Fightback in Perspective: What Difference Would It Make?

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Abstract

This article examines the economic, as opposed to social, effects of the Fightback package and concludes that both beneficial and adverse effects of the tax measures have been exaggerated. The switch from various taxes to a GST will increase efficiency but only slightly and will have a neglible effect on labour supply and savings. Adverse effects on small business and on federal financial relationships will not have a large impact on the economy. The superannuation proposals will probably reduce savings. The most important effect of the package may be to increase unemployment as a result of the emphasis on enterprise bargaining combined with a determination to prevent any rise in the rate of inflation following the introduction of a GST.

1. Introduction

The Opposition's policy manifesto, Fightback, contains many things that will be implemented whoever wins the next election. For example, both Fightback and the Government's response, One Nation, propose cuts in income tax rates, a single aviation market in Australia and New Zealand, a national power grid and so on. However, Fightback also contains proposals

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which are radically different from anything in current Government policy or in the extensions to that policy contained in One Nation. This article aims to assess the effects of implementing the Fightback proposals rather than continuing and modifying present policy in the way set out in One Nation. Not all effects will be considered. The proposals in the alternative manifestos will have different social effects - as symbolised in part by the titles chosen, Fightback as opposed to One Nation. This article will largely ignore these social effects and concentrate on the economic consequences if Fightback is implemented rather than the Government's proposals.

There are four major areas in which Fightback proposals are strikingly different from those in One Nation. These are:

1. the introduction of a goods and services tax, and associated changes in the tax mix and social welfare payments;
2. superannuation arrangements and other tax laws and regulations that affect savings;
3. labour market law and institutions, and
4. privatisation.

The first three of these will be discussed. Privatisation may have significant social effects, but the desired economic consequences can be just as readily be achieved through requiring public enterprises to place an emphasis on efficiency and profit making while remaining in public ownership. Selling public enterprises may, in the year the sale is made, reduce the recorded public sector borrowing requirement, but it does nothing to change the flow of funds coming on to the market to finance investment in physical assets in the private sector.

2 GST and the Tax Mix

Much of the discussion about the introduction of the Goods and Services Tax (GST) focuses on replacing income tax by a GST. For example, perhaps the academic article on Fightback most widely quoted in the media is Murphy 1992, which deals solely with this change in the tax mix. However, as Freebairn sets out in his article in this symposium, of the tax rate of 15 per cent proposed for the GST, only 3 percentage points are to produce revenue to offset income tax cuts. 5.2 percentage points are needed to replace the present wholesale sales tax, 3.7 percentage points to replace the petroleum products excise and 3.2 percentage points to replace the State payroll taxes.[1] Providing revenue to offset income tax cuts is thus the smallest of the four uses to which GST revenue will be put, and abolishing the wholesale sales tax the largest.

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Almost all economists would welcome the replacement of the wholesale sales tax by a GST. Again as Freebairn spells out in detail, the wholesale sales tax is narrowly based, has a rate structure which falls heavily on a few goods - particularly housing, furnishings and appliances and transport equipment - and raises less revenue from taxes on sales of consumption goods than from taxes on business inputs, including those used by exporters. The very variable tax rates on different business inputs distort relative input costs and reduce efficiency. As a result, replacing the wholesale sales tax with a GST would probably increase GDP by about 1 per cent.[2] If the tax mix change was restricted to abolishing the wholesale sales tax and replacing it with a GST, any inflationary impact would be very small. Finally, though this is more contentious, the switch would probably reduce both litigation and tax evasion.

There is a downside. The switch would undoubtedly increase compliance costs for small businesses and put them at some competitive disadvantage compared to large businesses. Sandford (1986) reports on a United Kingdom study which found that smaller firms had compliance costs 30 times as high as those of very large firms; for example in firms with a turnover in the range of £10,000 to £20,000 compliance costs averaged 1.2 per cent of turnover compared with 0.04 per cent for firms with a turnover exceeding £1 million. Sandford concludes that "the issue of the disproportionately high compliance costs of small firms has not yet been satisfactorily resolved" (p.254). Six years later this statement is still true.

