**IS THE ONLY GOOD TAX AN OLD TAX?
A HISTORICAL PERSPECTIVE ON
THE GST DEBATE***

Julie P. Smith

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SUMMARY

This paper critiques the arguments put by the Howard Government for an unadulterated, flat rate GST policy, by taking the characterisation of the current wholesale sales tax (WST) as an outdated tax without design or logic, and showing this view to be historically wrong and superficial. It does so by exploring the social reasoning adopted politically in constructing and evolving the sales tax, and its interaction with other taxes. It posits a `benevolent government' interpretation of tax design to contrast with the Treasury `rent-seeking' model, and examines the rationale for exemptions and multiple rates in historical context. It also asks whether economic change since 1930 does make the WST irrelevant to current conditions, as the Government has asserted.

The narrowness of the present sales tax base mainly reflects design decisions in the 1930s and 1940s. These aimed at limiting the burden on families with children, the poor, and other vulnerable groups through exempting essential expenditures. Exemption such as food from sales taxation reflected strongly held social values having bipartisan political acceptance. These values included `progressivity', but also encompassed other conceptions of `fair' taxation. Unless there have been major changes in public attitudes to what constitutes `fair' taxation, this implies the GST as presently proposed may not improve Australian's social welfare, and may not be politically viable in Australia.

The consumption tax base has declined substantially in relation to GDP since 1930, reducing the WST's potential yield. However, a GST would have been similarly `eroded'. Only since the 1980s is the growth of services a significant argument for consumption tax reform.

Tax reform is disruptive and costly. Benefits in terms of equity and efficiency gains must be reliable as well as substantial to make a valid case for change. If the `rent- seeking' thesis for the WST's narrow base prevails, and the GST taxes food to avoid encouraging `rent seeking', tax reformers must show how their `unadulterated' GST revenue base is protected against the lobbying which supposedly corrupted the WST.

Likewise, unless the GST is a Trojan horse for achieving undeclared changes in the distribution of income, its proponents must show how the GST compensation package prevents an `unadulterated' GST worsening present inequalities of income, not just beyond the next Budget but over the next several decades as the GST rate rises and/or Budget programs are pared back.

On both these grounds, exemptions for food might be best included in the design of the GST as part of the tax reform package.

IS THE ONLY GOOD TAX AN OLD TAX?

AN HISTORICAL PERSPECTIVE ON THE GST DEBATE

1 Introduction

The saying that "the only good tax is an old tax" reflects the reality that social values and political and economic forces shape the tax system over a long period of time. One of Australia's `old' taxes is the wholesale sales tax (WST), introduced in 1930.

The push for a comprehensive GST is defended by claims that WST is an outdated and unfair tax which reflects the economic circumstances and values of bygone days and the *ad hoc* results of political `rent-seeking'. A recent Commonwealth Treasury article, for example, purports to draw on historical analysis `to demonstrate that some of the original motivations for the design of the tax may no longer be relevant'.[1] Its present features are characterised as unintended consequences of socially inefficient lobbying in the post-war period, without significant implications for the equity of the tax system.

Such sentiments were also presented in the Howard Government's 1998 election tax policy statement[2] and in the Treasurer's second reading speech on the Bill to abolish the wholesale sales tax. According to the Treasurer, the WST was appropriate for a 1930s economy, but the economy had changed. Furthermore,

> "the wholesale sales tax needs to be abolished because it has no logic or design".[3]

While it may be true that changes in the economy have affected the yield of the tax, and anomalies have arisen over time, the proposition that this old tax has `no logic or design' needs to be challenged.

The present WST was introduced in 1930 at a single rate of 2 1/2%. This was raised to 8 1/3% within a decade. A multiple rate system of sales taxation was introduced in November 1940. In 1998 there were 5 different sales tax schedules, excluding the exempt category.

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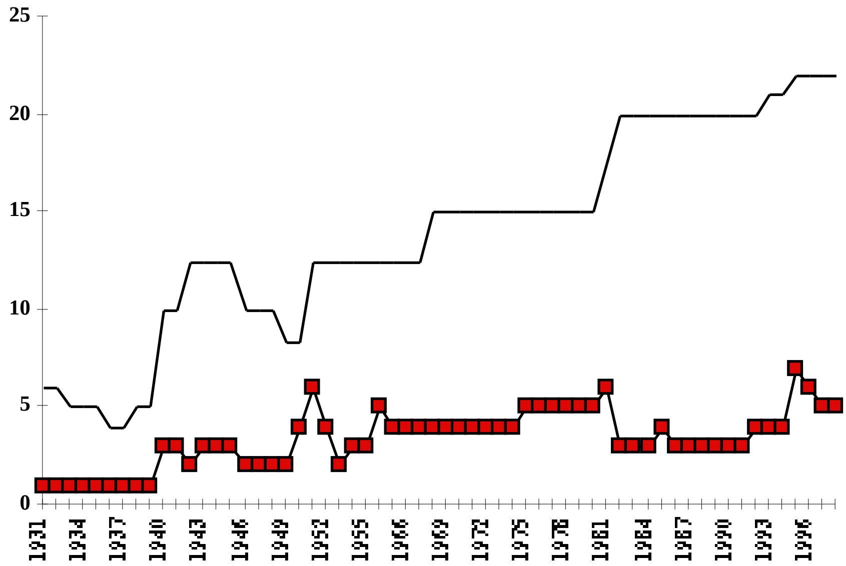
[1] Commonwealth Treasury (1998), “The wholesale sales tax: sixty-eight years on”, *Economic Roundup* (Summer), pp23-34.

[2] Costello P. (1998), *Not a new tax. A new tax system*, September, AGPS.

[3] Commonwealth Parliamentary Debates (CPD), 2 Dec 1998, p862.

