Australian Tax Reform: Which Way Ahead?

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Abstract

While the 1980s saw major changes to the Australian tax system which sought both to reduce avoidance and evasion and to reform the base structure of income tax, there are design deficiencies in some of these changes which must be attended to. Also a much closer approach to comprehensive and consistent taxation of investment income should be attempted. On the side of indirect tax the replacement of the wholesale sales tax by a broadly based value added tax is highly desirable, but is unlikely to be achievable politically unless lpart of a strategy which combines sales tax reform, tax mix change and income tax reform. In any case, meaningful and durable reform of the tax system requires a basic community consensus which cuts across sectional interest groups and political parties.

1. Introduction and Overview

After the very considerable efforts devoted to reform of the Australian tax system during the 1980s, first to stem the tide of avoidance and evasion carried over from the 1970s and subsequently to reform the basic structure of the personal and company income taxes, it would be comforting to be able to declare the 1990s a period for quiet consolidation and reassessment. As a society we do not benefit from continuing and divisive debate, and associated uncertainty, regarding the basic parameters of the revenue structure. Unfortunately, however, the achievements of the 1980s, although significant, have not been decisive and major issues of principle and procedure remain to be resolved.

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In the income tax area significant steps have been taken to move the tax base away from arbitrary legalistic distinctions inherited from the British income tax towards the application of a modern economic income concept. Even after recent reforms, however, the income tax base remains an awkward and possibly unsustainable hybrid of income and consumption elements; and the progressive rate scale still exhibits unpleasant features such as low cut-in points and is the subject of continuing debate. In spite of our best efforts - and a veritable mass of new and complex legislation in such areas as capital gains, fringe benefits, foreign source income, company tax imputation and retirement saving - it could hardly be said that a settled income tax structure has as yet been achieved.

In the sales tax area we are now quite unique among industrialised western countries in our reliance upon the narrowly based wholesale sales tax and the associated excise tax system. With the defeat of Option C at the Tax Summit in 1985 the issue of sales tax reform was for the time entirely lost. However, dissatisfaction with the existing structure remains strong and sales tax reform, whether in the context of tax mix change or in the context of a revenue-neutral reform of the commodity tax structure, is very high on the tax reform agenda of prominent business groups, the National Farmers' Federation and now also of the Federal Opposition parties.

As we enter the 1990s, therefore, it seems clear that in the area of tax reform, as in so many other major policy areas, Australia still stands very much at the crossroads. Although little has yet been definitively resolved, the debates and tax reform initiatives of the past decade have sparked some useful research into the effects of the present tax system and into the alternative options which might be pursued. As a result of this work the distortions and inequities of the prevailing income and commodity tax system have been much more fully analysed and where possible quantified. Although significant gaps and uncertainties in our knowledge remain, there is now a much better understanding of the serious economic damage which has resulted from our neglect of basic design principles of comprehensiveness and uniformity in the income tax and commodity tax systems.

With the rising sophistication of the public debate a variety of alternative options have been proposed and costed, often inspired by major tax reform studies and developments overseas - though with some characteristically Australian features. As a result, a veritable smorgasbord of options is now available more or less ready-made and with user-friendly software to tempt the appetite of any would-be tax mix reformer. In addition to mainstream offerings of sales tax reform and tax change packages, schemes for flat or modified flat rate income tax have been especially prominent, featuring threshold taxing and associated spending cuts in health and welfare. Of

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somewhat more specialised interest, there are also schemes for comprehensive inflation-adjustment of the income tax; and increasing attention has also been given to the expenditure tax alternative.

There is unfortunately much less agreement on the likely costs and benefits of these and other major tax reform alternatives to the present system. In some dimensions at least the advantages of the alternative structure in terms of equity, efficiency and/or simplicity may be completely clear and unambiguous - once we get there. This is true for a comprehensive income tax system. It is true for a value-added tax. It is true for an expenditure tax. It is true for a flat rate or linear income tax. What is true for the textbook, off-the shelf system once it is fully operational may not, however, be true when we take account of the many modifications and transitional provisions, to compensate losers, ameliorate windfalls, and, more generally, to buy off the opposition in order to implement the move from where we now are to where we would ideally like to be. This is, of course, the important distinction emphasized by Feldstein (1976) between tax design and tax reform. The new capital gains tax provides a telling example from the Keating income tax reform package; and the understandable misgivings over wage discounting and compensation for low-income households which contributed to the defeat of Option C at the Tax Summit provide another.

There are also large gaps in our knowledge and serious deficiencies in the economic modelling of some crucially important effects of tax reform. In the current environment of concern over historically low levels of private saving, important tax reform proposals to change the tax mix, to inflation-adjust the income tax system or to move to expenditure tax are understandably being promoted for their presumptively favourable effects on personal saving. In view of the conflicting empirical evidence, however, the economist, if caught off-guard by his employer or in a rare moment of extreme candour, would have to admit that we still have no convincing evidence or modelling on these vitally important issues. Similarly, although we may be sure that a flat or linear income tax system would be much simpler than the prevailing progressive personal income tax, we still could not estimate with any degree of certainty the likely effects in the crucial dimension of incentives to work.

In broad outline then, there seems to be strong evidence that the prevailing tax system in Australia, even after the reforms of the 1980s, remains highly unsatisfactory, as judged in the light of standard tax design criteria and tax policy objectives of equity, efficiency and simplicity. Considerable damage has already been done and continues to be done in the form of misallocation of savings and investment and distortion of the financial

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polices of Australian business. Tax compliance has been seriously eroded and confidence in the democratic budgetary system remains at a low ebb.

To resolve these problems a variety of alternative tax reform scenarios have been proposed beckoning us in radically different directions. In themselves, some of these alternative approaches offer unmistakable advantages, but these advantages are generally much reduced by transitional difficulties, compensation requirements and political concessions, leaving at best a package offering modest and highly uncertain benefits. Due to gaps in our knowledge some of the most important effects are for the present largely unknown and must be taken on trust. Under these circumstances, is a major tax reform possible or desirable, and if so, which of the various alternative options should we attempt to pursue?

As we well know, majority voting in a democracy is perfectly capable of producing *change* - in the tax area as in other matters. Indeed, as modern public choice analysis reminds us, there is a very real danger of socially and economically disruptive policy reversals and upheavals. The major political parties and sectional interest groups have an obvious incentive to play zero and indeed negative-sum redistributive games in important matters of institutional reform. We have already had some experience of this in the health area with obvious ill effects. If genuine reform of the Australian income and commodity tax system is to be achieved, a more principled approach is clearly required in which the familiar politics of short-term sectional self-interest must give way to wider considerations of equity and efficiency which go to the heart of rational budgetary decision-making in a democracy.

