve international competitiveness. But, as explained above, there is no such effect.

[2]"Pauline Hanson's One Nation Taxation Policy", http://www.gwb.com.au/onenation/policy/taxdoc.html (September 3, 1998).

[3]"Pauline Hanson's One Nation Taxation Policy: Implementation and Examples", http://www.gwb.com.au/onenation/policy/study.htm (September 3, 1998).

Like a debit tax, Easytax is distortionary, encouraging vertical integration and discouraging economies of scale. The reward for vertical integration favours big business at the expense of small business. Yet the policy document promises to ensure that multinational companies pay their fair share of tax! As vertical integration proceeds, it reduces the number of taxable transactions, forcing the tax rate to rise in order to maintain total revenue.

The One Nation documents are poorly argued. Some paragraphs are meaningless. Others contain unproven assertions bearing no relation to each other or to the policy proposals. The main technique of persuasion is to avoid the words "person" and "people" in favour of "Australian" and "Australians", thus appealing to the heart and bypassing the brain.

Transaction taxes are not a new idea. The turnover taxes formerly used in Europe were similar to Easytax except that they applied to a smaller class of transactions. Because the turnover taxes hindered industry by increasing the costs of inputs, rewarding vertical integration, and discouraging specialisation, they were abolished in favour of the VAT. In Australia we have something like a selective Easytax in the form of stamp duties, which the States impose on share purchases, credit cards (both contracts and individual purchases), hire purchase agreements, rent/lease agreements, mortgages, bonds, debentures, cheques, bills of exchange and promissory notes, car purchases, insurance premiums, and real estate conveyancing. Stamp duties, along with FID/BAD, are commonly called "nuisance taxes" because they are better at making work (destroying jobs) than at raising revenue. In 1978, the economist James Tobin proposed a tax on foreign exchange transactions as a means of slowing down international capital flows, making it easier for national governments to implement monetary policy [15, p. 364]. Tobin likened his proposal to "throwing sand in the wheels of international finance". Easytax amounts to an extension of the Tobin tax to every transaction across and within Australian borders, throwing sand in the wheels of the entire national economy.

B.3 NITs in employers' hair

A Negative Income Tax (NIT) builds the social security system into the tax system: the income tax bill is allowed to be positive or negative, and negative values of tax take the place of welfare payments. Poverty traps are avoided because the effective marginal tax rate (EMTR) is determined by taxation alone, and not by unplanned interaction between taxation and social security. But there are other ways to achieve the same result.

For the purpose of illustration, consider a 40% positive/negative income tax with a threshold of \$600 per fortnight: if you earn more than \$600 in a fortnight, you pay 40% of the excess; if you earn less than \$600, the Government pays you 40% of the shortfall. The same relationship between pre-tax and after-tax income can be achieved by two other methods which, for want of better names, I shall call the *pre-tax method*[4] and the *after-tax method*.

In the pre-tax method, the Government pays you a *pre-tax* income credit of \$400 per fortnight, which is taxed along with earned income at a flat rate of 40% . If you are a PAYE taxpayer, the pre-tax credit must be paid through your employer, who adds it to your wages and takes out the tax. If you have more than one employer, you must nominate a "main" employer to claim the pre-tax credit, and supply that employer with an Employment Declaration Form for the purpose. If you are entitled to additional "social security" payments, they are handled as variations to the pre-tax credit, so your main employer must know about them also. In sum, your main employer must do considerably more work, and must know considerably more about your personal affairs, than is necessary under the existing system—which already discourages employment by imposing excessive compliance costs on employers.

In the after-tax method, the Government pays you an *after-tax* or *tax-free* income credit of \$240 per fortnight, and you pay a flat 40% tax on everything else that you earn. The after-tax income credit is none other than the GR. Employers have no involvement in the payment of the GR because they do not need to deduct tax from it. They do not need any declaration forms or personal information. They simply deduct 40% from your wages and ask no questions. Hence the workload on employers is much lower than under the current personal income tax system.

The three methods of defining this sample NIT system are illustrated graphically in Fig. B.1. The "threshold method" is the first method, involving the \$600 threshold, with positive tax above the threshold and negative tax below.

I shall now show that the three methods are applicable to any rate and any threshold. Let

$$\begin{aligned} x &= \text{pre-tax income} \\ y &= \text{after-tax income} \\ R &= \text{tax rate (as a fraction)} \\ T &= \text{threshold} \\ P &= \text{pre-tax credit} \\ A &= \text{after-tax credit (GR).} \end{aligned}$$

[4]The same method, with different numbers, is described by Prof. Peter Dawkins in "Hip pocket solution to unemployment", *Australian Financial Review*, November 3, 1997.

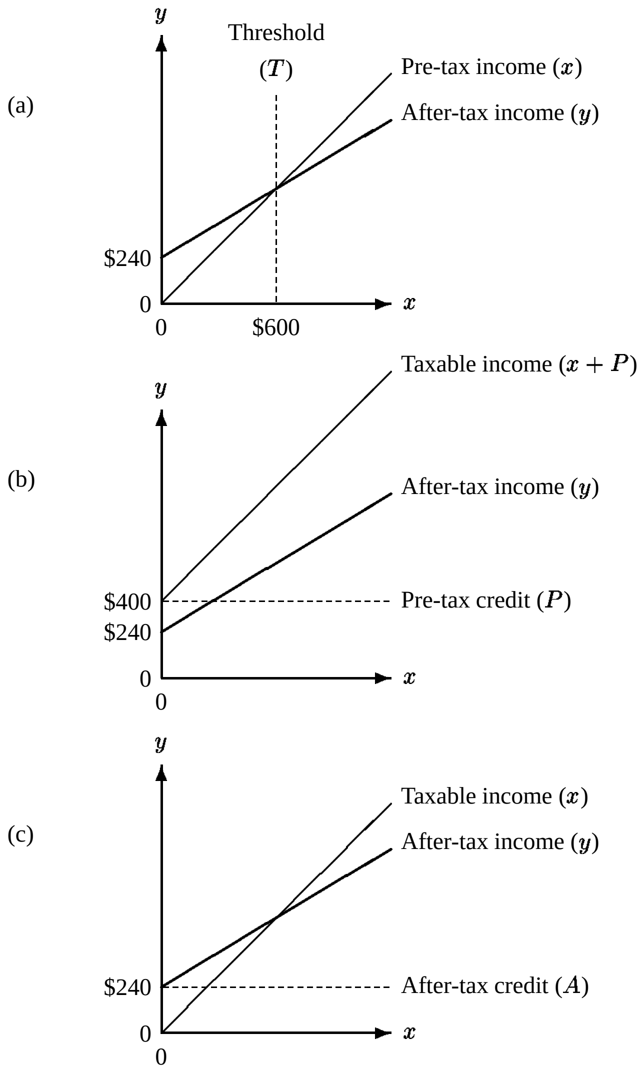

Figure B.1: Three equivalent implementations of a 40% NIT: (a) threshold method; (b) pre-tax method; (c) after-tax method.

For each method, we use the relationship

$$\text{tax paid} = R \times \text{taxable income.} \tag{B.1}$$

For the threshold method, the tax paid is $x - y$ and the taxable income is $x - T$, so Eq. (B.1) becomes

$$x - y = R(x - T)$$

whence

$$y = RT + (1 - R)x\ . \tag{B.2}$$

For the pre-tax method, the tax paid is $x + P - y$ and the taxable income is $x + P$, so Eq. (B.1) becomes

$$x + P - y = R(x + P)$$

whence

$$y = (1 - R)P + (1 - R)x\ . \tag{B.3}$$

For the after-tax method, the tax paid is $x + A - y$ and the taxable income is x, so Eq. (B.1) becomes

$$x + A - y = Rx$$

whence

$$y = A + (1 - R)x\ . \tag{B.4}$$

Notice that if

$$RT = (1 - R)P = A\ , \tag{B.5}$$

then Eqs. (B.2), (B.3) and (B.4) are identical and the three methods give the same relationship between pre-tax income x and after-tax income y. Moreover, in all three cases, the cost to the employer is x, and the net revenue—equal to the tax paid minus the credit received—is $x - y$, which is fixed if x and y are fixed. So under condition (B.5), the three methods produce the same cash flows for the employer, the employee and the Tax Office.

But the after-tax method (i.e. the GR) involves the least work for the employer and therefore creates the most jobs.

Although a flat tax offset by a GR is equivalent to a negative income tax, the GR by itself is not a NIT, because it does not vary with income. The GR by itself is a *fixed* amount paid to each citizen and is therefore most accurately described as a *negative poll tax*.

B.4 EITC: Extra Income-Tax Complication?