The other possible significant drawback in replacing the wholesale sales tax with a GST is adverse equity effects. Freebairn argues that these are small. The wholesale sales tax bears more heavily on housing (including furniture and appliances) and transport than would a GST. This offsets to a large extent the effects of increased food prices that would result from the 5.2 per cent GST rate required to raise the same amount of revenue as the wholesale sales tax. It would, of course, be possible to make the switch beneficial to low income groups by giving food a GST tax rate of zero, though this would increase slightly the compliance costs.

If one ignores the externalities, or effects on others, of using petroleum products, replacing the petroleum products excise by a GST can be justified on economic efficiency grounds. However, these externalities should not be ignored. The effects on global warming figure prominently in the media, but I would emphasis the effects of car and truck exhaust fumes on health. The petroleum products excise may not be the ideal way of reducing these external costs but it is better than nothing.

The Opposition proposal to replace payroll tax by a GST has two, probably unintended and certainly undiscussed, consequences. One is that the competitive position of small businesses vis-a-vis large businesses will be worsened because small businesses are exempt from payroll tax.[3] It may be argued that hitherto this exemption has given small business an unfair advantage, but nevertheless the effect of removing the exemption is clear. Secondly, payroll tax provides the States with nearly 40 per cent of their tax revenue. Abolishing it will cause a major increase in the fiscal imbalance between the Commonwealth and the States and exacerbate the present difficulties in Commonwealth-State financial relationships.[4]

Abolishing the payroll tax will bring two benefits. In an economy in which a high proportion of capital equipment is imported, payroll taxes create a bias against labour intensive, as opposed to capital intensive methods of production. The simplistic argument, that payroll taxes add to labour costs whereas consumption taxes do not, does not hold. In a closed economy, and in a world in which there were no exemptions from either tax for any reason, the economic effects of a payroll tax and a consumption tax would be very similar. But in Australia today replacing the payroll tax with a consumption tax will encourage employment by changing the labour capital ratio, and this effect will be greater in the transition period than it will be in long run equilibrium. Unfortunately, the Australian economy is likely to need such a boost to employment for some years.

The second benefit of abolishing payroll tax is the other side of the coin of the cost of removing the competitive advantage that exemption from payroll tax gives small business. Payroll tax is not a level playing field. In addition to exemptions for small businesses there are, in different States, exemptions for various other purposes. Moreover, there is not a uniform rate even within one State. The usual arguments suggest that economic efficiency would be increased if the payroll tax were abolished (or replaced by a payroll tax with a single rate and no exemptions). However, these efficiency gains are likely to be small, smaller than the modest gains that can be obtained by replacing the wholesale sales tax with a GST.

The final use of revenue from the proposed GST is to allow a cut in income tax rates. Supporters of the switch claim that this will increase the motivation to work and the supply of labour, reduce tax avoidance and evasion, increase the household savings ratio and reduce the distorting effects of income tax rates on investment decisions. On the other hand, opponents of the proposed switch from income tax to consumption tax, claim that it will be inflationary, increase unemployment and have undesirable equity effects pushing the Australian tax system as a whole from its current personal position of rough proportionality to a regressive system. Both sets of claims are often presented in a way which exaggerates the effects. The shift from income to consumption tax is small, since revenue from a 3 per cent GST rate represents only about 10 per cent of current personal income tax revenue.

Even apart from the size of the switch, effects on the supply of labour are likely to be small. While the increase in the supply of labour from second income earners in a household is likely to increase in response to an increase in real take home pay, there is little evidence that such an increase will significantly increase the supply of labour from primary income earners.[5] Moreover, in this case there will be no increase in real take home pay as the extra after tax earnings will be balanced by the higher prices of consumption goods. Any effect on the supply of labour must be due to money illusion.

While at present income tax is the most likely area for tax avoidance and evasion, the black economy, which does not pay income tax, will not pay GST on its production either. In recent years changes in tax law, including such things as the fringe benefits tax and a more effective capital gains tax have greatly reduced legal tax avoidance and more revenue would probably be obtained from continued attention to this type of change than from the switch to a GST.