This is, of course, why in all countries, major tax reform issues have so frequently been referred to the independent expert committee or Royal Commission, since such bodies are less prone to the politics of short-term sectional self-interest and are more likely to take the broader and more principled approach required. It is, however, one thing to secure agreement that the existing system is in dire need of reform and should be examined by an expert committee. It is unfortunately quite another, as we found with the Asprey and Mathews Committees in the 1970s, to ensure implementation in some form of the reform programs actually proposed. And it is more difficult again to be sure that any changes made will not be subject to costly and politically destructive policy reversals.

Whichever way we look at the problem of securing meaningful and desirable reform of the tax system, it seems clear that a necessary condition for success is the achievement of a broad consensus involving all the major interest groups and political parties. The experience of the 1980s in this regard is clearly not very encouraging. The consultative and participatory reform strategy initiated by the Hawke Government and culminating in the

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National Taxation Summit of 1985 had only limited success, though the quasi-constitutional character of the tax reform exercise has no doubt helped to confer at least some measure of legitimacy on the income tax reforms which emerged from the summit fiasco. The behaviour of business groups and the trade union movement in rejecting the Option C package of income tax reform, as favoured by the unions, in combination with sales tax reform and tax mix change, as favoured by the business community, is certainly not encouraging for the future of major tax reform in Australia. Unless the political parties and major interest groups are ready to take the broader views required and show a willingness to trade-off and compromise across divisive issues, little real progress can be expected.

The major interest groups and political parties in Australia clearly remain deeply divided on the central issues of income tax reform and sales tax reform. Opinions are divided in the choice of tax base between the major alternatives of income and consumption. They are also divided on the choice between flat rate and progressive rate structures. These differences no doubt reflect to some degree the perceived sectional self-interest of the business groups and the labour movement and in the case of the political parties of their core constituencies. To some extent they probably also reflect genuine differences in perceptions of tax equity and of the trade-offs between equity and efficiency. Whatever their origins, these differences are predictably reflected in the basic structure of our income and commodity tax systems and go far to explain the inconsistencies and design deficiencies that we observe and almost unanimously deplore.

2. Income Tax Reform - The Unfinished Agenda

As we have already noted, Australia's tax reform achievements during the 1980s have been concentrated almost exclusively in the area of income tax. Important new measures have been introduced to expand the inclusion of previously untaxed or preferentially taxed components of income, including capital gains, fringe benefits, lump sum superannuation and the investment income of superannuation funds. There has been a significant tightening of deductions in the area of employment expenses, notably the disallowance of most entertainment expense deductions. In the company tax area radical measures have been taken to remove the double taxation of dividends through a full imputation system and indeed, through the extension of the imputation credit to bonus shares and the (short-lived) alignment of the top marginal personal tax rate with the company tax in 1987-88, to fully integrate the company income tax with personal income tax. Tax preferences in the business tax area were dramatically reduced in the Treasurer's May 1988 Economic Statement with the decision to abolish the arbitrary and highly

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distorting system of 5/3 depreciation, which over time would help finance the substantial reduction in the company tax rate from 49% to 39%. Following the strong anti-avoidance measures introduced early in the decade, important new administrative measures have also been introduced, including the new tax file number system (in lieu of the Australia Card), the prescribed payments system, increased substantiation requirements, and a much expanded, more aggressive and better targeted tax audit system. Concern over high rates of personal income tax has been addressed with significant reductions in the top marginal rates, and further changes in the context of wage-tax trade-offs have resulted in useful cuts in the lower bracket rates, though the low cut-in points have remained largely unaffected.

This (incomplete) catalogue of income tax changes and reforms during the 1980s is certainly impressive, at least by Australian standards. After decades in which the basic income tax legislation and administrative procedures had been little changed, this was clearly a decade of frenzied activity putting enormous pressure on tax policy makers and administrators in Treasury and the Tax Office who deserve great credit for their efforts. The scope and magnitude of the design deficiencies and the associated distortions, inequities, tax avoidance and evasion problems of the Australian postwar income tax system were such that only a massive and multi-dimensional reform could suffice to stem the disintegration of the tax in the non-PAYE area and in the area of investment income and to restore some measure of public confidence in the fairness and structural integrity of the system.

2.1 Reform of the Income Tax Base

In view of the enormous efforts which have been made, it may sound ungenerous to report that *much remains to be done if the income tax system is ever to satisfy adequately the basic tax policy objectives of equity, efficiency and simplicity*. Setting aside the issue of retirement saving which straddles employment compensation and investment income, it can now quite fairly be said that most if not all the major gaps in the area of employment compensation have been closed (Head, 1989). The tax on non-cash fringe benefits works on the whole extremely well and disallowance of entertainment expenses is quite sweeping. The same cannot, however, be said in the crucial area of investment income. The reason for this is partly that the new measures introduced during the 1980s were not always very well designed and structured. The new capital gains tax provides a very bad case in point, where political opposition was such that sensible design requirements for a realisations tax, as set out in the Draft White Paper of 1985, could not be met and had to be compromised (Head,

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1987). The abandonment of the deemed realisation at death in favour of a carry-over of basis allows indefinite deferral which is equivalent to complete exemption. Much more serious are the absurdly generous transitional provisions which confine the tax to gains on assets purchased after September 19, 1985, the announcement date of the new legislation. As a result grandfathering was extended to the complete stock of capital assets existing on that date. Not merely the revenue but more importantly the structural benefits to be expected from the tax are as a result dramatically reduced and administration of the tax is greatly complicated. The lop-sided application of inflation adjustment under the capital gains tax is a further cause for concern, since without any corresponding adjustment for associated monetary liabilities or quarantining provisions geared investments in appreciating assets are strongly encouraged.

The newly integrated company income tax system provides another interesting example where what appears on the face of it to be a pioneering, indeed historic, application of a long cherished tax design ideal seems to have gone seriously awry. One basic structural problem with the new system when it was first introduced in 1987-88, with full Carter-style alignment of the top personal and company tax rates, was the large amount of exempt and preferentially taxed income in the base. Since the imputation credit was to be confined to income on which the full amount of company tax had been paid, there was a strong incentive to retain unfranked income and neutrality in relation to pay-out policy was not achieved. Moreover, since the imputation credit was confined to residents, accounting for about one-third of equity share ownership, since the company tax rate had in fact been raised from 46% to 49%, and the s.46 rebate applied to unfranked dividends, there was little reason to expect that the notorious distortion under the classical system in favour of debt and against equity would be reduced (Dixon and Vann, 1987). The problems posed by exempt and preference income have since been reduced as a result of the abolition of 5/3 depreciation and the extension of the imputation credit to the superfunds in the May 1988 Statement. These changes were made, however, in the context of a drop in the company tax rate from 49% to 39% which restores the incentive to retain rather than distribute profit for top bracketed shareholders and revives serious problems of surplus-stripping and tax avoidance. These problems could be overcome by dropping the personal tax rate to 39%, but without further base broadening the justification for such a concession at upper-income levels in the context of recent wage and salary trends seems very weak, indeed non-existent. The new imputation/integration system, based on rate alignment, is clearly very restrictive in the face of domestic and international developments which may require rate divergence. The

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reform effort in this area thus clearly exhibits serious design deficiencies and also considerable myopia in the face of downward trends in company tax rates in the international setting.