An Earned-Income Tax Credit (EITC) is an attempt to reduce destructive interaction between the tax and welfare systems by ensuring, at least, that a person who moves from welfare to work does not suffer a net financial loss due to work-related expenses and the withdrawal of the dole. The EITC is a tax refund for earned income up to a certain limit. For example, at the end of each financial year, you might be able to claim a refund of 30 cents for every dollar of income earned in that year, up to an income limit of $10 000; in that case, the maximum refund claimable would be $3000 per year.

The EITC is effective in supplementing low wages and ensuring that work pays better than welfare. But it is also creates new problems:

- To avoid what is seen as an excessive loss of tax revenue from high-income earners (who still benefit from the tax-free threshold), the Government may not only limit the amount of income for which credit can be claimed, but also withdraw the credit over a higher range of income. This, combined with taxation, produces an absurdly high EMTR over that higher range of income. Thus the EITC, rather than removing the disincentive effect of high EMTRs, merely shifts the disincentive from the low income range to the middle income range.[5]

- The EITC adds another layer of complexity to the already complex tax/welfare system, making it still more difficult to identify and correct undesirable interactions between tax and welfare.[6]

- If the EITC is claimed at the end of the financial year, it may be too late to stop the claimant from being evicted for falling behind with the rent. Tax returns for low-income earners become unavoidable, adding to compliance costs.

  If a claim-as-you-earn system is used, the EITC must be paid through employers. If you have more than one employer, it requires coordination between employers to ensure that the income limit is observed. Thus a claim-as-you-earn system increases compliance costs and discourages employers from hiring.

One could achieve the desirable effects of an EITC, while avoiding all of the above disadvantages, by reducing the rate at which the dole is withdrawn with increasing income. This method is deemed to be politically unacceptable

[5] P. Dawkins, "Taxing our negative income", *Australian Financial Review*, May 26, 1998, p. 20.
[6] ibid.

because it would increase social security expenditure and require an increase in tax revenue, whereas the EITC is classified as a tax refund and therefore does not appear as "expenditure" in the Budget! Another method is to cut marginal tax rates for low income earners and increase them for middle income earners. Politically, this method is even more objectionable because it involves an open admission that one is increasing the tax rate over a particular range of income, whereas the EITC disguises the marginal tax increase as the withdrawal of a refund.

Of course it is perfectly legitimate for governments to dress up their social security expenditure as tax refunds, because transfer payments are not part of the tax burden. But, because making work destroys jobs, and because complexity in the tax/welfare system leads to injustices and disincentives and encourages rorts, the repackaging of welfare payments as tax refunds must be done as simply—and as blatantly—as possible. The ultimate solution is provide the basic level of income support through a universal tax rebate: the GR. Because the GR is not classified as expenditure, and because it replaces rather than supplements the tax-free threshold, there is little apparent justification for means-testing it. Because the GR reduces all other welfare payments to small supplements, the visible welfare budget is small, so that there is little apparent justification for means-testing other payments. No means-testing means no poverty traps, no disincentive traps, and no scope for defrauding the system by failing to declare income. The GR is paid frequently—not held until the end of the financial year—and the absence of a tax-free threshold saves work for employers.

B.5 PET vs. FDET

The *Kaldor tax* or *Progressive Expenditure Tax* (PET) was first proposed by the British economist Nicholas Kaldor in 1955, and has been enthusiastically endorsed by Mark Latham MHR in *Civilising Global Capital* [15, Chap. 14]. It is a type of *direct consumption tax*, where "consumption" is defined as *income minus net savings*. In this definition of consumption, two points should be noted:

- Taxing consumption rather than income is equivalent to allowing an income-tax deduction for net savings, thereby encouraging private saving. This in turn reduces the current account deficit (CAD), which is equal to the public-sector borrowing requirement plus private investment minus private domestic saving, where "private investment" includes private domestic savings and foreign investments.

Table B.1: Sample thresholds and marginal rates for a Kaldor tax (after Hinckfuss [15, pp. 346–9]). The marginal expenditure tax rate is r_e . The equivalent marginal income tax rate is r_i .

Taxable expenditure	r_e	r_i
\$0–\$10 000	0 %	0.0 %
\$10 000–\$20 000	50 %	33.3 %
\$20 000–\$30 000	100 %	50.0 %
\$30 000–\$40 000	200 %	66.7 %
\$40 000–\$50 000	400 %	80.0 %

- The definition of consumption is *broad-based* in that it does not distinguish between goods and services and therefore does not cause any disputes over products that are partly goods and partly services (such as vehicle repairs and restaurant meals).

I agree with Latham on the merit of taxing consumption. My modification to income tax (Step 6) allows deductions for savings and is therefore a broad-based direct consumption tax, while a GST (Step 14) is a broad-based *indirect* consumption tax.

Latham rejects a GST, claiming that it is inflationary and regressive. These claims are true of a GST *by itself*, but not necessarily true of a GST in combination with other measures. In the package proposed in this book, the initial introduction of a GST does not cause a one-off increase in prices, but merely compensates for other measures which tend to cause a one-off *decrease* in prices. Thereafter, a variable GST can be used instead of variable interest rates to control inflationary pressures. A GST, even by itself, is not nearly as regressive as high interest rates. Moreover, while a GST *by itself* is regressive, a GST in combination with a flat PAYE tax and a GR is highly *pro*gressive: high income earners with high levels of consumption will pay more in PAYE and GST than they receive in the GR, so that they pay positive tax overall, while low income earners whose consumption is confined to necessities will pay less in PAYE and GST than they receive in the GR, so that they pay *negative* tax overall.

Whereas the progressiveness of my tax package comes from the GR, the progressiveness of Latham's PET comes from increased marginal rates at higher levels of expenditure. Let the marginal expenditure tax rate, expressed as a fraction, be r_e ; for example, a 50% rate is expressed by $r_e = 0.5$. Then, if you increase your expenditure by Δe , you increase your tax bill by $r_e \, \Delta e$, so that the extra income you need is $(1 + r_e) \, \Delta e$. The marginal tax rate on that extra income, which rate I shall call r_i , is the ratio of the extra tax to the extra income; that is,

$$r_i = \frac{r_e}{1 + r_e} \,. \tag{B.6}$$

The expenditure tax rate r_e is also called the *tax-exclusive rate,* while the equivalent income tax rate r_i is called the *tax-inclusive rate* (because the denominator is total income, which includes tax). Very conveniently, the subscript e stands for both "expenditure" and "exclusive", while the subscript i stands for both "income" and "inclusive".

In an appendix to Latham's book [15, pp. 346–9], Dr Ian Hinckfuss of the University of Queensland has drawn up a sample table of PET thresholds and marginal expenditure tax rates (values of r_e). His figures are for illustration only, and would not necessarily be acceptable to Latham. Using the above equation, I have augmented Hinckfuss's table by adding a column for r_i . The result is Table B.1. Note that the equivalent income tax rates (right column) are extremely high compared with present PIT rates—indeed, almost as high as present EMTRs for low income earners—but not nearly as bad as they are made to look in the middle column.

High marginal tax rates are usually thought to constitute a disincentive to work and wealth creation. According to Latham, this effect does not occur with a PET:

> Because the incidence of tax is shifted from earnings to consumption, high marginal rates are not able to act as a disincentive for earnings and economic effort. . . . High progressive rates of expenditure tax, levied on people with the income and wealth required for lavish consumption, serve only as a disincentive for the act of conspicuous consumption itself [15, p,. 138].

I am unconvinced. Earning income is not an end in itself. One earns money with the intention of putting it to particular uses, and one possible use is consumption. To the extent that one's earning activities are motivated by a desire for conspicuous consumption, any disincentive for conspicuous consumption is also a disincentive for the earning activities themselves. In other words, if a consumption tax forces you to work harder to sustain a desired level of consumption, you will reconsider whether the work effort is "justified" according to your set of values.

I conclude, with regret, that the maintenance of economic incentives requires the moderation of marginal tax rates, even if those marginal rates apply only to obscene levels of extravagance. Accordingly, I have proposed a Flat Direct Expenditure Tax (income tax with deductions for net saving) and a flat indirect expenditure tax (GST). The two flat rates, combined with the absence of means-testing for transfer payments, give a single, acceptable, visible, controllable EMTR for all taxpayers. When these taxes are offset by the GR, the system as a whole is progressive.

Table B.1 also shows a tax-free threshold whose purpose is to "exempt for each taxpayer a basic amount of expenditure on life's essentials" [15, p. 135]. But the PET threshold, like the PIT threshold, does *not* guarantee a basic amount of income from which to fund a basic amount of expenditure. Under my tax scheme, the GR does not merely exempt a fixed amount of expenditure from direct tax, but *refunds* a fixed amount of tax to each taxpayer and, in so doing, guarantees a minimum income.