While the change in the tax mix towards consumption taxes can only have a positive effect on savings, the effects are likely to be extremely small. Most of household savings in Australia is in the form of repaying loans on owner occupied dwellings or superannuation. Both these forms of savings already have favoured tax treatment which will not be affected by the changes in the tax mix. Moreover, in many cases savings in these forms is fixed contractually with the saver having little discretion at the margin about how much to save. Some of the remaining saving is probably a residual. In general, it is hard to see any significant increase in household savings, especially given the small size of the switch from income to consumption taxes.

Finally, it is claimed that the imperfections of the income tax system, such as the exemption from tax of imputed rent from owner occupied houses, and the taxing of nominal interest payments but only real capital gains, distorts investment decisions and reduces economic efficiency. There is no doubt that the interaction of inflation with an income tax system with such characteristics does distort investment decisions and does so the more the greater the rate of inflation. However, for low and moderate inflation the effects are not great. If moderately high rates of inflation had a large effect on efficiency through distorting investment decisions, investigators would have found an inverse correlation in OECD countries between inflation and productivity growth, but such a correlation has not been found.[6] If low rates of inflation continue in Australia, the investment distorting effects of exemptions or inconsistencies in our income tax system will be very small and a minor switch from income taxes to consumption taxes will have a neglible effect in reducing them.

Thirty years ago an article in the *American Economic Review* (Brown 1950) demonstrated that each dollar of revenue raised by a consumption tax depressed aggregate demand and employment more than did a dollar of revenue raised by an income tax. Various simulation studies since have confirmed this theoretical result (see e.g. Nevile 1986). The only question is how big is the effect. It could be so small to be trivial. A widely quoted study, Murphy 1992, found the effect of the switch from income to consumption taxes proposed in Fightback to be very small. It can be argued that Murphy's model is biased towards producing a small effect. It assumes that the economy returns to a long run full employment equilibrium after any shock and the model is constructed so that this happens quite quickly, damping down any employment reducing effect. Nevertheless, even the immediate effects are small. In any case, it is unlikely that a change in the tax mix as small as that proposed in Fightback will have a large effect on unemployment.

An element of Fightback more likely to increase unemployment is the determination to resist any rise in the inflation rate. Despite arguments about the exact figure, there is widespread agreement that the proposed changes in the tax mix will cause an increase in consumer prices of something like 4 to 5 percentage points in the first instance. The only question is whether this can be quarantined or will raise the ongoing rate of inflation. A study of the effect on inflation of the introduction of a GST in a large number of countries was made by Tait (1991). In a forthcoming article Torney (1992) summed up Tait's study with the words:

> It showed that the introduction of a broad consumption tax was only inflationary on a sustained basis in 4 out of 31 countries. Significantly, in each of those 4 countries the introduction of a GST was accompanied by loose wages and monetary policy. Such evidence provides a clear message to policy makers. A GST cannot be introduced as a single measure. Rather, it needs to be part of a policy reform package, which is directed to achieving low inflation.

Fightback is explicit on the need for monetary policy to be tight enough to keep inflation at least as low as it is at present. If the introduction of the GST does have a tendency to increase the ongoing rate of inflation, the Opposition would counter this by tight monetary policy.[7] Sufficiently tight monetary policy will be successful in preventing a rise in the ongoing rate of inflation, but at the cost of at least a temporary rise in unemployment. The rise in unemployment will take a long time to be removed and in part may be permanent due to hysterisis, or the tendency for unemployment - especially long term unemployment - to ratchet upwards whenever there is a significant decline in economic activity.