Both of the examples analysed above, and others we could have considered, also serve to illustrate a further fundamental problem with the capital income tax reform measures of the 1980s - that they simply do not go far enough. Over the past fifty years it has been generally agreed among public finance specialists that here is one and only one basic income concept which simultaneously satisfies the essential requirements, at the conceptual level, of internal consistency and, at the practical level, of objectivity and measurability. This is the Haig-Simons concept of comprehensive income or "net accretions" defined as consumption plus additions to net wealth. Under this approach all types of economic gain would be taxed alike, regardless of source, form or use. Interest, dividends, capital gains, pension rights, imputed rent, in-kind benefits, gambling winnings, etc., would all be fully taxed on the same basis as wages and salaries, ideally on accrual. Feasibility problems arise, of course, and must be squarely faced. The most important practical contribution of the Haig-Simons analysis has, however, been to demonstrate that neither equity nor efficiency objectives can be achieved under income taxation unless all the various types and forms of economic gain are taxed substantially on a uniform and consistent basis. And this is especially true in the sensitive area of capital or investment income.

Even after the very significant income tax reform measures undertaken during the 1980s, the Australian income tax system still reflects the conflicting priorities and points of view of all the major sectional interest groups. The high priority assigned to vertical equity, notably by the labour movement, is reflected in the nominally progressive rate structure; while the opposite view is still very strongly represented by gaps in the investment income tax base, in continuing large-scale abuse of related deduction provisions and in a poorly designed tax unit system, all of which serve to reduce effective tax rates for many high-income taxpayers. The income tax base also includes much saving and investment income, but the tax-favoured treatment of retirement saving, the exemption of imputed rent and the indexed realisations tax on capital gains collectively embody significant elements of a consumption or wages tax approach. The result of all these inconsistent provisions and internal contradictions is to frustrate the achievement of even the most moderate and widely-shared tax policy objectives of equity and efficiency.

Even if we abstract from the more specific design deficiencies which we have already discussed, the important structural reforms in the area of capital gains and company tax integration serve to illustrate very nicely the utter

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futility of a piecemeal approach to capital income tax reform. Particular measures, which may be extremely beneficial as part of a comprehensive and consistent blueprint, may be totally ineffectual or even counterproductive if implemented in isolation. Who would have thought, from a reading of the standard tax policy literature, that the introduction of a reasonably well co-ordinated system of capital gains taxation and company tax integration could leave basic tax distortions and avoidance problems associated with excessive gearing and corporate retentions largely uncorrected or even increased?!

Admittedly, the achievement of a fully comprehensive income tax base is a very tall order, especially in the area of investment income. Full taxation of accrued capital gains, accrued pension rights, imputed rent and accrued foreign source income, along with full company tax integration with or without rate alignment - may well be completely out of the question at least for the foreseeable future. The crucial issue, however, is whether a *sufficiently close approximation* is possible. Administrative and political acceptability problems loom large, and the answer may well vary from country to country. As a purely technical administrative matter, however, there is by now little question that an adequate approximation can be achieved in all the major areas required. Schemes which would satisfactorily approximate full accrual taxation of capital gains (Helliwell, 1969) and pension rights have long been familiar to economists and are clearly administratively feasible; and the same is true for company tax integration, inflation adjustment and even for imputed rent. The major difficulties are undoubtedly political, and they are much exacerbated by transitional difficulties and packaging problems, as illustrated by the recent Australian experience with capital gains, company tax integration and accelerated depreciation. International aspects also impose significant and often very challenging constraints. With imaginative packaging and sensible transitional provisions it should, however, be possible to go well beyond recent Australian achievements in this general area.

The possibilities for comprehensive income tax reform on the grand scale are nicely illustrated in official studies overseas, beginning with the monumental Carter report (1966) and followed in more recent years by landmark proposals from the US Treasury (1977) (1984) and the Irish Commission on Taxation (1982). An obvious advantage of the more comprehensive approach is the additional revenue available for the scaling down and fundamental restructuring of income tax scales. The Australian reforms of 1985, far-reaching as they might appear to be, were sufficient to finance only a minor, and in basic design terms essentially cosmetic, restructuring of our very unsatisfactory personal tax rate scale.

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If however, more comprehensive inclusion of untaxed or undertaxed investment income components must be ruled out, it is a fundamental principle of income tax design that any associated deductions must be very strictly controlled. The problems of interest deductability and tax arbitrage which have bedevilled the income tax systems of industrialised western countries throughout the postwar period provide an obvious illustration of the difficulties (Steuerle, 1985). Concessional treatment of particular forms of income or particular activities provides a powerful incentive for geared investment in tax-preferred areas. Unless interest deductions are quarantined and limited to the taxable income generated from investments of the same general class, the tax base can easily be dramatically eroded. The Australian tax reform effort in this regard has been grossly inadequate. A very modest scheme to quarantine the interest deduction in the case of rental property investments was introduced in 1985 but was abandoned, in my view mistakenly, in 1987. A much more full-blooded illustration of quarantining provisions applied to interest deductions is, however, contained in the US Tax Reform Act of 1986 (McIntyre, in Head and Krever, 1990). The US quarantining approach is admittedly not without problems and it involves the application of extremely complex tracing rules. The effects in Australia of an open-slather policy on the interest deduction in the context of our inconsistent and loophole-ridden investment income tax base are, however, extremely serious and require urgent attention.