In attempting to show that a PET involves less paperwork than a GST, Latham writes:

> It is important to note that the PET is levied on the net sum of each tax unit's consumption, rather than on each spending transaction. Accordingly, it avoids the huge volume of paperwork associated with the indirect taxation of consumption, plus the emerging issue of tax minimisation through the use of electronic transactions [15, p. 135].

He fails to mention the following facts:

- If a GST applies at a single rate, the amount of GST to be remitted by a business in any accounting period can be calculated from the *total* taxable inputs and outputs of the business during that period, without showing the tax on individual transactions. The calculation involves two multiplications and a subtraction.

- If a GST applies at a single rate, the GST to be paid by a customer at the cash register can be calculated from the subtotal and added to the bottom of the docket, without generating any additional pieces of paper. If the GST is buried in the prices of individual items, it need not appear on the docket at all.

- Businesses that have not yet reprogrammed their computers and cash registers for the GST can be allowed to include GST in their displayed prices until they upgrade their equipment in the normal course of business. If the GST is *permanently* buried in prices, no reprogramming of cash registers is required.

- A PET involves thresholds and multiple rates, and consequently encourages taxpayers to arrange their affairs so as to take maximum advantage of tax-free thresholds and low-tax brackets. *Thresholds mean rorts.*

- Internet commerce will not entirely replace the physical shop front.

- For small transactions, Internet commerce already bypasses existing sales taxes and tariffs.

- You can't buy anything over the internet unless you have a credit account or a debit account. The buyer can be required by law to choose an onshore credit/debit provider, who can be required by law to collect the GST on purchases from offshore suppliers. Preventing credit/debit providers in one country from facilitating tax avoidance in another country requires international cooperation, which will undoubtedly be forthcoming because all governments have an interest in protecting their revenue.

Using the numbers in Table B.1, Hinckfuss [15, pp. 346–9] considers a number of possible problems with the PET and proposes solutions. In the following paragraphs, I present a summary of Hinckfuss's problems and his solutions or responses, and add some comments in defence of my own tax proposals.

> **Problem 1:** Because of the high marginal rates at high levels of expenditure, a major purchase such as a car can result in a tax bill that exceeds the entire year's income.
>
> *Solution:* Allow the cost of the major purchase to be spread over five years.
>
> *Comment:* With a flat direct expenditure tax (FDET), the problem would not arise. A large purchase in one year would not increase the marginal tax rate, and spreading the cost over five years would not make any difference to the tax payable. Moreover, the tax paid by ordinary wage and salary earners would be strictly PAYE, so that there would be no "tax bill" after the event, no possibility of having insufficient funds to pay the tax, and no need to hire an accountant to calculate the tax payable.
>
> **Problem 2:** Members of the same family have different incomes and different taxable expenditures. The highest-spending member would be spending for others, but paying tax as if he were spending for himself.

Solution: Allow taxable expenditure to be split equally among family members.

Comment: This will lead to arguments over what constitutes a family for tax purposes. Individuals will have an incentive to get together and present themselves as families. In an effort to stamp out rorts, the ATO will want to know who is sleeping with whom. Under my FDET proposal, the problem would not arise. The highest-spending member of a family would be taxed at the same rate as the others, and splitting of income or expenditure between family members would not make any difference to the total tax bill.

Problem 3: A gift, if subsequently spent by the recipient, would be taxed twice.

Solution: Allow the gift to be claimed as a tax deduction by the giver, provided that it is declared as income by the recipient.

Comment: An FDET raises the same problem and invites the same solution. The procedure can be confined to cash gifts; a non-cash gift need not enter into tax calculations unless it is sold by the recipient.

Problem 4: The purchase of a home would put any family into a high tax bracket, even if the cost were split between family members and averaged over five years.

Solution: Count expenditure on one's primary residence (up to a reasonable limit) as a deductible investment, and count the proceeds from the sale of the residence as income.

Comment: It is simpler to exempt owner-occupied housing and the associated loans from the FDET net. This approach is also more logical because all spending on owner-occupied housing is consumption.

Problem 5: A PET would involve massive changes to the existing system.

Response: The calculation of PET liability does not require any data that are not already required for income tax or capital gains tax (which is automatically included in the PET). The pay-as-you-go provisions would remain as they are.

Comment: Pay-as-you-go provisions work best with a flat rate. If the rates vary steeply with the level of expenditure, it is much more difficult to guarantee that the taxpayer will not get a bill at the end of the financial year.

Problem 6: How would the Government know what thresholds and rates to set in order to obtain the desired amount of revenue in the first year of operation?

Solution: Any shortfall in the Federal Budget could only occur as a result of a shift in behaviour from consumption to investment, which is good news. The fiscal shocks could be reduced by introducing the changes one-at-a-time and adjusting the tax rates as required.

Comment: Similar remarks apply to the FDET and the GST. But because the introduction of the FDET and GST would not cause such huge changes in marginal rates, the likely fiscal shocks would be smaller.

Problem 7: The Kaldor tax applies to inheritances. This seems to imply that the inheritor of a business, who may have worked for the business without wages for many years, would be forced to sell the business in order to pay the tax.

Response: An inherited business will be an approved investment, and consequently will not be taxed unless and until it is sold. Even if it is sold, any part of the sale price that is reinvested appropriately will be a deduction. "Kaldor taxation, therefore, automatically sorts out the death duties dilemma."

Comment: The same thing can be done with an FDET. But I might not have recognised the problem or the solution if I had not read Hinckfuss's contribution. This is my principal debt to Latham and Hinckfuss.

Appendix C

Political stunts

Politicians are fond of paying compliments to the intelligence and decency of the average voter. Their real assessment of the average voter is revealed not by their words, but by their chosen political strategies, and the success of the said strategies indicates the accuracy of the said assessment.

C.1 A HECS on welfare

Mark Latham [15, pp. 227,229] suggests that welfare recipients who subsequently enjoy a spectacular improvement in their circumstances should repay some of their benefits through an income-contingent levy along the lines of the Higher Education Contribution Scheme (HECS). If this proposal were implemented, people who have suffered hardship in the past would pay higher taxes than people on the same current income who have *not* suffered hardship in the past: it would be a tax on past economic hardship. This is not equity. This is a sop to the politics of downward envy, inviting taxpayers to exact vengeance on fellow taxpayers who were once counted among those detestable welfare recipients.

Like HECS, the welfare repayment scheme would be introduced at such a high income level, and at such a low rate, that no thinking person could possibly object. But, like HECS, it would grow more onerous with the passage of time, cutting in at ever lower incomes and at ever higher rates, and eventually becoming just another poverty trap and another disincentive to self-improvement. The income test would eventually apply to weekly incomes instead of annual incomes, so that dole recipients would start repaying their benefits whenever they could find a few days of full-time work. Then the downward-envy addicts would be able to have their cake and eat it, watching the "bludgers" alternate between "bludging" and paying tax for the privilege of "bludging".

C.2 Work for the Dole

Question: What is the difference between (a) making the unemployed "work for the dole" at award rates, and (b) giving them jobs at award rates?

Answer: There are five differences:

1. Work for the Dole does not entirely remove the stigma of unemployment (note the retention of the word "dole") and does not look as good on one's CV as a normal job;
2. Work for the Dole allows the workers to be paid nothing but the dole, whereas a part-time job with a fortnightly wage equal to the dole does not entirely eliminate eligibility for Newstart under the income test, and results in a total income greater than the dole;
3. Work for the Dole is more expensive to administer, because it requires coordination between DSS and the participating employers, whereas direct job creation can be effected by funding the same employers through the usual Commonwealth grants process; *but*
4. Work for the Dole attracts the attention of the media and gives the appearance of Doing Something About Unemployment, whereas direct job creation is part of the normal business of government and consequently not newsworthy;
5. Work for the Dole exploits resentment of "dole bludgers" by making the "bludgers" work, whereas direct job creation turns the "bludgers" into normal workers who can no longer be vilified for political gain.

In summary, Work for the Dole is the deliberate adoption of bad policy for the sake of good politics—the politics of division and downward envy. Opinion polls confirm that the mug voter has swallowed it whole.

C.3 Job search diaries, etc.

On February 29, 1997, the *Australian* published a letter from Michael Raper, president of ACOSS, concerning an unemployed person who had his dole payments suspended for 12 weeks after he missed one of a series of interviews. The suspension was equivalent to a $2000 fine. This revelation was of a piece with the better-known policy of requiring the unemployed to record their job-searching activities in official diaries, on pain of losing their benefits.