The question remains: if macroeconomic policy is just tight (or loose) enough to leave unemployment at the level it will have been at in the absence of the change in the tax mix, will a switch from income taxes to consumption taxes raise the ongoing rate of inflation? Because of its nature, Tait's study did not, and can not, answer this question. The article by Perkins in this symposium addresses it. Perkins examines simulation experiments with half a dozen English and Continental European econometric models and concludes that a switch from direct to consumption taxes would have an ongoing inflationary impact if macroeconomic policy was set to keep aggregate demand and output the same as in base line cases in which no changes were made to the tax mix or policy settings. However, given the small size of the switch proposed in Fightback, any resultant tendency to ongoing inflation should not be very large.

Finally, the opponents of a GST are concerned about the equity effects of reducing income taxes and increasing consumption taxes. Many overseas countries have countered perceived adverse equity effects by giving a low or zero tax rate to food and, in some cases, certain other categories of expenditure. Fightback chooses not to do this, but instead to put in place a wide ranging set of compensation arrangements. The equity effects of Fightback are the subject of a separate article, by Raskall, in this symposium and will not be discussed in this article.

In summary, the economic effects of the tax mix changes proposed in Fightback are both good and bad, but in general small. The major benefit is an increase in economic efficiency. The most important reason for this is the replacement of the wholesale sales tax by the GST, but the abolition of payroll tax will also contribute. In principle the switch from income taxes to consumption taxes will increase the efficiency of investment decisions but the size of this effect will be negligible. In total the efficiency effects will probably give a once off increase in GDP of between 1 and 2 per cent spread over a few years.

The switch from payroll tax to a GST will tend to increase employment and that from income tax to a GST will tend to increase unemployment. My guess is that the first (beneficial) effect will be the larger, but both effects will probably be dominated by another influence on unemployment. The tight monetary policy needed to prevent any ongoing inflation after the introduction of the GST will increase unemployment at least temporarily. How big this increase will be, and for how long, will depend on the industrial relations institutions and climate, which are discussed in section 4 below.

The abolition of the payroll tax, and compensation to the States by increases in their grants from the Commonwealth, would have potentially serious effects on Federal financial relations. The ability to exempt many exporters from paying GST on business inputs which are now taxed is a benefit, but the abolition of the petroleum products excise will add to pollution, especially in urban areas. Finally one of the larger effects of the changes in the tax mix will be to disadvantage small businesses, both through the relatively high compliance costs of a GST for small businesses and the disappearance of the advantage they currently have through exemption from payroll tax.

Disadvantaging small businesses may have significant social costs, but the economic consequences are not likely to be very great. Small businesses are often lauded for providing employment and for being conducive to innovation. However, employment lost because of a competitive disadvantage of small businesses vis-a-vis in large firms is likely to be offset to some extent by increased employment by big business. Secondly, while large firms may have various attributes which are not conducive to innovation, e.g. cumbersome internal communciation and risk-adverse management, they also have advantages which facilitate innovation, such as the ability to raise funds more easily on the capital market. Studies show that the majority of innovations in industrialised countries are carried out by large firms.[8] The role of small businesses in innovation should not be neglected, but should be encouraged directly - not indirectly by measures which affect all small businesses equally.

3. Superannuation Arrangements and Tax Free Savings[9]

The age structure of the Australian population is such that the proportion of retired people to those of working age will increase substantially over the next three decades. The present pension for men over 65 and women over 60 makes it rational for even well off people to make insufficient savings during their working lives and to rely on the old age pension in retirement. The tendency to do this has been increased by changes in social attitudes towards receiving welfare benefits from the Government. In the interests of keeping manageable the ratio of old age pensioners to taxpayers, there is a strong case for taxation concessions to encourage superannuation savings, and to make possible adequate private retirement provision over the typical lifetime period in the labour force. Indeed many argue that to some degree superannuation savings should be compulsory.

Secondly, a major factor contributing to the current account deficit is a level of savings in Australia that is below the level necessary to finance appropriate rates of economic growth. Whether those economists who argue that the current account deficit should not be a matter of concern are in principle right or wrong (and I think they are wrong), in practice they are wrong since a continuing deterioration in the current account situation leads the Government to dampen down aggregate demand and increase unemployment. For both these reasons measures to encourage superannuation savings are desirable. Moreover, apart from paying off loans used to finance owner occupied dwellings, superannuation is the only major form of household savings in Australia. Hence, tax rates relating to superannuation provisions can have a large effect on the level of savings in Australia.