FIGURE 1: Sales tax rates and number of schedules (excluding exempt category), 1931 to 1998[4]



In arguing for a comprehensive GST, the Commonwealth Treasury's `history' of sales tax compares its multiple rate and narrow base unfavourably with the presumed ideal of a uniform rate, broad-based consumption tax.[5] A comprehensive GST of the type proposed by the Howard Government would cover around 80% of the consumption base, representing around half of GDP,[6] compared with the 22% of consumption, and 14% of GDP under the present sales tax.

Treasury argues the WST's present narrow base is an unintended consequence of the encouragement to socially unproductive rent-seeking provided by exemptions and differential tax rates.[7]

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[4]Sources: Commissioner of Taxation (1984), *63rd Report 1983-84*, p169; *Budget Papers*, various years, from 1984 to 1998.

[5]A uniform rate comprehensive tax is far from `perfect' in theory and in practice. Optimal tax theory points to differential tax rates to minimise economic distortions. However, in practice, there are always at least two rates of GST, one on marketed-, and one on non-marketed goods and services produced by households for themselves. Practical difficulties in taxing financial services and some other publicly provided services ensures a multiplicity of effective rates of GST (See Quiggin J. (1998), `Should food be taxed', in Disney J., et al., (1998), *Perspectives on the GST package*, Discussion Paper No 18, Australia Institute, Canberra, September). The proscription of differential tax rates in favour of a uniform rate for commodity taxation rests on judgements about encouragements to rent-seeking, or presumptions that the information requirements of Ramsey-type consumption taxation are excessive (See Stigler J E. (1988), *Economics of the public sector*, W. W. Norton & Co, New York).

[6]Warren N. (1998), *Tax facts and tax reform*, Research Study No 31, Australian Tax Research Foundation, Sydney.

[7]Commonwealth Treasury (1998), *op cit*, p30.

Like Sawer,[8] who characterises the federal sales tax as "a regressive impost which infringes the principles of taxation in accordance with ability to pay", Treasury dismisses the possibility of sales tax design reflecting any distributional objectives. It also argues multiple rates of sales taxation are `a response to the specific circumstances of the war', intended to direct resources into war production, rather than reflecting social objectives of taxing luxuries more heavily. Multiple rates are said to reflect `special circumstances that no longer apply'.

This Treasury view corresponds to the conventional wisdom that the WST commenced on a broad base, and has been eroded mainly in recent decades. For example, Collins and Warren assert that,

> "the Federal government introduced the Wholesale Sales Tax in 1930 on a fairly broad base, and at a uniform rate. However from the 1940s onwards, it was characterised by a narrowing of its base and the adoption of multiple rates."[9]

TABLE 1: Long term trends in the sales tax base (1930-31 to 1995-96, selected years)[10]

Year ending June:	Taxable sales/private consumption (PFCE) (%)	Taxable sales/ GDP (%)	Private consumption (PFCE)/GDP (%)
1931	28	22	77
1932	32	24	75
1935	28	22	77
1940	28	19	70
1945	27	15	58
1950	25	17	68
1955	23	15	67
1960	22	14	65
1965	21	13	62
1970	20	12	60
1975	20	11	58
1980	19	11	59
1985	21	13	60
1990	26	15	59
1995	22	14	62

[8]Sawer G (1963), *Australian Federal Politics and Law 1929-1949*, Melbourne University Press, Parkville, Victoria, p10.

[9]Collins D and N. Warren (1998), *Understanding consumption taxation - everyone's guide,* Research Study No 30, Australian Tax Research Foundation, Sydney, p17.

[10]Sources: Groenewegen P. D. (1983), `The Australian Wholesale Sales Tax in Perspective', in Head J. (1983), *Taxation issues of the 1980s*, Australian Tax Research Foundation, Sydney, p339-361, Table 1, for 1930 to 1982, p363; Butlin M. (1977), *A preliminary annual database, 1900/01 to 1973/74*, Research Discussion Paper 7701, Reserve Bank of Australia, Sydney, May; Foster R.A. and Stewart S.E. (1991) *Australian Economic Statistics 1949-1989-90*, Reserve Bank of Australia, Occasional Paper No. 8, February, Table 5.9 for 1966 to 1985; Warren N. (1996), `Information is king when designing taxes on consumption and production', Submission to ACCI/ACOSS National Tax Reform Summit, *Correcting the Balance*, Canberra, November.

However, as evident in Table 1, much `erosion' of the WST occurred early in its history. Contrary to the conventional view that it was initially a broad based tax, the WST covered only a third of private consumption spending (PFCE) when it was introduced. It fell to around 23% of spending in the late 1940s, and after briefly rising during its heyday as a tool of stabilisation policy in the 1950s, remained at around 18-22% of spending for most of the period since. Likewise, it commenced with a coverage equivalent to around 22% of GDP, and by 1945 had fallen to about the same share of GDP as it is today.

Furthermore, during the 1980s and 1990s, WST revenue collections reached historical peaks as a percentage of GDP (Table 2).

TABLE 2: Sales tax collections as a share of private spending and GDP, 1940[11]

Year ending June:	Sales tax collections/private consumption (PFCE) (%)	Sales tax collections/ GDP (%)
1931	1	
1932	2	1
1935	2	1
1940	2	1
1945	4	2
1950	2	2
1955	3	2
1960	4	2
1965	3	2
1970	3	2
1975	3	2
1980	3	2
1985	4	2
1990	5	3
1995	4	3

The conventional analysis therefore raises important questions about the origins and evolution of sales taxation in Australia. Did the Scullin Government introduce sales tax during the worst depression this century without regard to its distributional impact? Did the sales tax base shrink simply because unprincipled governments were corrupted by pressures from special interest lobbying? And do multiple rates of sales tax reflect only the special circumstances of the Second World War, a legacy of wartime economic management objectives?

Does the Australian sales tax really have no design or logic, other than to raise revenue? Has economic and social change really made it irrelevant? What are the implications of its history for the present tax reform debate?