Defenders of these policies would presumably claim that they are intended not to throw the needy onto the streets, but to force those who can get a job to do so. Taking this at face value, and assuming for a moment that the policies actually succeed in forcing a dole bludger to get a job, let us count the winners and losers:

- Because there are far more job-seekers than vacancies, the bludger *takes the job from some other person who wants to work*; that unknown person is worse off.

- The employer is worse off, because she has hired a bludger when she would otherwise have hired someone who wants to work.

- The taxpayers are no better off, because they simply have one person on the dole instead of another. Indeed, the taxpayers are worse off, because they pay for the bureaucracy that administers the useless diaries and interviews—it would be cheaper for the taxpayers if all the bureaucrats were on the dole.

- The bureaucrats are worse off, because if the Government can afford to pay them to increase the demand for jobs at a time when the demand already exceeds the supply, it could afford to pay more of them to do something useful.

- The bludger is not entitled to any sympathy; but neither can it be denied that he is, by his own standards, worse off, because he now has to work when he would rather be on the dole.

- The only winners are the politicians who would rather make scapegoats of the unemployed than admit the shortcomings of their policies.

Of course the judgement would be different if the number of job vacancies exceeded the number of applicants: then the dole bludgers would be depriving employers of much-needed labour at taxpayers' expense. But at present, when the bludgers are helping genuine job-seekers by reducing the competition for jobs, the best thing to do with bludgers is to let them bludge.

To any reader who finds this conclusion obscene, I answer that the obscenity of the conclusion merely reflects the obscenity of entrenched unemployment.

Appendix D

The Constitution in plain English

The original text of the Australian Constitution was set out in Section 9 of the Commonwealth of Australia Constitution Act (UK), signed by Queen Victoria on July 9, 1900. Between May and September 1899, referenda in all six founding colonies had accepted federation under a similar Constitution. But the UK Parliament, before passing the Act, amended the Constitution so as to ensure the continuation of appeals to the Privy Council [25, p. 262].

This appendix contains paraphrases of the Constitution and of related Acts affecting the relationship between Australia and the United Kingdom. The full texts of these documents, together with numerous other Federal and State Acts, have been published on the Internet by the Australasian Legal Information Institute at http://www.austlii.edu.au . The following conventions are used in the paraphrases:

- Transitional provisions—that is, provisions which are related to the initial process of federation or to the introduction of Constitutional amendments and related Acts, and which have been rendered inoperative by the passage of time—are omitted. If a whole section or subsection is transitional, it is labelled as such. If only part of a section or subsection is transitional, the omitted part is indicated by ellipsis (. . .). If a provision is of the form "Until the Parliament otherwise determines, . . . " it is rewritten in the form "The Parliament may determine . . . " and the temporary arrangement is omitted [see Section 51(36) of the Constitution].

- Words in *italic type* are quoted verbatim from the Constitution or Act, even if the italics are used for emphasis.
- Words in **bold type** are headings inserted by the author.
- Words in square brackets [thus] are explanatory notes inserted by the author.
- The "President" means the President of the Senate—not the President of the Republic!

Most of the "explanatory notes" rely on J. McMillan, G. Evans and H. Storey, *Australia's Constitution: Time for Change?* (Sydney: Law Foundation of NSW / Allen & Unwin, 1983). Notable constitutional events not covered by McMillan et al. include the Australia Act 1986, the Constitutional Convention of 1998 and the unsuccessful referenda of 1984 and 1988.

D.1 The Constitution

Contents

Chapter I - The Parliament

Part I - General

1. *The legislative power of the Commonwealth shall be vested in a Federal Parliament, which shall consist of the Queen, a Senate, and a House of Representatives . . . .*

2. *A Governor-General appointed by the Queen shall be Her Majesty's representative in the Commonwealth, and shall have and may exercise in the Commonwealth during the Queen's pleasure, but subject to this Constitution, such powers and functions of the Queen as Her Majesty may be pleased to assign to him.*

3. The salary of the Governor-General may be determined by the Parliament, but shall not be altered during his continuance in office.

4. The person serving in the office of Governor-General shall not simultaneously receive any salary from the Commonwealth in respect of any other office.

5. The Governor-General may appoint the times of Parliamentary sessions, may prorogue the Parliament, and may dissolve the

House of Representatives. After any general election, the Parliament shall meet within 30 days of the day appointed for the return of the writs. . . .

6. The Parliament shall not be in continuous recess for longer than one year.

Part II - The Senate

7. *The Senate shall be composed of senators for each State, directly chosen by the people of the State* for a term of six years. The names of the senators elected for each State shall be certified by the State Governor to the Governor-General. The Federal Parliament may determine the number of senators for each State, but each Original State shall have the same number of senators and shall not have fewer than six senators.

[The "Original States" are the six founding States, which are still the only States of the Commonwealth. Sections 121 to 124 deal with the possibility of new States.]

8. In each State, the qualification for electors of senators shall be the same as for electors of members of the House of Representatives; but in the choosing of senators each elector shall vote only once.

9. The Federal Parliament *may make laws prescribing the method of choosing senators, but so that the method shall be uniform for all the States. Subject to any such law, the Parliament of each State may make laws prescribing the method of choosing the senators for that State.*

The Parliament of a State may determine the times and places of elections of senators for the State.

10. Transitional.

11. If a State fails to provide for the election of its senators, the Senate may proceed without them.

12. The Governor of any State may issue writs for elections of senators for the State. If the Senate is dissolved, the writs shall be issued within ten days.

13. **Staggered Senate elections:** After a double-dissolution election [Section 57], the Senate shall divide the senators for each State

into two groups of equal size. The places of the first group shall become vacant after three years and the places of the second group shall become vacant after six years. The places of senators elected thereafter [in a half-Senate election] shall become vacant after six years.

The election to fill vacant places shall be made within one year before the places are to become vacant.

For the purposes of this section, the term of a senator elected in a half-Senate election shall be reckoned from the first day of July *following* the election, and the term of a senator elected in a double-dissolution election shall be reckoned from the first day of July *preceding* the election.

14. Before a half-Senate election at which the number of senators for a State is to be changed, the Federal Parliament may *make such provision for the vacating of the places of senators for the State as it deems necessary to maintain regularity in the rotation.*

15. **Casual vacancies in the Senate:** If the place of a senator for a State becomes vacant before the expiration of his term, a joint sitting of the State Parliament shall choose a replacement for the remainder of the term. If the State Parliament is not in session when the vacancy is notified, the State Governor in Council may appoint a replacement to serve until 14 days after the beginning of the next session of the State Parliament or until the expiration of the term, whichever is sooner.

If the outgoing senator was elected as a publicly endorsed candidate of a political party, his replacement shall be a member of that party unless there is no member of the party available for appointment. If the replacement, before taking his seat, ceases to be a member of that party while the party still exists, his appointment shall be invalid and the vacancy shall again be notified in accordance with Section 21.

The name of the replacement senator shall be certified by the Governor of the State to the Governor-General.

[Numerous transitional provisions follow.]

16. *The qualifications of a senator shall be the same as those of a member of the House of Representatives.*

17. The Senate shall choose a senator to be the President of the Senate and shall not proceed to any other business while the office of President is vacant. The President shall cease to hold his office if he (a) ceases to be a senator, (b) is removed from office by a vote of the Senate, or (c) resigns his office or his seat by writing addressed to the Governor-General.

18. The Senate may choose a deputy President to act in the absence of the President.

19. A senator may resign his seat by writing addressed to the President or, in his absence, to the Governor-General.

20. A senator shall lose his seat if, without the permission of the Senate, he fails to attend sittings for two consecutive months of any session.

21. Any vacancy in the Senate shall be notified to the Governor of the affected State by the President or, in his absence, by the Governor-General.

22. The Parliament may determine how many senators constitute a quorum.

23. A question arising in the Senate shall be determined by a majority of votes. Each senator, including the President, shall be entitled to one vote. If the votes are tied, the result is *negative*.

Part III - The House of Representatives

24. The House of Representatives shall be composed of members directly chosen by the people of the Commonwealth. The Federal Parliament may determine the number of members for each State, provided that

- the number of members of the House shall be, as nearly as possible, twice the number of senators [this requirement is commonly called the "nexus"], and
- the number of members for each State shall be proportional to its population.

Notwithstanding the above, each Original State shall have at least five members.

25. *For the purposes of the last section, if by the law of any State all persons of any race are disqualified from voting at elections for the more numerous house of the Parliament of the State, then, in reckoning the number of the people of the State or of the Commonwealth, persons of the race resident in that State shall not be counted.*

[Question 2 of the 1988 referendum would have repealed this section. The question was defeated.]