Australia's problems in this area are certainly much exacerbated by our continuing high inflation rate. Existing tax incentives for geared investments would be much reduced if the system of inflation-adjustment which is currently confined to capital gains taxation could be applied uniformly and consistently to all business and investment income and associate expense. Such a system was recommended for the United States in the US Treasury proposals of 1984 and was recommended for further study in the Draft White Paper of 1985. A detailed practical proposal for inflation adjustment in Australia is contained in a forthcoming study by Vann and Dixon (1990) and the issue clearly merits further attention. A satisfactory system of adjustment for interest payments and receipts will require, of course, careful attention to transitional problems which must bulk large after years of grossly excessive tax-distorted borrowing. Since a considerable net cost to revenue may be inevitable, comprehensive indexation should clearly be packaged with some significant base-broadening measures, such as a move to consistent accrual taxation of interest income and/or accrual taxation of capital gains. In the light of recent discussions and analysis it now seems clear that all the major administrative problems of comprehensive inflation adjustment can be handled satisfactorily, though detailed packag-

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ing and transitional matters remain open for political compromise. In the international setting there remains some question as to whether Australia could "go it alone". If, however, comprehensive inflation adjustment must be ruled out, consideration should instead be given to the full taxation of all realised gains *without inflation adjustment* as under the US Tax Reform Act of 1986.

Further attention also needs to be given to the retirement saving concessions which, even after the recent reforms in the May 1988 Statement, remain poorly targeted and expensive (Dixon, in Head, 1989).

2.2 Reform of the Personal Tax Rate Scale

Reform of the income tax base in accordance with the comprehensive income principle, whatever its potential - and I believe very substantial - merits from the point of view of standard equity and efficiency criteria, is certainly *not simple*. If it were not for the desire to implement a progressivity principle under the vertical equity objective, the complexities of income taxation could in fact be much reduced, though not by any means completely eliminated. Throughout most of the seventy-five year modern history of income taxation in industrialised western countries there can be little question that the principle of progressivity has enjoyed strong and widespread community support. Only this strong measure of popular support could possibly explain the prodigious amount of intellectual and administrative effort and ingenuity which have been devoted to creating and sustaining a viable system of progressive personal income taxation. Like everything else, however, views on progressivity and vertical equity are subject to change; and the recent upsurge of interest in proposals for a flat or at least much flattened personal tax rate structure, both in Australia and overseas, raises obvious questions regarding the present shape of the progressive rate scale.

Top rates of income tax have been substantially reduced in a number of major overseas countries during the 1980s. As we have already noted, quite dramatic reductions have been achieved in the context of vertically neutral income tax reform on the comprehensive income principle in the United States, which now has a rather peculiar hump-backed rate scale with marginal rates of 15%, 25%, 33% and 28% (McLure, in Head, 1989). After flirting with the possibility of a flat rate tax of 24% in 1988, New Zealand has moved from 1988-89 to a two-rate structure with marginal rates of 24% and 33%, achieved very largely through tax mix change but with some associated broadening of the income tax base (Stephens, in Head and Krever, 1990). The UK moved in 1988-89 to a two-rate structure with rates of 25% and 40%, though in the context of a vertically regressive redistribution. The

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interesting recent Swedish tax reform of 1990 features very substantial across-the-board rate reductions achieved in the context of a vertically neutral reform with a top rate of 50% and involving a substantial increase in the weight of tax on investment income achieved through the imposition of a flat 30% tax on interest income with full source withholding.

Even after the reforms of the 1980s, the personal tax rate scale in Australia clearly remains a highly unsatisfactory and arguably unstable compromise between progressive and flat tax features with the top marginal rate of 47% cutting in at an income level little above average weekly earnings and a rate of 39% cutting in as low as two-thirds of AWE. In the tax reform package of 1985, significant reductions were confined to the higher marginal rate brackets, though vertical neutrality was at the same time preserved, at least to some degree, by the base broadening measures in such areas as capital gains and non-cash fringe benefits, in accordance with standard tax reform strategies in the comprehensive income tax tradition. Negotiations with the ACTU in the wage-tax context have since resulted in useful reductions in the bottom rate and a small further increase in the tax threshold. On the whole, however, it would have to be said that the recent changes have been essentially cosmetic in basic design terms. The postwar trend towards flat or modified flat rate taxation due to the interaction of inflation and real income growth with an unindexed rate scale has continued and indeed been reinforced by the legislated reduction in the top marginal rate in the 1985 package.

Pressure for further rate reductions and/or rate flattening in Australia remains strong, and approaches other than conventional income tax base broadening have been proposed. Threshold-taxing schemes have been particularly prominent and have become something of an Australian speciality. Two such schemes surfaced at the time of the National Taxation Summit, the first a vertically regressive proposal produced by the Monash Centre of Policy Studies (Porter et al., 1985) under which a three-rate structure with marginal rates of 20%, 30% and 40% would have replaced the 1985 rate structure without the need for any conventional base broadening. The second, by Dixon, Foster and Gallagher (1985), would have increased effective progressivity with lowered rates of 30%, 40% and 50%. Both schemes would compensate low-income households through a system of refundable tax credits. A major objective of the threshold taxing approach, highlighted in the COPS studies, is to enhance incentives to work; but although marginal rates are substantially reduced for upper-bracketed taxpayers, the compensation scheme for low-income households involves much higher effective marginal rates over a phase-out range at lower-middle-income levels which could be expected to produce offsetting work

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disincentive effects on secondary earners with high labour supply elasticities (Apps, in Head and Krever, 1990). Some relatively limited base-broadening would be achieved indirectly under threshold taxing, since the threshold would be withdrawn from income-splitters, part-time and secondary earners; but the impression that substantial across-the board reductions in effective tax rates can be financed from threshold taxing is simply an illusion.

At the political level the adoption by the Liberal Party of a modified flat rate income tax proposal with an apparent threshold-taxing feature at the time of the 1987 election was a development of particular significance, and a similar two-rate structure with a top rate of 39%, aligned with the current company tax rate of 39%, remained a medium-term policy objective of the federal opposition parties in the fun-up to the federal election of 1990. An important feature of the threshold-taxing and rate-flattening schemes which surfaced at the time of the 1987 election were the associated proposals for substantial reductions in government spending. Schemes for personal tax rate flattening have thus become increasingly intertwined with schemes for spending cuts. Three alternative rate-flattening and revenue-reduction proposals were published by COPS in 1987 as part of the National Priorities Project sponsored by the major business groups (Freebairn, Porter and Walsh, 1987). Under each option a revenue shortfall of $5 billion is assumed. Option T is a threshold-taxing proposal in the spirit of the original COPS proposal at the National Taxation Summit in 1985. The second alternative, Option U, applies a rate scale modelled on the current US rate scale introduced under the Tax Reform Act of 1986, but without the fundamental base-broadening measures and vertical neutrality features which characterise the US package. The third alternative, Option V, involves tax mix change. Each option offers a complex package involving associated changes in the welfare system and related tax allowances and rebates to compensate low-income households.