These questions are addressed below. Firstly, in section 2, the paper examines the Parliamentary debates during the 1930s and early 1940s, when the essential structure of

[11]Source: Groenewegen (1983), *op cit*; Foster and Stewart (1991), *op cit;* ABS (various years), *Taxation Revenue Australia,* Cat No. 5506.0.

the current sales tax was put in place. Section 2 analyses Parliamentary debates and circumstances surrounding the introduction of the WST, and its evolution during the 1930s to see how if at all, the distributional effects entered into the selection and design of the tax as a revenue tool. Section 3 looks at sales taxation against the background of wartime tax policies, to see why multiple rates were introduced, and how sales taxation was to fit into the nation's post-war taxation structure. In section 4, the evolution of the sales tax is surveyed statistically to explore whether economic change has fundamentally altered the relevance of the WST since 1930. Section 5 draws summarises and discusses this historical evidence on the design and evolution of sales tax as an element of Australia's tax system. The final section concludes with the implications of this tax policy history for the debate over the Howard Government's proposed GST and tax reform package

2 The choice of sales tax as a new federal revenue tool: sales tax policy in the 1930s

The design of Scullin's 1930 sales tax

Parliamentary debate on the WST commenced with its announcement in the 1930-31 Budget in early July 1930.[12] The second reading of the relevant legislation took place from 30 July.[13] The Scullin Labour Government was severely chastised by the parliamentary Opposition and accused of hypocrisy for changing its former critical stance on indirect taxation.[14] The Labour platform had been that indirect taxation was wrong because the burden fell chiefly on the poorer people, and particularly on families in which there were most mouths to feed.[15] Scullin's indirect tax measures were said to sin against all accepted principles of tax policy, in particular "ability to pay". However, the debates reveal that the Opposition's alternative policy was not necessarily more progressive, and the Scullin Government specifically designed the sales tax to reduce its regressivity.

In 1930-31, the Scullin Government faced an expected deficit of £14 million in the absence of new tax measures. The proposed 2 1/2 per cent sales tax was expected to contribute £5 million in new revenue, alongside additional customs and excise taxes of £5.7 million, and higher federal income taxation adding £850,000.

The Commonwealth's main practical revenue alternative to the sales tax was lowering the federal income tax threshold from around £300 to around £150 pa, with much heavier burdens on lower and middle incomes.[16] Direct taxation, the

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[12]CPD, vol 125, pp 3889-3904.

[13]CPD, vol 126, p4930.

[14]CPD, vol 126, p4421, p4518. This was reinforced by critical comment on the regressive distribution effects of the sales tax by Brigden, writing in the *Sydney News* on 14 July, and in the *Sydney Morning Herald* on 15 July (see CPD, vol 126, p4543).

[15]CPD, vol 126, p4518.

[16]CPD, vol 126, p5521.

Nationalist/Country party Opposition argued, was more progressive. Indirect taxation was inequitable because the rate was governed by the goods purchased and could not be subject to graduation - "whether a man earns £4 or £40 a week, he pays the same rate".[17]

The Opposition pointed to the NSW unemployment relief tax as a model. This was a flat rate levy of 3d in the £1 tax imposed on all but those earning less than £80 pa:[18]

> "the tax applies practically to all wage-earners, and it is expected to bring in £3,000,000, which, it is estimated, will provide for most of the unemployment in that State".[19]

This the Opposition argued was `a fair tax'. Unlike the sales tax, `a tax on the poor man' it reflected `ability to pay'.[20] Opposition speakers also argued that the fairest form of indirect taxation was that on luxuries, such as the bulk of excises, because the taxpayer could quite easily do without them if he did not want to pay the tax. `Conventional necessaries' such as tea, might also be dispensed with without causing serious injury to health, although such items were desirable to enable the people to confirm to the standard of living in the country in which they lived. Next to a tax on luxuries, the Opposition considered a tax on such conventional necessaries to be least harmful to the country.

The Labour Government's response was that avoiding new federal taxation through cutting Budget spending on wages and unemployment relief was more unfair to workers than its sales tax proposal. Scullin argued that the new tax merely replaced lost customs revenues. The incidence of the new taxes had been spread as fairly and as widely as possible, in order that "an undue burden may not fall on any one section of the community and there may be the least possible disturbance of industry".[21] Under Labour's taxation policy, all suffered a similar loss. By contrast, the Opposition's fiscal and wage policies would diminish the incomes solely of the wage earning class.

Scullin was also sharply critical of Opposition proposals to encroach onto States' field of taxation such as by extending federal income taxation to lower incomes. The Government had rejected this option because;

> "existing State taxes preclude the Commonwealth from imposing heavy additional taxes in fields in which the States also operate."[22]

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[17]CPD vol 126, p5286.

[18]The NSW unemployment relief tax was one of the numerous special taxes that were introduced by State governments during the Depression to fund social services and public relief for the unemployed (Bland, F. A. ([1934] 1976), "Unemployment relief in Australia", in Roe, J. ed., *Social Policy in Australia, 1901-1975*, Griffin Press, Melbourne: 165-191). By 1930, these very regressive flat rate or fixed taxes on weekly wages and low incomes raised more revenue than states' income taxes.

[19]CPD, vol 126, p4629.

[20] CPD vol 126, p5286.

[21]CPD, vol 125, pp 3902.

[22]CPD, vol 126, p4721-4723.

According to Prime Minister and Treasurer Scullin, the sales tax was also better than leaving the States to deal with cuts in grants from the Commonwealth. Cutting grants to States was tantamount to taking money from the right-hand pocket and putting it in the left-hand pocket;

> "We should be big enough to visualise Australia as one people. Surely the Commonwealth and the States are one. There is not the slightest doubt that if we withdrew £2,500,000 [for roads and unemployment relief] from the States, the State Treasurers would have to increase taxation by that amount, and some of the States are not in a position to increase taxation at all."