26. Transitional.

27. *Subject to this Constitution, the Parliament may make laws for increasing or diminishing the number of the members of the House of Representatives.*

28. *Every House of Representatives shall continue for three years from the first meeting of the House, and no longer, but may be sooner dissolved by the Governor-General.*

29. The Federal Parliament may determine the electoral boundaries for the House of Representatives. An electorate shall not straddle a State border.

[Nothing in this Constitution requires electorates to have approximately equal numbers of voters ("one vote, one value"). Question 2 of the 1988 referendum would have introduced this requirement, but was defeated.]

30. The Parliament may determine the qualification of electors of members of the House of Representatives; but each elector shall vote only once.

[Nothing in this Constitution guarantees that women or aborigines have the right to vote. Question 2 of the 1988 referendum would have given this guarantee, but was defeated.]

31. Transitional.

32. Within ten days from the expiry of a House of Representatives or from the proclamation of a dissolution thereof, the Governor-General shall issue writs for a general election of members of the House.

33. **By-elections for casual vacancies in the House:** Whenever a vacancy happens in the House of Representatives, a writ for the election of a new member shall be issued by the Speaker or, in his absence, by the Governor-General.

34. Transitional.

35. The House shall choose a member to be the Speaker and shall not proceed to any other business while the office of Speaker is vacant. The Speaker shall cease to hold his office if he (a) ceases to be a member, (b) is removed from office by a vote of the House, or (c) resigns his office or his seat by writing addressed to the Governor-General.

36. The House may choose a deputy Speaker to act in the absence of the Speaker.

37. A member may resign his seat by writing addressed to the Speaker or, in his absence, to the Governor-General.

38. A member shall lose his seat if, without the permission of the House, he fails to attend sittings for two consecutive months of any session.

39. The Parliament may determine how many members of the House constitute a quorum.

40. A question arising in the House of Representatives shall be determined by a majority of votes. The Speaker shall not vote unless the numbers are equal, in which case he shall have a casting vote.

Part IV - Both houses of the Parliament

41. No adult person who is eligible to vote in elections for the more numerous house of the Parliament of a State shall be prevented by any Federal law from voting in Federal elections.

42. Before taking his seat, every member of the Federal Parliament shall make an Oath or Affirmation of Allegiance, in the form set out in the Schedule to this Constitution, in the presence of the Governor-General or his appointee.

[Any reader who thinks the Affirmation is for atheists is invited to consult Matthew 5:33–37 and James 5:12.]

43. A member of either house of Parliament cannot be elected or sit as a member of the other house.

44. The following classes of persons cannot be elected or sit as members of Federal Parliament:

(1). persons *under any acknowledgement of allegiance, obedience, or adherence to a foreign power, or … entitled to the rights and privileges of a subject or citizen of a foreign power*;

(2). persons convicted of treason, or under sentence or subject to be sentenced for any offence punishable under Federal or State law by imprisonment for one year or longer;

(3). undischarged bankrupts or insolvents;

(4). persons receiving any salary from the Crown or any pension from the Commonwealth, except as Federal or State Ministers or serving or former members of the armed forces of the Queen or the Commonwealth;

(5). persons with any pecuniary interest in any agreement with the Federal Public Service *otherwise than as a member and in common with the other members of an incorporated company consisting of more than twenty-five persons*.

[Notes:

- If you have dual citizenship, subsection (1) means that you cannot stand for Parliament, even if you have no way of renouncing your non-Australian citizenship.
- If you are a government employee wishing to stand for Parliament, subsection (4) means that you must resign your job before—not after—the election. And if you are elected to the Senate in a half-Senate election, Section 13 means that you do not take your seat or your Parliamentary salary until July 1 following the election. What you do for a living in the mean time, which could be as much as a year, and during which you will be besieged by constituents who think you have already taken your seat, is your problem.]

45. A senator or member of the House of Representatives shall lose his seat if he

(1). falls into any of the classes mentioned in Section 44,

(2). takes advantage of any law relating to bankruptcy or insolvency, or

(3). directly or indirectly accepts any offer of payment for *services rendered to the Commonwealth* [a dangerously broad and ambiguous category], or any offer of payment for *services rendered in the Parliament to any person or State* [i.e. a bribe or kickback].

46. The Federal Parliament may prescribe penalties for persons who sit as members of the Parliament while disqualified from doing so by this Constitution.

47. The Parliament may prescribe procedures for settling questions arising in either house on the qualifications of members, vacancies in either house, and disputed elections.

48. The Parliament may provide for the remuneration of the members of each house.

49. The Parliament may determine the *powers, privileges, and immunities of the Senate and of the House of Representatives, and of the members and the committees of each house.*

50. Each house of the Parliament may make rules and orders concerning

(1). the exercise and protection of its powers, privileges, and immunities, and

(2). the order and conduct of its business.

Part V - Powers of the Parliament

51. Powers of the Federal Parliament [not all exclusive]:

(1). *Trade and commerce with other countries, and among the States* [including navigation, shipping and railways (see Section 98) but not manufacturing or retailing or intrastate trade];

(2). *Taxation; but so as not to discriminate between States or parts of States*;

(3). Bounties on the production or export of goods, which must be uniform throughout the Commonwealth [this power is exclusive under Section 90];

(4). Borrowing money for the Commonwealth;

(5). Postal, telegraphic, telephonic, and other like services [including radio and TV, but not newspapers; exclusive under Section 69];

(6). Defence of the Commonwealth and the States [exclusive under Section 69], and the enforcement of Federal law;

(7). *Lighthouses, lightships, beacons and buoys* [exclusive under Section 69];

(8). *Astronomical and meteorological observations*;

(9). *Quarantine* [exclusive under Section 69; I am aware of some State involvement in quarantine, but I am at a loss to explain how this can be reconciled with Sections 52 and 69];

(10). *Fisheries in Australian waters beyond territorial limits*;

(11). *Census and statistics*;

(12). *Currency, coinage, and legal tender*;

(13). Banking other than State banking; State banking extending beyond State limits; banks; paper money;

(14). Insurance other than State insurance; State insurance extending beyond State limits;

(15). *Weights and measures*;

(16). *Bills of exchanging and promissory notes*;

(17). *Bankruptcy and insolvency*;

(18). Copyrights, patents, designs, trade marks;

(19). *Naturalisation and aliens*;

(20). *Foreign corporations, and trading or financial corporations formed within the limits of the Commonwealth* [ambiguous];

(21). *Marriage* [but not de facto relationships];

(22). Divorce and matrimonial causes including custody of children [but stepchildren and orphans are State responsibilities; the resulting division of jurisdiction has benefited no one but lawyers];

(23). *Invalid and old-age pensions*;

(23A) *The provision of maternity allowances, widows' pensions, child endowment, unemployment, pharmaceutical, sickness and hospital benefits, medical and dental services (but not so as to authorise any form of civil conscription), benefits to students and family allowances*;

(24). *The service and execution throughout the Commonwealth of the civil and criminal process and the judgements of the courts of the States*;

(25). *The recognition throughout the Commonwealth of the laws, the public Acts and records, and the judicial proceedings of the States*;

(26). *The people of any race, for whom it is deemed necessary to make special laws*;

(27). *Immigration and emigration*;

(28). *The influx of criminals*;

(29). *External affairs* [useful for preventing the States from building dams within their own borders];

(30). Relations between the Commonwealth and Pacific islands;

(31). *The acquisition of property on just terms from any State or person for any purpose in respect of which the Parliament has power to make laws*;

(32). Control of railways for military purposes;

(33). Acquisition of State railways on terms agreed with the State;

(34). Railway construction with the consent of the affected State;

(35). Industrial disputes extending beyond the limits of any one State [but not disputes within one State; hence the present mixture of Federal and State awards and industrial commissions];

(36). *Matters in respect of which the Constitution makes provision until the Parliament otherwise provides* [wherefore this paraphrase deletes such temporary provisions and declares the associated powers of the Parliament];

(37). Matters referred to the Commonwealth by the Parliament(s) of any State(s), but so that the resulting law shall extend only to the referring State(s) and any other States that subsequently adopt the law [thus Victoria handed responsibility for industrial relations to the Commonwealth in 1996];

(38). *The exercise within the Commonwealth, at the request or with the concurrence of the Parliaments of all the States directly concerned, of any power which can at the establishment of* *this Constitution be exercised only by the Parliament of the United Kingdom or by the Federal Council of Australasia* [this power was used to enact the Australia Act 1986];

(39). *Matters incidental to the execution of any power vested by this Constitution in the Parliament or in either house thereof, or in the Government of the Commonwealth, or in the Federal Judicature, or in any department or officer of the Commonwealth.*

52. **Exclusive powers of the Federal Parliament:**

(1). The Federal seat of government and all places acquired by the Commonwealth for public purposes;

(2). Matters relating to any department of the public service transferred to the Commonwealth by this Constitution [see Section 69];

(3). *Other matters declared by this Constitution to be within the exclusive power of the Parliament* [see Sections 67, 90, 94, 96, 111, 112, 114, 115, 121, 122, 125, 128].