Whatever the merits of these and other proposals for income tax rate flattening in Australia, it is important to observe that they are generally *far from simple*, and the same is true of overseas developments, including the radical Roger Douglas scheme for a flat rate income tax in New Zealand (Stephens, in Head and Krever, 1990). The complexity results fundamentally from the need to compensate low-income households with differing socio-demographic characteristics. Instead of a simple two-rate or single-rate system, households with differing incomes and socio-demographic characteristics face a complex tangle of divergent marginal tax rates as high or higher in the low and middle-income ranges as under the alternative scale to be replaced. If full vertical neutrality is desired, further complications

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arise from the more conventional income tax base broadening measures required. In the present state of knowledge and the economic modelling available, the possible effects of such a package on incentives to work are largely unknown. Although much has been claimed, serious doubts arise over possible disincentive effects on secondary earners. Particularly in schemes involving expenditure reductions, there has been a tendency to ignore the effects of the associated spending cuts. Most of the supporting studies available are accordingly quite inconclusive and exhibit serious, indeed crippling, methodological and data limitations.

This rather sceptical assessment of some of the recent rate-flattening proposals and developments should not, however, be construed as providing much comfort or support for the existing rate structure. With a rate of 30% now cutting in at about two-thirds of AWE, it is certainly disturbing to note, for example, John Freebairn's estimate that a linear tax rate of about 31.5% would have been sufficient to replace the rate structure for 1987-88 (Freebairn, in Head and Krever, 1990). Clearly the design and reform of the rate scale deserves more careful and explicit public consideration than it has received over recent decades when its shape has been left to be determined, and seriously distorted, by the effects of tax drift and fiscal drag.

3. Sales Tax Reform and Tax Mix Change

With the defeat of Approach C at the Tax Summit, all hope of fundamental reform of the wholesale sales tax - and any chance of achieving tax mix change from income tax to sales tax - in the 1980s was entirely lost. Reform in the sales tax area was largely confined to reclassification and rationalisation within the existing narrow-based framework, though some modest base-broadening was also achieved, as reflected in the small but nevertheless significant rise in the weight of sales tax as a percentage of GDP over recent years.

3.1 Sales Tax Reform

The case for reform of the narrow-based wholesale tax has been almost universally acknowledged by economists. Criticism has rightly focussed on the distorting effects and the discrimination or horizontal inequity which must result from the large exemptions and differentiated rates. Although the exemptions and rate differentiation had some apparent rationale when they were first introduced, as a method of ameliorating the inherently regressive tendencies of indirect consumption taxes, it has long been recognized that the costs in terms of resource misallocation and horizontal equity are very substantial in relations to any modest reduction in

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regressivity which may result. Rate differentiation based on commodity classes is simply a very inefficient way to relieve regessivity across income groups. Apart from special situations involving strong externality or benefit tax considerations (as in the case of the excise taxes on liquor, tobacco and petrol), we do best in the sales tax area to follow the standard public finance design criteria of comprehensiveness and uniformity of application across different classes of consumption goods.

A broadly based indirect consumption tax has a potentially very important role in the overall mix of taxes as a relatively simple, neutral and horizontally equitable method of raising large amounts of revenue which would otherwise add to existing pressures on the more fragile structure of the income tax system. In its ideal form the tax represents simply a proportionate levy on personal consumption; but the resulting burdens on low-income households can be relieved quite effectively by direct compensation through adjustments in welfare payments or by a system of sales tax credits. In itself, of course, the broadly-based indirect consumption tax makes no contribution to progressivity. This is not, however, its proper function and is much more effectively pursued through a personal direct tax system designed on the comprehensive income principle. As in the case of the income tax, the Australian sales tax system reflects instead the conflicting principles both of income base and consumption base, with as much as half the revenue derived not from consumption but from the taxation of industrial inputs; and the tortured attempt to introduce elements of progressivity through exemptions and rate differentiation has drastically reduced revenue potential whilst at the same time grossly violating equity and efficiency requirements.

During the 1980s the reform alternatives of retail sales tax and value-added tax were much debated; and some attention was also given to possibilities for achieving a broader and more uniform system under the existing wholesale tax. It is by now, however, generally accepted that relatively little can be achieved within the present wholesale sales tax framework. Effective rates of tax could never be uniform across commodity classes, and very awkward problems would be created by the need for a separate retail tax on services. The serious options are therefore the retail sales tax and the value-added tax. During the 1980s there was considerable support for the retail tax, following the unsuccessful reform initiatives of the Fraser Government in 1979 and 1981. In the Draft White Paper a broadly based retail sales tax at a rate of 12.5% was accordingly proposed to replace the existing wholesale tax and to serve as the vehicle for a major change in the tax mix. The comparison of the retail tax with value-added tax in the Draft White Paper, although interesting in some respects, is heavily loaded

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against the VAT, with the decisive consideration being the somewhat shorter period required for implementation of the retail tax in the context of a very tight election schedule. In the public finance literature the retail tax has had some very distinguished advocates, most notably John Due; but the balance of argument over the past 20 years has swung very heavily in favour of the VAT (Cnossen, in Head, 1989). Major advantages of the VAT include: the measure of self-enforcement and the clear audit trail under the standard quarterly invoice method; the more accurate and complete exemption possible in the case of investment goods and industrial consumables; the more accurate and complete exemption of exports and inclusion of imports; and the much broader coverage of services which can be achieved. By comparison, a broadly based retail tax has some very awkward features, as can easily be seen from the provisions for input taxing and the large category of so-called restricted goods which would be taxable regardless of end use under the Draft White Paper proposals. Due to its greater neutrality, broader coverage and greater administrative robustness, the revenue potential of the VAT is substantially greater than for RST, with rates of 20% or more posing no particular problem under VAT as compared with an upper limit of perhaps 15% for RST.

In more recent Australian discussions and proposals the balance of opinion has now clearly shifted decisively in favour of VAT. Examples are the various COPS proposals for VAT (Cishold, Freebairn and Porter, 1990) which have been endorsed by such bodies as the Business Council and the Victorian Employers Federation, and the recent proposal of the National Farmers Federation. It is, however, highly significant that all the major proposals for sales tax reform go well beyond the revenue-neutral replacement of the wholesale tax. Although a broadly based VAT would significantly reduce distortions and inequities as compared with the existing wholesale tax, packaging and implementation problems arise. Low-income households must be compensated as the tax base is broadened to include previously exempt items, notably food. And whilst the administrative costs of the VAT are quite low under an established or ongoing VAT system, the costs and upheaval involved in the *introduction* of the new tax with a much broadened coverage are far from negligible. There will also be significant and predictable gainers an and losers among industry groups. The formidable political opposition to the proposal for revenue-neutral replacement of the manufacturers sales tax by VAT in Canada over the past year should serve as a timely warning of the potential difficulties which should clearly not be underestimated in the current Australian setting. In the revenue-neutral context, the implementation costs, the compensation and transitional problems and the resulting need for political compromise and concessions

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in the design features of the new system must accordingly loom very large. And all this disruption and controversy for economic benefits on the efficiency side which are most unlikely to exceed, say, one-half of one percent of GDP.