Under the Scullin Government's 1930 sales tax legislation, more sales were exempt than taxable.[23] The new tax exempted exports and goods made by primary producers. However, most exemptions were for items prominent in the budgets of Basic Wage households, including basic foods such as "milk, butter, cheese, condensed milk, wheat, flour, sugar, bread and pastry, potatoes and market garden produce, orchard produce, poultry, other dairy produce, fish, grapes".[24] A long list of domestically manufactured goods also escaped sales tax on similar grounds.[25]

Granting exemptions for such Basic Wage items but not for inputs to primary production led to accusations the Labor Government was favouring labour-intensive manufacturing industry over primary producers.[26] The Government was also accused of `coddling the millionaires of Australia as they have never been coddled before', because sales tax would not tax large professional incomes or incomes from rent yet would hit the workers' and families' living costs.[27]

Labor member Chifley's speech on the sales tax bills makes clear that the extensive exemptions from the original sales tax were a deliberate policy to reduce its regressivity.[28] The Government's sales tax was equitable because:

> "Under this tax practically all foodstuffs will be exempt. From 50 to 75 per cent of the earnings of the workers is spent on rent and foods. The average working man is paid not more than £250 a year, and it is safe to say that £175 or £200 out of this income is used in the purchase of foods and services that will be exempt from the tax. Those persons with incomes ranging from £750 to £1000 a year do not have

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[23]Commissioner of Taxation (1931), *14th Report 1927-28-29-30-31*, p14.

[24]It might be asked why the Government was concerned to exempt such items when the Commonwealth Basic Wage was indexed for price increases. It may have preferred to protect wage earners directly, as indexation of the Basic Wage occurred only after a lag of 5 months and State wage tribunals did not necessarily follow the Commonwealth Arbitration Court. Furthermore, protecting Basic Wage earners would have exposed many other wage earner families to the regressive effects of sales tax, unless compensated through higher wages. (By contrast, compensation for the GST targets mainly those on low incomes, rather than families with children who also face a relatively heavy burden from the new tax.)

[25] CPD, vol 126, p4933-35.

[26]CPD, vol 126, p4440.

[27]CPD, vol 126, p4542-43.

[28] CPD vol 126, p5305-5309.

nearly such large families as do the bulk of the workers, and a good deal of their earnings are disbursed in the purchase of goods that will be subject to the tax".

Chifley argued the poorer section of the community would not be substantially affected by the tax:

"As the commodities that are necessary to preserve life are exempt, those who have a comparatively low income, and cannot afford to purchase luxuries, will largely escape. The man who buys an £800 motor car will pay more on that one transaction than the average worker will pay in nine or ten years".

Acknowledging that sales taxes tended to be regressive, Chifley cited authorities on `the almost universal practice' of exempting, or taxing at special low rates, the foodstuffs and other items that constitute the major portion of the expenditures of the poorer classes, but a smaller fraction of the expenditures of the richer classes:

"If the renting of dwellings, as a service, is untaxed, and foods are entirely exempted, the entire distributive character of a general turnover tax is changed. The poorer classes are practically entirely relieved of its burden".

Rural representatives also expressed their approval of exemptions for those commodities that were viewed as `absolutely necessary to the producer's and the working man's family',[29] including basic foods. They joined rural Labour parliamentarians in seeking further exemptions for other foods.[30] It is likely both their economic interests, and their interests as relatively low income consumer households motivated such representations.

Contemporary economic opinion argued that the relatively few exemptions for items in the working man's budget compared to the Canadian model made the Australian sales tax more objectionable on distributional grounds.[31]

Although exempting items such as hay and straw, fertilisers and other products used in primary production, the Government resisted most industry calls for further exemptions. Revenue considerations overrode all but the most pressing cases for further exemption. Exempting half the potential base had already necessitated a rate of 2 1/2 per cent rather than 1 1/4 per cent. However, Scullin promised to give priority in future Budgets to widening exemptions if revenue permitted;

"The government hopes that in the course of time the rates may be reduced and the exemptions increased. That has been the experience of other countries, particularly Canada".[32]

In the event, the sales tax raised less than anticipated. In the 1931-32 Budget, it was increased from 2 1/2% to 6%. Controversy erupted over the change:

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[29] CPD, vol 126, p4443.

[30] For example, see CPD, vol 126, p5287, p5291-300.

[31] Burton H. (1930), "The sales tax". *The Economic Record,* November: 244-248, p246.

[32] CPD, vol 126, p4935.

> "While some wholesalers and manufacturers had been content to submit to the failure to recoup the 2 1/2 per cent tax paid by them, they felt it was impossible to adopt the same attitude towards a 6 per cent tax".[33]

The increased sales tax rate was accompanied by an extension of the exemption list in late 1932. This mainly aimed at extending exemptions `in aid of primary production', but also responding to concerns at equity or administrative difficulties of taxing basic household goods.[34]

As fiscal conditions improved from 1933 sales taxation was eased. In 1933, the rate of tax was reduced to 5%.[35] The Government gave highest priority to increasing exemptions rather than reducing the general rate, with the objective of lowering production costs for domestic industry. Although numerous additional exemptions were introduced during 1933 and 1934, under the *Financial Relief Acts* of 1933-35, the general rate was not lowered again until 1935, to 4%.[36] By 1935, the sales tax raised £9.3 million annually. Receipts remained around that level for the rest of decade.

3 Sales tax policy during World War II

Revenue or resource allocation? Sales tax policy in 1940

In the first full-scale war Budget announced on 21 November 1940, the Fadden (UAP/Country Party) government introduced a tax package including:

- higher sales taxation;
- a lower personal income tax threshold of £150 pa.; and,
- excess company profits taxation

Although income tax measures produced more revenue, rates had already been increased substantially.[37] While the Government saw income tax as the preferred and most effective method of collecting from each individual a contribution to the cost of the

[33] Commissioner of Taxation (1931), *14th Report 1927-28-29-30-31*, p14. It is not clear why industry felt the incidence of the tax was borne by producers. Certainly the presumption during the 1930 Parliamentary debates was that the tax would fall on consumers. The issue was somewhat muddied by technical legal issues which created some confusion about whether the tax could be passed on by wholesalers; this was remedied by amending legislation the following year. However, it would appear that the depressed conditions experienced in some industries at that time made it difficult for producers or importers to pass on the tax, and this affected some industries more than others. See also Burton (1930), *op cit*.