[There are other powers which are logically exclusive to the Commonwealth, although not declared to be so by this Constitution.]

53. **Money bills:** Bills appropriating revenue or imposing taxation, other than fines or licence fees or service fees, shall neither originate in the Senate nor be amended by the Senate, and the Senate shall not amend any bill *so as to increase any proposed charge or burden on the people*.

If the Senate cannot amend a bill, it may return the bill to the House of Representatives with a non-binding request for amendment.

Otherwise the powers of the Senate shall be equal to those of the House.

54. Appropriation bills shall deal only with appropriation.

55. A law imposing taxation shall deal only with the imposition of taxation, and with only one subject of taxation.

56. A vote, resolution, or bill for appropriation shall not be passed unless the purpose of the appropriation has been recommended in the same session by the Governor-General.

[Hence the “message from His Excellency the Governor-General” which precedes the Budget speech. It is not clear what would happen if His Excellency did not see fit to send such a message. Assuming, however, that the Governor-General acts on the advice of the Prime Minister, the effect of this section is that an appropriation bill must be a Government bill, not a private member’s bill.]

57. **The “double dissolution trigger”:** If the House of Representatives passes a bill, and the Senate rejects or fails to pass it or passes it with amendments to which the House will not agree, and if after three months the House of Representatives, in the same or the next session, again passes the bill with or without any Senate amendments, and the Senate again rejects or fails to pass it or passes it with amendments to which the House will not agree, then the Governor-General may dissolve the Senate and the House of Representatives simultaneously, unless the full term of the House of Representatives is due to expire within six months.

[It is not clear what actions or inactions of the Senate constitute failure to pass a bill.]

Joint sittings: If, after the double dissolution, the two houses remain deadlocked on the same bill, the Governor-General may convene a joint sitting of the two houses, which shall deliberate and vote on the bill (as last proposed by the House of Representatives) and on the disputed amendments; and if the bill, with or without any of the disputed amendments, is approved by an absolute majority of the joint sitting, then the bill with any approved amendments shall be taken as duly passed by the houses of Parliament.

58. When a bill passed by both houses of the Parliament is presented to the Governor-General for the Queen’s assent, he may assent in the Queen’s name, or withhold assent, or reserve the bill for the Queen’s pleasure, or return the bill to the house in which it originated with such amendments as he may recommend.

59. The Queen may disallow any law within one year from the Governor-General’s assent, in which case the law shall be null from the day on which the disallowance is announced by the Governor-General.

[This power has never been used. The corresponding power of the Queen to disallow State laws was abolished by Section 8 of the Australia Act 1986.]

60. A bill reserved for the Queen's pleasure shall be null unless and until the Governor-General, within two years from the day on which the bill was presented to him, announces that it has received the Queen's assent.

Chapter II - The Executive Government

61. *The executive power of the Commonwealth is vested in the Queen and is exercisable by the Governor-General as the Queen's representative, and extends to the execution and maintenance of this Constitution, and of the laws of the Commonwealth.*

62. *There shall be a Federal Executive Council to advise the Governor-General in the government of the Commonwealth, and the members of the Council shall be chosen and summoned by the Governor-General and sworn as Executive Councillors, and shall hold office during his pleasure.*

63. In this Constitution, the Governor-General in Council means the Governor-General acting with the advice of the Federal Executive Council.

64. The Governor-General in Council may establish Commonwealth departments. The Governor-General may appoint and dismiss Ministers to administer such departments. Ministers shall be members of the Federal Executive Council.

Responsible government: No Minister shall hold office for longer than three months unless he is or becomes a senator or a member of the House of Representatives.

65. The Parliament may determine the number of Ministers, who shall hold such offices as the Parliament prescribes or, in the absence of such provision, as the Governor-General directs.

66. The Parliament may provide for the remuneration of Ministers.

67. The Parliament may determine the manner of appointment and removal of all other officers of the Executive Government of the Commonwealth.

68. The Governor-General, as the Queen's representative, is the commander in chief of the armed forces.

69. The following departments of the public service in each State are transferred to the Commonwealth:

Posts, telegraphs, and telephones;
Naval and military defence;
Lighthouses, lightships, beacons, and buoys;
Quarantine;
Customs and excise.

70. In respect of matters which pass from the States to the Executive Government of the Commonwealth, the former powers of the Governor or the Governor in Council shall pass to the Governor-General or the Governor-General in Council.

Chapter III - The Judicature

71. The judicial power of the Commonwealth is vested in a Federal Supreme Court called the High Court of Australia, any other Federal courts created by the Parliament, and any other courts vested with Federal jurisdiction by the Parliament. The High Court shall consist of at least three Justices, including a Chief Justice and as many other Justices as the Parliament prescribes.

72. The Justices of the High Court and other Federal courts

(1). *shall be appointed by the Governor-General in Council*;

(2). *shall not be removed except by the Governor-General in Council, on an address from both houses of the Parliament in the same session, praying for such removal on the ground of proved misbehaviour or incapacity*;

(3). *shall receive such remuneration as the Parliament may fix; but the remuneration shall not be diminished during their continuance in office.*

But Justices of the High Court shall retire at the age of 70 years.

The Parliament may make laws fixing a retirement age not exceeding 70 years for Justices of a court created by the Parliament [not the High Court], and may repeal or amend such laws, but any changes in the retirement age shall not apply to incumbent Justices.

A Justice of any Federal court may resign by writing under his hand delivered to the Governor-General.

73. **Appellate jurisdiction of the High Court:** Subject to such exceptions and regulations as the Parliament may prescribe, the High Court may determine appeals from

(1). the original jurisdiction of the High Court,

(2). any other Federal court, or any court exercising Federal jurisdiction, or a State Supreme Court, or any other State court from which, at the establishment of the Commonwealth, an appeal could be made to the [UK] Privy Council, or

(3). the Inter-State Commission, but only on questions of law,

and in such cases the decision of the High Court shall be final.

The Parliament shall not prevent the High Court from determining any appeal from the Supreme Court of a State in any matter in which, at the establishment of the Commonwealth, an appeal could be made to the Privy Council.

74. **Appeals to the [UK] Privy Council:** There is no line of appeal from the High Court to the Privy Council concerning the division of powers between States or between the Commonwealth and a State or States, unless the High Court certifies that the question should be determined by the Privy Council.

Except as provided in this section, nothing in this Constitution diminishes the Royal prerogative to grant special leave of appeal from the High Court to the Privy Council. The Parliament may make laws limiting the matters in which such leave may be requested, but any such laws shall be reserved by the Governor-General for Her Majesty's pleasure. [In 1975, the Federal Parliament used this power to abolish all appeals from the High Court to the Privy Council. The last such appeal was eventually decided in 1980.]

75. The High Court has original jurisdiction in any matter

(1). arising under a treaty,

(2). affecting representatives of other countries,

(3). in which the Commonwealth, or a person acting on behalf of the Commonwealth, is a party,

(4). *between States, or between residents of different States, or between a State and a resident of another State*, or

(5). in which an order or prohibition or injunction is sought against an officer of the Commonwealth.

76. The Parliament may make laws conferring original jurisdiction on the High Court in any matter concerning

(1). this Constitution or its interpretation,

(2). laws made by the Parliaments,

(3). naval and maritime jurisdiction;

(4). *the same subject-matter claimed under the laws of different States*.

77. Concerning any of the matters in the last two sections, the Parliament may make laws

(1). defining the jurisdiction of any Federal court other than the High Court,

(2). excluding jurisdiction belonging to or invested in State courts from the jurisdiction of any Federal court, or

(3). investing any State court with Federal jurisdiction.

78. *The Parliament may make laws conferring rights to proceed against the Commonwealth or a State in respect of matters within the limits of the judicial power.*

79. *The federal jurisdiction of any court may be exercised by such number of judges as the Parliament prescribes.*

80. The trial of a person indicted of a Federal offence shall be by jury, and shall be held in the State where the offence was committed or, if the offence was not committed within any State, wherever the Parliament prescribes.

Chapter IV - Finance and Trade

81. All revenue received by the Executive Government of the Commonwealth shall form a single Consolidated Revenue Fund.

82. The expenses incurred in the collection and management of the Consolidated Revenue Fund shall form the first charge thereon, and shall be followed by the expenditure of the Commonwealth.