3.2 Tax Mix Change

It is not therefore too surprising that recent Australian proposals for sales tax reform have been packaged with additional goodies calculated to enhance their political appeal. Somewhat in the spirit of the Keating Option C, the VAT proposals of COPS and the business groups are linked with income tax cuts and advocated as a cure, if not for AIDS, then at least for low national savings and as a spur to work incentives. As Mr Keating observed in his Press Club address on May 8, however, the terms of the trade-off between sales tax reform and tax mix change have worsened very significantly since the phoenix first flew at the Tax Summit in 1985. At that time a 12.5% retail sales tax would have been sufficient, with a little help from associated income tax reform, to finance income tax rate reductions of almost 30% across-the-board. And this after providing for repeal of the wholesale sales tax and a $2 billion compensation package for low-income households. As a result of recent increases in the weight of WST, it would now require a retail or VAT rate of 7-7.5% instead of only 5%, to replace the wholesale tax. Even with the most optimistic assumptions regarding the coverage of the new VAT, and suitably discounting some of Mr Keating's more extreme claims and arguments in his Press Club address, it would now take a VAT rate of 15% to finance income tax cuts of a modest 10%.

It is, moreover, a basic observation that, in a vertically neutral framework, tax mix changes is a *very ineffective method of reducing top marginal tax rates*. The largest proportionate reductions in marginal income tax rates would be confined to the bottom of the income scale (Kesselman, in Head, 1986). If significant work incentive effects are only to be derived from a flattening of the income tax rate scale, as New Right doctrines would have us believe, then tax mix change is clearly not the way ahead. In a vertically neutral context, much more could clearly be achieved, from this perspective, by a further broadening of the income tax base in the area of investment income. If, however, we are willing to countenance a vertically highly regressive package, tax mix change would, of course, quite comfortably finance a reduction in the top personal tax rate to 30%, though such a package would seriously divide the community.

The attempt to hitch tax mix change and income tax rate flattening to the rising star of concern over low national savings levels also fails entirely. In view of the very small tax mix changed involved and continuing deficiencies

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in our knowledge and economic modelling of tax effects on saving, the confident assertions of some business economists and New Right groups have little credibility, and must be interpreted as simple optimism or as a flimsy rationalisation for regressive zero-sum games. For every optimistic finding of a significant savings response to changes in the net of tax return, there is in the literature an equally convincing demonstration of a low or zero response (Howrey and Hymans, 1980). More generally it must be conceded that empirical work in this area has simply not reached the stage, even in the United States, where it could possibly serve as a usable foundation for tax policy (Ballard, 1990). Unfortunately there is, as a result correspondingly more room for ideology, snake oil and gaming in the public debate on these matters.

Even if we take a much more cautious and less swashbuckling view of the likely factor supply response, and even if we insist on approximate vertical neutrality, it nevertheless still seems to me that a respectable and responsible case can be made for sales tax reform and tax mix change in the somewhat broader framework of an updated Option C containing a significant further measure of income tax reform on the comprehensive income principle. Given my original diagnosis of the cause of our existing tax design deficiencies in fundamental divisions between major interest groups over the choice between income and consumption base and flat versus progressive rate structures, agreement should be possible, with imaginative packaging, to clean up the investment income tax base in the context of a drop in the top marginal tax rate to 39% and across-the-board reductions and restructuring of lower bracket rates and cut-in points, accompanied by the introduction of a new VAT and further sweetened by a tax-mix switch along the lines, say, of the COPS proposal for the Victorian Employers Federation (Chisholm, Freebairn and Porter, 1990). By pursuing tax reform simultaneously in the income and sales tax area and by trading-off across the mix, it may be possible to improve the reform prospects in both areas. I leave it to the number crunchers to come up with an appropriately sexy offering.

But what are the prospects for such a package in the present Australian context? Clearly the recent experience with Option C in 1985 is far from encouraging. Having rejected the sales tax reform and associated tax mix change rather than accept a modest income tax reform, we now see business and New Right groups returning to the support of the original Option C component which could have been expected to attract them. Are they now sufficiently far sighted and responsible to consider packaging sales tax reform and tax mix change with much needed further reform in the income tax area? And what about the Federal Opposition parties? Both business groups and the Opposition parties have shown discouraging signs of wanting

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to roll back even the modest income tax reforms which have so far been achieved in the area of fringe benefits and of capital gains. Meaningful and durable reform of the income tax and the sales tax clearly requires a more responsible attitude and a much greater willingness to co-operate and compromise in major institutional reform.

On the labour side the prospects are scarcely more encouraging. The unions are still profoundly suspicious of broadly-based indirect consumption taxes. And to complete the picture we have the unedifying spectacle of the Federal Treasurer, only yesterday the great champion of the heroic Option C package, now totally disenchanted as a result of the Tax Summit experience, and as ready as the Federal Opposition to play politics with the tax system by opposing basic reform in the sales tax area. Consensus and co-operation in the achievement of major institutional reform is nevertheless clearly an idea whose time has come. Having been tried and failed in the tax area in the mid-80s, it is, however, far from clear whether our major players could rise like Mr Keating's proverbial phoenix to a similar occasion to be arranged for the mid-90s. The potential agreement and the necessary components are, I think, still there; and the need is hardly less pressing. Whether the vision is there, and whether the necessary hard bargaining can be done in advance to get it all together again, clearly remains to be seen.

4. The Expenditure Tax Alternative

In view of the very obvious deficiencies of existing personal and associated company income tax systems and the difficult problems involved in achieving a sufficiently close approximation to the comprehensive income tax ideal, increasing attention has in recent years been paid to the alternative of a personal direct consumption tax. At the conceptual level, as an instrument for the pursuit of equity and efficiency objectives, the personal expenditure tax has significant attractions which have increasingly been recognised. In standard life-cycle models of saving for future consumption, it is well known that comprehensive income taxation discriminates against saving and is therefore horizontally inequitable and non-neutral; whereas the burden of the consumption tax is independent of the pattern of lifetime consumption and the tax is completely neutral with respect to consumption-saving choice. By substituting the personal direct consumption tax for the personal income tax it should therefore be possible to pursue the economic growth objective without sacrificing vertical equity since a progressive rate scale can be applied.