[34] Commissioner of Taxation (1933), *15th Report 1928-29-30-31-32*, p15.

[35] Commissioner of Taxation (1934), *16th Report 1929-30-31-32-33-34*, p19.

[36] Commissioner of Taxation (1939), *21st Report 1937-38-39,* p24; Commissioner of Taxation, *22nd Report*, (1940), p20.

[37] Federal income tax rates had already been increased 50% in Spender's *Financial Statement* of May 1940, following rises of 15% and 10% in the 1938 and 1939 Budgets. This imposed heavily on middle income earners because of the need to accommodate varying State income taxes on higher incomes.

war, radical changes were needed to make it a major instrument of war taxation.[38] Higher sales tax was to bring £3.4 million of the £31 million sought in extra revenue for 1940-41, along with increases in duties on luxury items such as alcohol and tobacco yielding £4.2 million.

On Treasury's interpretation,

> "Multiple rates [of sales taxation] were first introduced in 1940 to encourage resources to flow to `essential' war related activities. Goods were classed according to the standards of the time. Subsequent classifications and reclassifications have also reflected the values that prevailed at the item of classification. Many of these judgements no longer appear appropriate given the rapid changes in technology and consumption patterns".[39]

Treasury continues:

> "Overall revenue needs were high and there was a high priority placed on channelling resources into war-related activities. It is also important to note that differential rates were established not to tax `luxuries' more heavily but to channel resources into more `essential' areas in time of war."

The war time evolution of taxation and fiscal policy in Australia was generally shaped by ideas and policy in the United Kingdom,[40] where the thinking and advocacy of Keynes was highly influential. Avoiding inflation required sharp reductions in consumer spending, to be effected in part by heavily taxing lower and middle income earners. One concern about such a policy was the effect on incentives to work of low to moderate wage earners.[41]

However, the Australian sales tax changes of 1940 were not aimed at channelling economic resources to war needs as suggested by Treasury. They were motivated simply by traditional public finance concerns of revenue and tax equity. Fadden as Treasurer from October 1940 was at this stage unreceptive to the Keynesian framework for tax and financial policy.[42] He emphasised tax policy to `raise money' for financing defence expenditures rather than to conserve and direct economic resources for the war effort.[43]

The Government's view of indirect taxation was simply that,

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[38]Income taxation of wage and salary earners, to be achieved through the lowering of the income tax threshold, was strongly resisted by Labour unless there was commensurate sacrifice by the wealthy. State income taxes were a factor standing in the way of the Government meeting Labour's demands.

[39]*Op cit*, 1998, p26.

[40]Watts, R. (1987), *The foundations of the national welfare state*, Allen & Unwin, Sydney; Coombs, H. C. (1981), *Trial Balance*, The MacMillan Company of Australia, Crows Nest, Sydney.

[41]Sayers, R.S. (1956), *Financial Policy 1939-45*, HMSO, London, pp181-183; Land, H. “The introduction of family allowances: an act of historic justice?”, in P. Hall, H. Land, R. Parker and A. Webb (eds.) (1975), *Change, choice and conflict in social policy*, Heinnemann, London, p75, pp111-114.

[42]Coombs (1981), *op cit*, p10-11.

[43]Walker, E. R. and R. M. Beecroft (1941), "New developments in Australia's war economy", *The Economic Record,* June.

> "taxes upon the necessaries of life are to be avoided because they fall heavily upon the family and because they add, directly or indirectly, to costs of production. Taxes upon luxuries are free from these objections ... ."[44]

Its stated policy was to use customs and excise taxes (rather than sales tax) to reduce and divert consumption and discourage spending on luxuries and those goods likely to be in short supply.[45]

Treasury's interpretation appears to confuse this application of the traditional `sumptuary' approach to indirect (customs and excise) taxation, with introduction of multiple sales tax rates, motivated by broader tax policy objectives emphasising revenue and tax fairness.

Continuity of principle in sales tax policy

When revenue needs increased from around 1938 with defence preparations for the Second World War, the Government increased the rate, rather than winding back exemptions, to generate revenue. The rate of tax was increased to 5% in 1938, 6% in 1939, and 8 1/3% in May 1940.[46] The differential sales tax rates introduced in 1940 permitted raising of additional sales tax revenues without infringing accepted principles for equitable sales taxation.

The Government was at the time very vulnerable to Opposition criticism of the increase in sales taxation.[47]

> "there were still many persons who can well afford to pay a higher rate of income tax, and additional revenue should be obtained from those persons rather than from married men with families, the lower wage earners, and the invalid and old-age pensioners by means of this unfair indirect tax".[48]

The Government's proposals were also criticised for being particularly inequitable for families.

> "This form of taxation falls with particular severity on the lower sections of the community, and the larger a man's family, the more he has to pay".[49]

Labour leader Curtin reached agreement with Prime Minister Menzies to criticise but not oppose the measures.[50] Despite this, a number of his Labour colleagues directly

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[44]Budget Speech and Papers, 1940-41, p10-14.

[45]*Ibid*, p97.

[46]Commissioner of Taxation, (1939), p21, p24; Commissioner of Taxation (1940), *22nd Report 1938-39-40*, p20.

[47]CPD, 21 Nov 1940, vol 165, p935; CPD, pp790-91. All was not well in the government ranks. After tensions between the UAP and the Country Party had come to a head in late 1939, Menzies had formed a UAP government with the `discriminating support' of the Country party. Spender became Acting Treasurer in November 1939, and Treasurer in March 1930. Following an election in September 1940, Menzies headed a minority UAP Government kept in office by two Independents. The following month, Fadden who had been Assistant Treasurer since March, replaced Spender as Treasurer. During 1941, Menzies stood aside as Prime Minister for Fadden in the interests of political harmony.