83. *No money shall be drawn from the Treasury of the Commonwealth except under appropriation made by law* . . . [appropriation bills and supply bills].

84. When a department of a State is transferred to the Commonwealth, all officers of the department shall become subject to the Federal Executive Government, and shall not suffer any diminution of their conditions of employment. The cost of an officer's retirement or severance payments shall be shared between the Commonwealth and the State in proportion to his durations of service to each.

85. When a department of a State is transferred to the Commonwealth, the Commonwealth shall acquire all State property used exclusively by that department, and may acquire any other State property used by that department. The Commonwealth shall compensate the State for all acquired property and shall assume all the existing obligations of the transferred department.

86. Transitional.

87. Transitional.

88. Transitional.

89. Transitional.

90. The Federal Parliament shall have exclusive power to impose *duties of customs and excise, and to grant bounties on the production or export of goods.*

91. Nothing in this Constitution prohibits a State from subsidising the mining of metals or, with the consent of both houses of Federal Parliament, subsidising the production or export of goods.

92. *Trade, commerce, and intercourse among the States … shall be absolutely free.*

93. Transitional.

94. The Federal Parliament may provide for the monthly payment of all surplus Commonwealth revenue to the States, on such basis as it deems fair.

95. Transitional.

96. The Federal Parliament *may grant financial assistance to any State on such terms and conditions as the Parliament thinks fit.*

[Hence the Commonwealth can dictate policy to the States on matters which are otherwise within the exclusive power of the States.]

97. Transitional.

98. The Federal power over trade and commerce extends to navigation and shipping, and to railways owned by any State.

99. In trade, commerce, or revenue, the Commonwealth shall not discriminate between States or parts thereof.

100. The Commonwealth power over trade and commerce does not limit the right of a State or its residents to reasonable use of rivers for conservation or irrigation.

101. *There shall be an Inter-State Commission, with such powers of adjudication and administration as the Parliament deems necessary for the execution and maintenance, within the Commonwealth, of the provisions of this Constitution relating to trade and commerce, and of all laws made thereunder.*

102. The Federal Parliament may make laws to forbid any preference or discrimination by any State in the operation of its railways, which preference or discrimination is judged by the Inter-State Commission to be undue and unreasonable, or unjust to any State.

103. The members of the Inter-State Commission

(1). *shall be appointed by the Governor-General in Council*;

(2). *shall hold office for seven years, but may be removed within that time by the Governor-General in Council, on an address from both houses of the Parliament in the same session praying for such removal on the ground of proved misbehaviour or incapacity*;

(3). *shall receive such remuneration as the Parliament may fix; but such remuneration shall not be diminished during their continuance in office.*

104. Nothing in this Constitution prevents a State from charging a rate for the carriage of goods upon its railways, provided that the rate is deemed by the Inter-State Commission to be necessary for development of the State and applies equally to interstate and intrastate carriage [cf. Section 92].

105. The Federal Parliament may take over the States' public debts, or a proportion thereof according to their respective populations. The States shall indemnify the Commonwealth in respect of the debts taken over, and the interest thereon shall be deducted

from the portions of the surplus Commonwealth revenue payable to the respective States. If the surplus is insufficient, the shortfall shall be paid by the respective States.

105A. **Agreements on State debts:**

(1). The Commonwealth may make agreements with the States regarding their public debts, including (a) the take-over of debts by the Commonwealth, (b) management of debts, (c) payment of interest, sinking funds, (d) consolidation, renewal, conversion and redemption of debts, (e) indemnification of the Commonwealth, and (f) borrowing by the States or by the Commonwealth, or by the Commonwealth for the States.

(2). Transitional.

(3). The Parliament may make laws for the carrying out of such agreements.

(4). *Any such agreement may be varied or rescinded by the parties thereto.*

(5). Every such agreement shall be binding, notwithstanding anything else in Federal or State law or this Constitution [!] or the State Constitutions [!].

(6). The powers conferred by this section are not limited by Section 105.

Chapter V - The States

106. Subject to this Constitution, the Constitution of each State shall continue or be amended according to its own provisions.

107. **Residual powers:** The State Parliaments retain the powers of the former Colonial Parliaments which are not otherwise exclusively vested by this Constitution.

108. Transitional.

109. *When a law of a State is inconsistent with a law of the Commonwealth, the latter shall prevail, and the former shall, to the extent of the inconsistency, be invalid* [assuming of course that the Commonwealth has the power to make that law].

110. The provisions of this Constitution relating to the Governor of a State extend to any person acting in the position of Governor.

111. *The Parliament of a State may surrender any part of the State to the Commonwealth; and upon such surrender, and the acceptance thereof by the Commonwealth, such part of the State shall become subject to the exclusive jurisdiction of the Commonwealth.* [Thus South Australia surrendered the Northern Territory in 1911.]

112. A State may levy on goods passing into or out of the State such charges as are necessary for executing its inspection laws; but the net produce of the charges shall be for the use of the Commonwealth; and any such inspection laws may be annulled by the Federal Parliament. [This is apparently designed to stop the States from circumventing Section 90 or Section 92 by means of so-called inspection charges.]

113. All alcoholic liquids in a State are subject to the State's laws as if they had been produced in the State.

114. A State shall not, without the consent of the Federal Parliament, maintain any defence force. A State shall not impose any tax on Commonwealth property and vice versa. [The latter provision did not prevent the Howard government from abolishing the sales tax exemption for vehicles purchased by State and local governments.]

115. *A State shall not coin money, nor make anything but gold and silver coin a legal tender in payment of debts.*

116. *The Commonwealth shall not make any law for establishing any religion, or for imposing any religious observance, or for prohibiting the free exercise of any religion, and no religious test shall be required as a qualification for any office or public trust under the Commonwealth.*

117. *A subject of the Queen, resident in any State, shall not be subject in any other State to any disability or discrimination which would not be equally applicable to him if he were a subject of the Queen resident in such other State.* [But nothing in this Constitution forbids discrimination against Territorians visiting a State or State residents visiting a Territory.]

118. *Full faith and credit shall be given, throughout the Commonwealth, to the laws, the public Acts and records, and the judicial proceedings of every State.*

119. The Commonwealth shall protect every State against invasion and, at the request of the State Executive Government, against internal violence.

120. Every State shall provide as required for the detention or punishment of persons accused or convicted of offences against Federal laws, and the Federal Parliament may make laws to give effect to this provision.

Chapter VI - New States

121. The Federal Parliament may admit or establish new States on such terms as it thinks fit, including the extent of representation in each house of the Parliament.

122. The Federal Parliament may make laws for the government of any territory surrendered by any State to the Commonwealth [see Section 111], or of any territory placed by the Queen under the authority of the Commonwealth, and may determine the representation of such territory in each house of the Parliament.

123. With the approval of the Parliament of a State and a majority of the voters of the State, the Federal Parliament may increase or diminish the limits of the State on the terms and conditions so approved.

124. *A new State may be formed by separation of territory from a State, but only with the consent of the Parliament thereof, and a new State may be formed by the union of two or more States or parts of States, but only with the consent of the Parliaments of the States affected.*

Chapter VII - Miscellaneous

125. The Federal seat of government shall be determined by the Parliament, but shall be within New South Wales, at least 100 miles from Sydney, and within a territory of at least 100 square miles owned by the Commonwealth.

126. The Queen may authorise the Governor-General to appoint a deputy or deputies.

127. Repealed (May 27, 1967).

Chapter VIII - Alteration of the Constitution

128. *This Constitution shall not be altered except in the following manner*:

> The proposed alteration must be passed by both houses of Parliament and, after an interval of at least two months and at most six months, submitted to the electors of all States and Territories who are eligible to vote in elections for the House of Representatives.
>
> But if one house passes the alteration, and the other house rejects or fails to pass it or passes it with any amendment to which the first house will not agree, and if after an interval of three months the first house, in the same or the next session, again passes the alteration with or without any amendment made or agreed to by the other house, and the other house rejects or fails to pass it or passes it with any amendment to which the first house will not agree, then the Governor-General may submit the proposed law as last proposed by the first house, with or without any amendments subsequently agreed to by both houses, to the electors of all States and Territories who are eligible to vote in elections for the House of Representatives.
>
> And if the alteration is approved by an overall majority of voters and by a majority of voters in each of a majority of the States, it shall be presented to the Governor-General for the Queen's assent.

No alteration diminishing the proportionate representation of any State in either house of the Parliament, or the minimum number of representatives of a State in the House of Representatives, or increasing, diminishing, or otherwise altering the limits of the State, or in any manner affecting the provisions of the Constitution in relation thereto, shall become law unless the majority of the electors voting in that State approve the proposed law.