It has, however, been much less clear whether, at the practical level, the expenditure tax represents a feasible alternative. Fisher's major contribution in the 1930s was to show that the progressive spendings tax is in fact

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quite feasible and indeed offers the possibility of considerable administrative simplification. His work in this regard has since been taken up and further clarified and extended in subsequent contributions by Kaldor (1955), Andrews (1974), the US Treasury (1977), the Meade Committee (1978), Aaron and Galper (1985) and others. The starting point for these more recent discussions is the original Fisher insight that personal or family consumption can be determined indirectly on the basis of a pure cash flow calculation by taking the individual's total receipts from all sources whether on current or capital account, and subtracting all non-consumption outgoings. In addition to familiar income sources such as wages, interest, dividends, profits, etc., total receipts would include bequests and gifts, sales of capital assets (such as shares or real property), borrowings and repayments received on account of past loans; while non-consumption outgoings would include such items as purchases of capital assets, amounts lent, repayments of past borrowings, and any net increase in money balances. Since the whole calculation is based on a realisation or cash flow principle, difficult problems of determining accruals in such areas as capital gains, pension rights and depreciation, which greatly complicate the comprehensive income tax, do not arise.

The most significant additional administrative complication under the Fisher method, as compared with the comprehensive income tax, is the need to keep track of all sales and purchases of capital assets. More recent analysis by Andrews (1974), the Meade Committee (1978) and the U.S. Treasury (1977) suggests, however, that there is much to be gained and little to be lost if the inclusion or exclusion of sales and purchases of certain classes of assets is left to the discretion of the individual taxpayer. A similar treatment has been recommended for borrowing and lending. In this way difficult imputations in the case of consumer durables, including owner-occupied housing, can be entirely avoided, and averaging problems can also be much reduced. In the case of these "unregistered" asset purchases, tax would be paid in effect on the original purchase, the so-called "prepayment approach". Another difficult problem under the comprehensive income tax becomes thereby much easier to handle under the consumption tax.

Under high rates of inflation the personal consumption tax offers the further extremely important advantage that indexation of the tax base is completely unnecessary. The complications and likely practical imperfections of inflation adjustment for capital income under the income tax alternative do not therefore arise. Whereas, under the comprehensive income tax, problems of unequal treatment of different types of income from capital must be solved by taxing such incomes fully and equally, under the consumption base income from capital is in effect *exempt from tax* whatever its form or source, except in so far as it is spent for consumption purposes.

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The attractions of the personal expenditure tax, in terms of equity, efficiency and simplicity are accordingly very considerable, even in comparison to the comprehensive income tax ideal. The comparison with the present Australian income tax is, of course, even more favourable to the expenditure tax alternative. Once again, however, these advantages are clear only for an *already established system.* Transitional difficulties and packaging problems arise and must be squarely faced. In relation to transitional problems, the point has nevertheless rightly been emphasized, by Andrews and others, that existing income tax systems are mostly far from pure and can fairly be characterised as some sort of hybrid of income and consumption elements - as we have already stressed in the case of Australia. It can therefore be argued that it would in fact be much easier, from where we now are, to move to a consistent application of the consumption tax principle under expenditure tax than to tax all income on accrual as required under the comprehensive income tax. The present tax regime in the case of imputed rent and retirement saving already approximates consumption tax treatment, and difficult problems in other areas, such as capital gains and depreciation provisions, would either be removed or greatly simplified under a consumption tax. The transitional difficulties remaining in the case of the expenditure tax are nevertheless quite formidable. They include the need to provide relief for expenditures by those retirees who have not saved through concession channels, and problems of revenue loss and severe capital market disturbances which could result unless all existing assets are treated as registered at the start of the new system. Solutions have been proposed for these and related difficulties in the overseas studies, but they must greatly increase the problems of achieving political acceptance.

In the packaging area fundamental difficulties arise out of our earlier observation that the income base, like the consumption base, still enjoys strong community support. The same schizophrenic attitude is indeed to be observed among leading advocates of expenditure tax. It is argued by the Meade Committee, for example, that a supplementary wealth tax would be required to compensate for the "extra benefits" from saving in the form of power, prestige, security and opportunity. Fisher, Kaldor and Meade would also insist on the need for an appropriately structured system of wealth transfer taxes in order to control excessive wealth concentrations. The proposals, by Kay and King (1978) in the UK and Aaron and Galper (1984) in the U.S., for a gifts-inclusive definition of personal consumption would similarly involve the intrusion of extraneous elements of an income principle in the form of a double tax on overlife savings. With very few exceptions, therefore, leading proponents of the expenditure tax would insist upon retaining a significant measure of wealth or wealth transfer taxation pre-

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cisely analogous to the problematic dimension of capital income taxation to which they take such exception under the accretion principle.

At the policy level in Australia there can be little question that a move to expenditure tax would result in strong pressure for some compensating tax on wealth or wealth transfers. Achieving some appropriate mix of consumption tax and wealth tax emerges therefore as a major policy trade-off issue in the expenditure tax scenario. This is even more obviously the case under the so-called prepayment, yield exemption or wages tax variation on the basic expenditure tax principle. As a result, however, the potential advantages of the expenditure tax strategy in terms of tax simplification would be greatly reduced; and current political disputation over aspects of capital income taxation would almost certainly be replaced by comparable or even greater difficulties and divisions in the politically very sensitive area of wealth taxation. This is Hobson's choice indeed; but my own view is that reform of the income tax on the comprehensive income principle, in combination with appropriate adjustment in the weight of indirect consumption tax, remains on balance the more promising alternative for Australia. In this regard the unfamiliarity and lack of discussion of the expenditure tax in the context of the recent Australian tax reform debate must weigh very heavily against the expenditure tax approach.

Since much has been made of the intertemporal neutrality benefits of the expenditure tax and the likely beneficial effects on saving, it is important to emphasize once again the gaps in our knowledge and deficiencies in the economic modelling of these tax effects. As compared with tax mix change of the modest magnitudes currently under discussion, the expenditure tax proposal would, of course, involve a much greater reduction in the tax on saving. Whatever effect there might be on saving under tax mix change, the effect under expenditure tax would be some appropriate multiple of this. Whether the savings effect would be significant still depends, however, on the elasticity of supply of savings; and as we have already noted, even for the United States, the jury is still out. Recent dynamic simulation studies, notably by Summers (1981) and Auerback and Kotlikoff (1987) have highlighted possible differences in the savings and growth effects of the true cash flow consumption form of expenditure tax and the wages or prepayment tax alternative, though these effects turn essentially on transitional differences and associated intergenerational redistributive effects. As Ballard (1990), for example, has recently emphasized, economic modelling of tax effects on saving still has a long way to go before it could provide a basis for rational policy choice between the various alternatives of income tax and expenditure, wages or indirect consumption taxes.