[48]*Ibid* p938.

[49]*Ibid*, p800.

repudiated the compromise. They bitterly challenged the equity of extending indirect taxation at a time when the government was proposing direct taxation for the first time on ordinary wage earners. The Government was accused of trying to lift the burden of direct taxation from the shoulders of its supporters with the view to spreading it over the community as a whole.

The Labour left were especially critical of the taxation of drugs and medicines while veterinary products used by primary producers remained exempt.

> "... the woman who has done her duty in rearing children has to pay sales tax on the medicine bought for her kiddies when they become ill, whereas another woman who has failed to do her duty, and prefers to nurse a poodle-pup, can get all of the medicine that she requires for her pet dog and not pay any sales tax on it. ... Can the Minister justify the imposition of sales tax on the surgical footwear required by a child who has suffered from infantile paralysis, whilst medicines and requisites used in the treatment of racehorses, dogs, pigs and other animals are exempt from the tax?".[51]

The Government was also accused of provoking strikes and industrial disputes by lowering the purchasing power of workers, in contradiction of its strong stance of opposition to inflation.[52]

Treasurer Fadden's response emphasised that the Government's priorities were to raise revenue, and to raise it quickly.[53] The proposed sales tax changes continued previous principles for sales taxation, namely preferential treatment for food, primary produce and certain primary industry inputs.[54] He revealed that the Government had been pressured to hold down the general rate of taxation by abolishing all exemptions. However, it did not adopt that approach.[55] Treasurer Fadden listed the well-defined criteria for exemptions from sales tax;

"(1) The goods are basic foodstuffs.

(2) They are primary products.

(3) They are primary producers' machinery, or materials of production.

(4) They are goods used in industries which in peace time it is necessary and desirable to foster.

(5) They are goods used in activities relating to religious, philanthropic, benevolent, educational or medical and surgical activities."

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[50]Sawer (1963), *op cit*, p141. Menzies had, among other things, agreed to lower the income tax threshold to £200 rather than £150 pa.

[51] CPD, vol 165, p780.

[52]*Ibid*, p938.

[53]CPD vol 126, p806.

[54]*Ibid*, p95, p805

[55]*Ibid*, p95.

Of the £565 million total of goods estimated to be consumed, no less than £314 million would remain exempt. Nearly two thirds of the value of exemptions represented basic foodstuffs, fuel, light and power (Table 3).

TABLE 3: Exemptions from sales taxation, 1940[56]

Item	*£ million*
Basic Foodstuffs	131
Fuel, light and power	60
Primary products	25
Primary producers machinery, materials and aids	23
Goods sold to Government departments	40
Beverages, tobacco etc., subject to heavy duties of customs and excise	17
Sundry items such as small manufacturers, boots and shoes under 15s. a pair wholesale, foods for public hospitals and public institutions and church equipment	18
Total value of exemptions	**314**

Under the circumstances, the Treasurer argued, the proposed changes to sales tax did not materially depart from the major principles upon which exemption from sales tax had hitherto been granted. Differential rates had been avoided in the past, according to the Treasurer "not because of any view that a varying burden could not be justified", but simply because of the higher compliance and administrative burden."[57] The alternative to differential rates was a greater rise in the general rate.

To obtain the same £3.4 million of revenue from a single rate of sales tax, it would have been necessary to increase the existing rate from 8 1/3 per cent to 13 1/2 per cent. With the option of imposing differential rates of tax on non-essential goods, the Government felt it could not justify such an increase:

> "The loading of an additional 5 per cent on goods already heavily taxed would have had serious repercussions in many directions".[58]

Total withdrawal of exemptions

> "would so disturb the nation's economy as to cause harm greatly outweighing the advantages to be derived from ease of classification and the relatively lower rate".

The Government therefore chose to raise £1.5 million by increasing the general sales tax rate, and the balance from selective increases and base broadening.[59] Taxing a limited selection of other previously exempted goods at half rates "preserved the

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[56] Source: CPD, 21 Nov 1940, vol 165, p95.

[57] *Ibid*, p109.

[58] *Ibid*, p806.

[59] CPD, vol 165, p107. The increase in the sales tax rate to 15% for less essential items would contribute £600,000 and the widening of the field to previously exempt goods would raise £1,300,000.

principle of preference". While these items had "undeniable" claims to exemption in times of peace, "standards formulated in peace-time have to be adjusted to war-time necessities." The items included in the 15 per cent category were not necessarily luxury goods but supplied "less urgent needs" than those contained in the other schedules to the Act, or those upon which the general rate would fall.

The official rationale for the 1940 changes was summed up by the Tax Commissioner in his Twenty Third Report.[60]

- Three different rates of taxation were introduced in lieu of the one flat rate formerly in force, "because of the need of increased revenue for war purposes".
- The chief reason for the introduction of differential rates was "the desire to avoid an unduly high general rate".
- The maximum rate of 15 per cent was applied only to goods "which were considered to serve the less urgent or essential needs of the people, and which consequently might, in a time of national emergency, bear an impost greater than that imposed upon goods generally".
- Certain goods formerly exempt from tax were also now taxed at 5 per cent. Withdrawal of the previous exemption was to raise additional revenue, but as "these goods were still considered to have a claim for preferential treatment", they were taxed at the rate of 5 per cent only, half the general rate of 10 per cent.

The role of sales tax design in taxation of low incomes; reconciling efficiency and equity concerns

By 1941, there were increasing concerns about inflation. To avoid fuelling price rises in the fully employed economy, the Government now avoided increases in indirect taxes. In October, the Menzies-Fadden Government fell and Curtin became Prime Minister, with Chifley as Treasurer.