The Opposition's policy is to reduce compulsion and put the emphasis on voluntarism. The present superannuation guarantee levy legislation will, if it becomes law, force those in employment to save 9 per cent of their wages and salaries by the turn of the century. The Opposition proposes to freeze superannuation guarantee levies at the rate in effect when a Coalition Government comes to power, leaving it to taxation concessions to provide the motivation for increased superannuation savings. However, rather than a cut, Fightback proposes an increase from 15 to 25 per cent in the tax rate on the earnings of superannuation funds. Under the income tax rates proposed in Fightback, 25 per cent is higher than the marginal tax rates on incomes up to $20,700 a year and only a little below the 30 per cent marginal tax rate that applies to incomes between $20,700 anmd $50,000 a year. While there is a tax rebate of 25 per cent on contributions up to $6,000 a year, on balance there is not a great incentive for the vast majority of workers to lock up savings in superannuation funds.

Moreover, the limit of $6,000 on superannuation contributions eligible for tax concessions is low enough to reduce the contribution rates of many of those who traditionally save through superannuation schemes. While the proposed rules curtailing the size of lump sums may reduce immediate dissavings following retirement, the size of the lump sum received by a typical worker will not be greatly affected by this unless and until there has been a substantial increase in superannuation contributions for a long period. Fightback superannuation proposals will almost certainly result in less savings than present Government policy for the next 20 years or so.

Fightback includes another significant initiative to increase savings. It proposed to give a tax rebate of 30 cents in the dollar on the first $1000 of interest on new savings which are lodged in a special account. The size of the rebate means that, up to the limit of $1000 a year, interest on these savings will be tax free for the majority of taxpayers. Eligibility for the tax concession will be checked through the use of tax file numbers. On the basis of the interest income declared in tax returns in the year(s) prior to the introduction of the scheme a base year's income will be determined for each taxpayer. This base year interest income will be adjusted each year by an index of the overall level of interest rates, and the rebate will apply to the excess of any interest income in the base year adjusted for interest rate changes. Taxpayers who negatively gear and have negative net interest income will be given a base year interest income of zero. Similarly mortgage interest offset schemes will not be eligible for the tax rebate and generally only positive net interest income will be counted for the purposes of the scheme.

It is clear that very complex regulations will be required to restrict the tax concession to new savings. Assuming that the operation of the scheme has no effect on the level of Government expenditure, public savings will be reduced by the amount of the tax rebates granted. Thus, if the scheme is to increase national savings, it is important, as far as possible, not to give tax rebates for interest on savings that would occur in any case or are merely new savings in form and not in substance. It is impossible to predict how successful such a scheme would be in quarantining the tax concession to new savings and hence how much it will increase national savings. Consequently, it is very difficult to predict with any confidence whether, taken as a whole, the Fightback proposals would increase the proportion of income saved in Australia. My guess is that they would not, or that any increase would be very small, but this is just a guess, howbeit I hope an intelligent well informed one.

4. Labour Market Institutions and Practices

The Leader of the Opposition has stated that a detailed industrial relations policy will be announced within a year, but the outline of that policy is already clear. Opposition policy is for all wage bargaining to take place at the enterprise level with central tribunals playing no part. There are other articles in this symposium relating to industrial relations aspects of enterprise bargaining and the role, if any, that should be played by central tribunals. In this article I wish only to discuss the macroeconomic implications of abandoning Australia's historical centralised wage bargaining system.