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As in so many other matters the international dimension is also extremely important in any move to expenditure tax. For a country like Australia significant benefits are derived under income taxation from the associated company income tax on foreign investment. Revenue of perhaps $5 billion or more could as a result be sacrificed in a move to personal expenditure tax. Alternative forms of cash flow business or company tax have been expressed, for example by the Meade Committee, which could complement the personal expenditure tax and serve as a method of taxing foreign investment. Major candidates would include the Brown tax or what the Meade Committee (1978, ch.12) call the "R base", confined to real transactions, and the "R+F base" which extends the coverage to financial transactions. These cash flow business taxes offer similar advantages in terms of neutrality and simplicity to their personal tax counterparts, though transitional problems remain. In the international dimension, however, serious problems arise as tax is confined to rents, and the normal return to capital is in effect exempt. The revenue from foreign investment may therefore be much reduced. Even more serious, perhaps, is the further point that there is no guarantee that any tax payable by Australian subsidiaries of foreign resident companies would be creditable against domestic tax liability in those very important overseas jurisdictions with foreign tax credit systems. This is another obvious case, therefore, in which it may be very costly of difficult for Australia to "go it alone" in a major departure from prevailing international tax practice.

Because of its almost total unfamiliarity the expenditure tax alternative in Australia remains, in any case, only a politically rather remote possibility for major tax reform. If a few important overseas countries were to adopt expenditure tax systems, the whole situation could soon change. To date, however, no country has been willing to take the plunge, though the issue has certainly been the subject of increasing interest and debate. There is accordingly still plenty of time to get debate started on this issue in Australia, and some small beginnings have already been made. My own guess is that a move to expenditure tax by any major country in Europe or North America is highly unlikely for some time to come.

5. Conclusion

How then should we answer the question posed in the title of this paper?

(a) High priority should, I believe, be given to pushing on with the unfinished agenda in the income tax area. Design deficiencies in some of the major structural reforms of the 1980s must be attended to; and a much closer approach to comprehensive and consistent taxation of investment income should also be attempted.

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(i) In the case of the company tax imputation system it may be possible in the context of further income tax base broadening and/or tax mix change to design a vertically neutral package under which the top personal rate could be realigned with the company tax rate at or about the 39% level. Failing this, however, anti-avoidance measures must immediately be reintroduced to control the worst abuses resulting from the present non-aligned rates. Measures which have long been applied in Canada might serve as a suitable model.

(ii) In the case of the capital gains tax a deemed realisation should be considered to end the complexity of the grandfathering arrangements and to bring the capital gains tax into fully effective operation. If general inflation adjustment is not to be introduced, the present lop-sided application in the capital gains area should be terminated.

(iii) Serious attention should, however, be given to the possibility of extending inflation adjustment consistently to all business and investment income. The current incentives for excessive gearing would as a result be greatly reduced along with a variety of other tax distortions and inequities of inflationary origin. Such as system should be packaged with further base-broadening, including a move to consistent accrual taxation of interest, and a move to accrual taxation of capital gains should also be seriously considered. Such measures are highly desirable in their own right and they would also help to offset the cost of inflation adjustment and greatly assist in the design of a consistent and effective indexation system.

(iv) As long as capital gains remain taxable only on realisation and enjoy the benefits of the present lop-sided indexation concession, quarantining provisions should be urgently reconsidered to control continuing large-scale abuse and erosion of the base through the present unrestricted nominal interest deduction. Indeed the case for restricting the interest deduction would still be quite strong under a system of full inflation adjustment so long as the Australian income tax base falls so far short of the comprehensive tax ideal. The 1986 U.S. reforms comprehensively quarantining the deduction of interest expense could serve as a model in any such review.

(v) The present system of tax concessions for retirement saving remains highly unsatisfactory in spite of recent reforms.

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Even if the total abolition of such concessions under an accrual tax system New-Zealand style is not feasible agenda in the Australian context, the damaging tax arbitrage effects under the existing concession treatment of superfund income and the very considerable inequities and excessive cost of revenue, strongly suggest the need for more reform and a better targeted and quarantined concession for retirement saving.

(vi) Imputed rent, like retirement saving, clearly enjoys the status of a sacred cow and probably cannot be taxed. The further distortion due to the principal residence exemption under the capital gains tax should, however, be removed. An indexed personal lifetime exemption of (say) $250,000 applying to capital gains of all types, and not restricted to the principal residence, could serve this purpose very well and would not be difficult to administer.

(b) Fundamental reform of the wholesale sales tax should also be vigorously pursued, and its replacement by a broadly based value-added tax with a minimum of exemptions is clearly the right way to go. A revenue-neutral substitution of this type is, however, highly problematic and unlikely to be politically successful. The same is probably true of a broadened approach which would involve the replacement of other indirect commodity taxes at the state and/or the federal level; though such a reform, properly designed, could have very favourable effects in reducing discrimination and inefficiency. More promising politically, however, is a strategy which combines sales tax reform, tax mix change and income tax reform; though the terms of trade have certainly turned against any pure tax mix change strategy as a result of recent developments.

(c) The prospects for a fundamental reform of personal direct taxation on the alternative expenditure tax principle clearly lie much further off. Study and debate on this issue should be stepped up somewhat during the 1990s, but should not be allowed to distract from the more immediate priorities in the area of income tax reform, sales tax reform and the tax mix change. If further initiatives in these priority areas during the 1990s should fail - and especially if international developments have in the meantime seen the introduction of a real live system of expenditure tax (which I do not expect) - the time could then be ripe for more serious consideration of this and the associated wealth tax issues in Australia.

(d) Most importantly of all, it must become more widely appreciated by our leading players that meaningful and durable reform of the tax system requires that a basic community consensus be achieved cutting across sectional interest groups and political parties. In this regard tax reform is,

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of course, no different from basic structural and institutional reform in other areas, such as health, education, social security, privatisation or labour market reform. Having been tried, however, at the time of the National Taxation Summit - and having failed so abysmally - there is a clear and present danger of a reversion in the tax area to zero-sum gaming and the politics of short-term sectional self-interest. Both business and the union movement, and both the major political parties, must approach the quasi-constitutitonal issue of tax reform seriously and responsibly if any real and lasting reform is to be achieved either in the 1990s or beyond. As in economic life generally, the existence of divergent preferences, views and attitudes in the tax area is not necessarily an insuperable barrier to reform. On the contrary, opportunities for trade and mutual gain exist through imaginative packaging and a willingness to trade and compromise across divisive issues of income tax reform and sales tax reform - or expenditure tax and wealth tax. The opportunities are still out there, but they must now be grasped. Otherwise we face the certain and unattractive prospect of continuing to wallow in our current inequitable, distorting, and possibly unsustainable income and sales tax systems.

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