Chifley's *Financial Statement* on 29 October 1941 articulated clearly the Labour Party's view of the role of sales taxation.[61] Labour’s view was that many people on lower incomes could undoubtably make a further contribution to war financing - in fact it was essential that they should do so. However, the Treasurer was unwilling to impose additional income taxation on middle and lower incomes, as income tax "could not discriminate fully between individuals in accordance with their financial responsibilities".[62] A heavy increase in tax on these incomes would frequently impose serious hardship. Hence, the `tax contribution' from lower and middle income earners would be applied through taxation of non-essential consumption:

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[60] 1942, p33.

[61] CPD, vol 169, p31.

[62] Budget Speech and Papers, 1941-42, p7.

> " ... as a means of reducing consumption, I think that for middle and lower incomes it is better to get the reduction by means of taxes on goods and services not really essential - which can be foregone without injury to health or efficiency".[63]

Chifley also foreshadowed that this policy of taxing lower incomes through selective taxation of consumption would be consolidated the following year. with further increases in sales tax - to 25% from the old 20% rate on non-essentials, and to 12 1/2% from the old general rate of 10%. At the same time, the 5% tax on drugs and medicines introduced in 1940 would be abolished.[64]

Sales tax was now reaching its limits in wartime taxation policy because of its potential to fuel cost-of-living increases and wage claims in the booming war economy. Shortages, rationing and other restraints were also reducing consumption levels and the revenue base.[65] The only further sales tax changes of any substance were reductions in rates on rationed clothing and drapery from 12 1/2% to 7 1/2% in July 1943, and exemption of all building materials from September 1944. These measures were price stabilisation measures, offsetting clothing price increases that had already occurred, and responding to serious rises in housing costs.

The sales tax was used to good effect as an anti-inflationary device in the 1950s and early 1960s.[66] An important precursor to this use of taxation for economic management purposes had been the introduction of the national child endowment scheme in 1941.[67] However, increasing policy preoccupation with inflation was a factor in sales taxation falling into disuse as a stabilisation tool from the 1960s.

The main change in the sales tax since the 1950s is the increase in the general rate (Figure 2). The effective rate of taxation on all taxable sales was little changed between then and the 1980s at around 15%.[68] At times there have been up to seven different rates. More typically, there have been fewer.

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[63]*Op cit*, p7.

[64]CPD vol 170, p711.

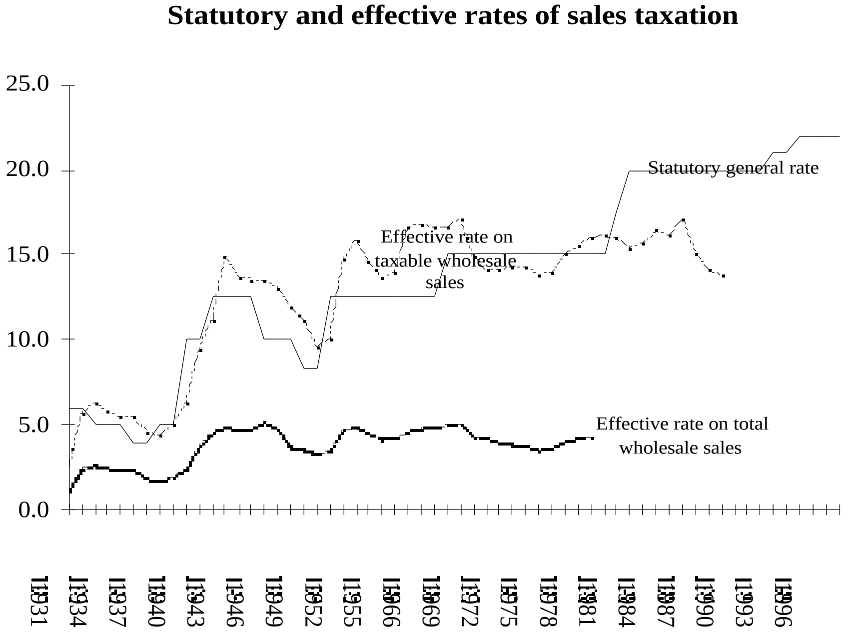
[65]Butlin S. J. and Schedvin C. B. (1977), *The War Economy 1942-45*, Australian War Memorial, Canberra, p314.

[66]Groenewegen (1983), *op cit*.

[67]See Land *op cit*, (1975), and Watts, *op cit*, (1987). This was apparently part of a deal to forestall an increase in the Basic Wage. Supplementing the purchasing power of families through child endowment permitted heavier taxation of ordinary wage earners, and protected families from counter-cyclical sales tax policy changes.

[68]Groenewegen (1983), *op cit*, Appendix Table A2.

FIGURE 2: Statutory and effective rates of sales taxation, 1931-1996



4 Economic change and the `outdated and irrelevant' sales tax

As observed earlier, the sales tax base was substantially reduced at the outset by the policy of exemptions. Table 1 (above, p6) summarises the declining trend in the ratio of the wholesale sales tax base to GDP over the period 1931 to 1996. In the first full year of its introduction, the tax base covered 24% of GDP. By 1945, the tax base had reduced even further to 15% of GDP, compared to current levels of 14%. This suggests that the 1930s and 1940s were the critical period in the evolution of the sales tax.

An important factor in the declining GDP share of the sales tax base was economic change. The declining relative importance of private consumer spending substantially reduced the potential base for consumption taxation. For example, while consumer spending represented around 75% of GDP through the 1930s, this fell sharply to around 60% from 1942 (Table 1). This corresponded to a rise in the private investment share of GDP from around 5% pre-World War II to around 15% in the post-war period. The public sector share of expenditure has also risen, from 15% to around 20% of GDP, since the 1930s.[69]

However, the change in economic structure over the period does not support the argument that economic changes since the 1930s warrant replacing the sales tax with a GST.[70] The observed decline in the sales taxable share of GDP due to a decreasing consumption share would have similarly affected a GST.