In this section, "Territory" means any territory represented in the House of Representatives according to Section 122.

Schedule

> OATH:
>
> *I, A.B., do swear that I will be faithful and bear true allegiance to Her Majesty Queen Victoria, Her heirs and successors according to law. SO HELP ME GOD!*
>
> AFFIRMATION:
>
> *I, A.B., do solemnly and sincerely affirm and declare that I will be faithful and bear true allegiance to Her Majesty Queen Victoria, Her heirs and successors according to law.*

The name of the King or Queen is to be updated as required.

D.2 Statute of Westminster (UK) 1931

An Act to give effect to certain resolutions passed by Imperial Conferences held in the years 1926 and 1930. . . .

1. Definition of "Dominion": The Commonwealth of Australia is named as a Dominion.

2. Any law made hereafter by the Parliament of a Dominion

(1). shall not be subject to the Colonial Laws Validity Act 1865, and

(2). shall not be void on the ground that it is contrary to the law of England or of the United Kingdom, and may be repealed or amended by the Parliament of the Dominion in so far as it is part of the law of the Dominion.

3. The Parliament of a Dominion may make laws having extra-territorial operation.

4. No future Act of the UK Parliament shall extend to a Dominion unless the Act expressly declares that the Dominion has requested and consented to the Act. [The exception was abolished in Australia by sections 1 and 12 of the Australia Act 1986.]

5. Without prejudice to the above, the Parliament of a Dominion shall no longer be regarded as a legislature of a British possession for the purposes of the Merchant Shipping Act 1894.

6. Without prejudice to the above, those provisions of the Colonial Courts of Admiralty Act 1890 which subject certain laws and procedures to His Majesty's approval shall no longer apply in the Dominions.

7. Relevant to North America only.

8. *Nothing in this Act shall be deemed to confer any power to repeal or alter the Constitution or the Constitution Act of the Commonwealth of Australia . . . otherwise than in accordance with the law existing before the commencement of this Act.*

9. Concerning the Commonwealth of Australia:

(1). Nothing in this Act empowers the Federal Parliament to make laws on any matter hitherto within the exclusive jurisdiction of the States.

(2). Nothing in this Act diminishes the existing authority of the UK Parliament to make laws, without the concurrence of the Commonwealth, on any matter within the authority of the States but outside the authority of the Commonwealth.

(3). The request and consent referred to in section 4 of this Act means the request and consent of the Parliament and Government of the Commonwealth.

[Subsections (2) and (3) were repealed in Australia by section 12 of the Australia Act 1986.]

10. In Australia, New Zealand and Newfoundland,

(1). None of sections 2 to 6 of this Act shall extend to a Dominion unless that section is adopted by the Parliament of the Dominion from the date of this Act or such other date as is specified by that Parliament;

(2). The Parliament of a Dominion, having adopted a section of this Act, may subsequently revoke the adoption.

[Subsection (2) was repealed in Australia by section 12 of the Australia Act 1986.]

11. In future acts of the UK Parliament, the word "colony" shall not apply to a Dominion or any Province or State forming part of a Dominion.

12. Short title.

D.3 Statute of Westminster Adoption Act 1942

1. Short title.

2. *This Act shall come into operation on the day on which it receives the Royal Assent.*

3. Sections 2 to 6 of the Imperial Act entitled the Statute of Westminster 1931 are adopted with effect from September 3, 1939.

D.4 Australia Act 1986

WHEREAS the Prime Minister of the Commonwealth and the Premiers of the States at conferences held in Canberra on 24 and 25 June 1982 and 21 June 1984 agreed on the taking of certain measures to bring constitutional arrangements affecting the Commonwealth and the States into conformity with the status of the Commonwealth of Australia as a sovereign, independent and federal nation:
AND WHEREAS in pursuance of paragraph 51 (xxxviii) of the Constitution the Parliaments of all the States have requested the Parliament of the Commonwealth to enact an Act in the terms of this Act . . .

1. No future Act of the UK Parliament shall extend to the Commonwealth or a State or Territory thereof.

2. The legislative powers of the Parliament of each State include

(1). *full power to make laws for the peace, order and good government of that State that have extra-territorial operation*, and

(2). all legislative powers that the UK Parliament might hitherto have exercised for the peace, order and good government of that State, excluding any new powers to engage in relations with countries outside Australia.

3. Any law made hereafter by the Parliament of a State

(1). shall not be subject to the Colonial Laws Validity Act 1865, and

(2). shall not be void on the ground that it is contrary to the law of England or of the United Kingdom, and may be repealed or amended by the Parliament of the State in so far as it is part of the law of the State.

4. Sections 735 and 736 of the UK Merchant Shipping Act 1894, in so far as they are part of the law of a State, are repealed.

5. Sections 2 and 3(2) above

(a) are subject to the Commonwealth of Australia Constitution Act and to the Constitution of the Commonwealth, and

(b) do not empower any State Parliament to enact legislation that would *repeal, amend or be repugnant to this Act, the Commonwealth of Australia Constitution Act, the Constitution of the Commonwealth or the Statute of Westminster 1931 as amended and in force from time to time.*

6. Notwithstanding sections 2 and 3(2) above, a law made by a State Parliament concerning its own constitution, powers or procedures shall be void unless it is made in accordance with its own existing laws.

7. Concerning the Queen and the State Governors:

(1). *Her Majesty's representative in each State shall be the Governor.*

(2). *Subject to subsections (3) and (4) below, all powers and functions of Her Majesty in respect of a State are exercisable only by the Governor of the State.*

(3). Subsection (2) above does not apply to the power to appoint and dismiss the Governor.

(4). While Her Majesty is present in a State, she may exercise the powers and functions in subsection (2) above.

(5). The advice to Her Majesty concerning the exercise of her powers and functions in a State shall be tendered by the Premier of the State.

8. Hereafter, when an Act of a State Parliament has been assented to by the Governor, it shall not be subject to disallowance by Her Majesty or reserved for Her Majesty's pleasure.

9. No law or instrument shall be of any force or effect in so far as it purports to

(1). require a State Governor to withhold assent from any bill that has been duly passed by the State Parliament, or

(2). require a bill to be reserved for Her Majesty's pleasure.

10. The UK Government shall hereafter have no responsibility for the government of any State.

11. **Abolition of appeals to the Privy Council:**

(1). Hereafter, there shall be no line of appeal to the Privy Council against any decision of an Australian court, and no authority may grant leave for such an appeal.

(2). The enactments listed in subsection (3) below and any other provisions of existing UK Acts that provide for appeals to the Privy Council, together with any orders, rules, regulations or other instruments made under or for the purposes of those enactments, are no longer part of the law of the Commonwealth or of any State or Territory thereof.

(3). The enactments referred to in subsection (2) above are the Australian Courts Act 1828 (section 15), the Judicial Committee Acts of 1833 and 1844, the Australian Constitutions Act 1850 (section 28), and the Colonial Courts of Admiralty Act 1890 (section 6).

(4). Subsections (1) to (3) above do not affect appeals, grants of leave to appeal or applications for leave to appeal that were made before the commencement of this Act. Neither does this subsection create any new right of appeal.

12. Sections 4, 9(2,3) and 10(2) of the Statute of Westminster 1931 are no longer part of the law of the Commonwealth or of any State or Territory thereof.

13. Consequential amendments to the Constitution Act 1867–1978 of the State of Queensland [not informative when out of context].

14. Consequential amendments to the Constitution Act 1889 of the State of Western Australia [ditto].

15. **Amendments:** This Act, and the Statute of Westminster 1931 as amended and in force, in so far as they are part of the law of the Commonwealth or a State or Territory thereof, may be amended by one of the following methods, but not otherwise:

(1). explicitly, by legislation enacted by the Federal Parliament, at the request or with the concurrence of the Parliaments of all the States, purporting to repeal or amend this Act or the Statute of Westminster, or

(2). implicitly, by legislation enacted by the Federal Parliament, at the request or with the concurrence of the Parliaments of all the States, containing provisions inconsistent with this Act or the Statute of Westminster, or

(3). by the Federal Parliament, using any other power conferred upon it by an amendment to the Constitution of the Commonwealth in accordance with section 128 of that Constitution [i.e. by referendum].

16. **Definitions** [excluding the obvious]: An appeal to the Privy Council includes any appeal to Her Majesty. A "State" is an original or new State of the Commonwealth of Australia. An "Australian Court" is a Territorial or State or Federal court other than the High Court [which is the subject of section 74 of the Constitution].

17. This Act may be cited as the Australia Act 1986 and shall come into force at a time to be fixed by Proclamation.

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