The discussion in section 2 above, argued that, unless prevented by tight wages and/or monetary and fiscal policy, the immediate impact on prices of the imposition of the GST will increase the ongoing rate of inflation in Australia. Econometric simulations in Murphy (1992) also suggest that policy, tight enough to prevent a rise in wage rates following the initial price rise, is important if an introduction of the GST is not to produce a sustained rise in the rate of inflation. The Opposition's wages policy is designed to assist productivity growth and ignores macroeconomic consequences. If all wage bargains are made at the enterprise level with no reference to any central tribunal, there can not be any overall wages policy. The Opposition's guidelines are that wages in each enterprise should not increase faster than productivity in that enterprise. However, the wage bargains will be determined by employees and the employer in each enterprise and will reflect union and employer attitudes and relative bargaining strengths. Moreover, given the long history of comparative wage justice in Australia, large increases in some, perhaps highly productive enterprise, are likely to influence upwards wages in other enterprises unless restrained by high levels of unemployment. Also, there is the very real danger in an economy like Australia's, where oligopoly is so widespread, of employers believing that it will be more profitable to accede to union wage demands and pass them on in higher prices than to face disruptive strikes. Unless aggregate demand is depressed (restraining employers) and consequently unemployment is high (restraining unions), enterprise wage bargaining is unlikely to prevent wages rising following the introduction of the GST with a consequent rise in the ongoing inflation rate.

The Opposition is very concerned to reduce inflation not increase it, but it proposes to use monetary policy as the major instrument to do this. To this end it proposes both to give more independence to the Reserve Bank of Australia and to make price stability the over-riding objective of that institution. Tight monetary policy can, usually after a lag, restrain and indeed reduce inflation, as the events of 1991 demonstrated. However, it does this at the cost of increased unemployment. Tight monetary policy also leads to a high value of the Australian dollar on foreign exchange markets, which worsens the current account deficit. The combination of the Opposition's industrial relations policy with its dedication to restraining inflation through monetary policy means that unemployment is likely to be higher if Fightback and associated policies are implemented.

5. Conclusion

Overall what difference would Fightback made? It would probably increase productivity or output per hour worked. If employment remained the same this would increase GDP by between 1 and 2 per cent as result of the tax mix changes, plus a further amount as a result of the industrial relations policy. However, unemployment is likely to be greater if Fightback is implemented. The Opposition has made it clear that it believes monetary policy should be tight enough to prevent any rise in the rate of inflation.

Without any centralised wage policy institutions, preventing a rise in the rate of inflation following an introduction of a GST will require an increase in unemployment above the level that otherwise would have been possible without inflationary consequences. It is impossible to predict how big, and how sustained, an increase would be necessary, but it would not have to be very high to offset any increase in GDP due to the productivity increases resulting from implementing Fightback proposals.

Three other consequences of Fightback are worrying, although their immediate economic impact may be small. Pollution will increase following the abolition of the petroleum products precise tax, there will be adverse effects on small businesses from the change in the tax mix and problems in Federal financial relationships will be exacerbated by the abolition of payroll tax. Finally it is possible, though by no means certain, that the Fightback package will reduce the level of savings in Australia.

Notes

1. It is at least theoretically possible that a State would decline to cease collecting payroll tax, leaving residents in that State subject to both payroll tax and the GST. However, the Commonwealth could make the payment of general revenue grants to states conditional on a State not levying payroll tax. In any case, once one State abolished payroll tax, competitive forces would put great pressure on others to follow.
2. This is only a rough estimate and is based on work described in an unpublished Ph.D. thesis by John Piggott.
3. Depending on the levels of renumeration, businesses employing up to 30 people are exempt in NSW.
4. My solution is simple. For reasons set out in Nevile (1974), I recommend that the Commonwealth reduce its income tax rates by an amount which raises revenue equal to the general revenue grants to the states, discontinue these grants and offer to collect for each State income tax at rates set by that State. However, whatever its economic merits, this solution seems politically impossible.
5. Standard estimates made in the United States of the price elasticity of the supply of labour are close to zero for males and around 0.5 for females. See Friedman (1992).
6. See e.g. Kyriakopoulos (1991) and Nevile (1990).
7. Fightback sees wages policy as an instrument to increase productivity at a micro level. It has no macroeconomic role for wages policy as an anti-inflationary weapon.
8. See e.g. Rothwell and Zegveld (1985).
9. Much of this section is based on material in Piggott (1992).

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