[69]As government activities are not taxed, the expansion of government consumption and investment has commensurately reduced the potential size of the tax base in relation to GDP.

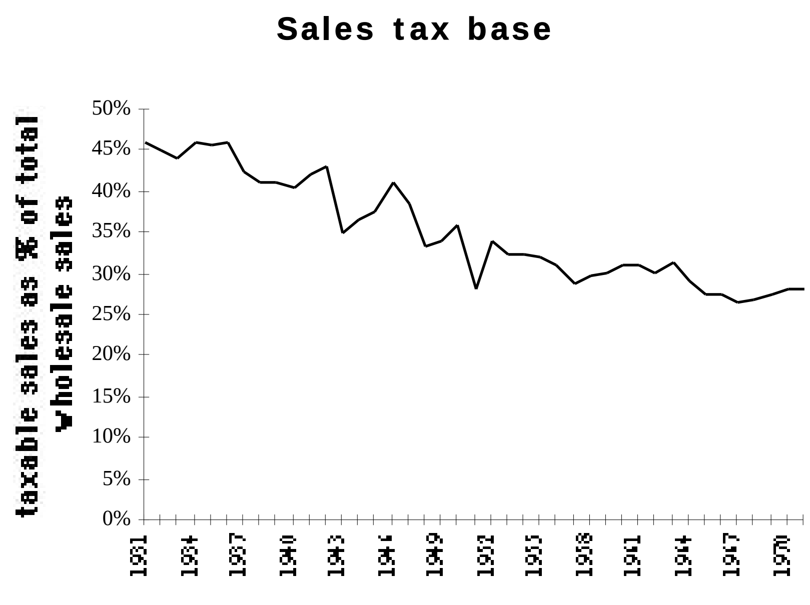
[70]This argument constitutes an important part of the Howard Government's rationale for its GST policy (CPD, 2 Dec 1998, p862).

Another view of trends in the wholesale sales tax base is provided by the ratio of taxable sales to total sales (Figure 3). This ratio provides a better indication of the effects of legislative change on the sales tax base. Around half of taxable wholesale sales were exempted in the original legislation of 1930, and exemptions were extended in the following decade. The main decline in the taxable share of sales occurred in the period prior to 1951, the ratio remaining approximately stable at 27% and 21% of private consumption spending from the mid to late 1950s.

The data shows that the significant episodes of legislative activity reducing the taxable field were in 1936-1940, and 1942-1944. In 1931, 44% of sales were taxed. In the period 1936-1940, the taxable share of sales was reduced by 5% points to 38%, while during the 1942-43 period it was reduced by a further 4% points. By 1943, taxable sales were already only 32% of the total.

As noted earlier, these exemptions from sales tax in the 1930s and 1940s were not obviously and simply an *ad hoc* response to the pressure of special interests. Rather they mainly reflected a policy of exemptions based on principles of equity and social values, and to a lesser extent, concern to minimise the effect on economic activity and employment in key industries of a rise in the general rate.

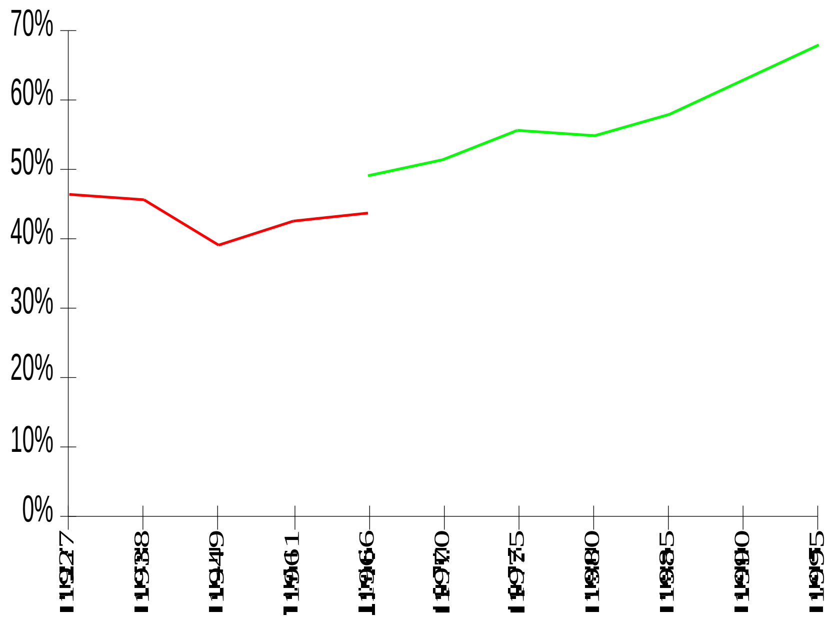
FIGURE 3: Sales tax base, 1931-1972[71]



[71]Source: Commissioner of Taxation (various years), *Report.*

Another common argument for replacing the sales tax with a GST is the expansion of services in recent times. However, as evident in Figure 4, services were an approximately stable share of GDP from around 1929 until at least the late 1960s.[72] The services share of GDP did not increase significantly until the early 1980s, by approximately 13 percentage points between 1980 and 1996.

FIGURE 4: Services share of GDP, 1927-1995[73]



Moreover, as noted earlier, sales tax collections increased, rather than decreased in importance over this period of an expanding services sector. WST collections increased to historical highs of 3% of GDP and 5% of private consumption spending in the late 1980s, and early 1990s. The rising revenue importance of the sales tax followed rate increases in the early 1980s, and base broadening activities in the second half of the 1980s. Between 1980 and 1996, taxable sales rose from 11 to 14% of GDP. These

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[72] Dowie J. A. (1970), `The service ensemble', in Forster C. ed., *Australian economic development*, Allen and Unwin, Sydney. Australia had achieved a high services share of GDP by world standards early in the century and before.

[73]Sources: Dowie 1970, *ibid*, p234, p260, for 1927 to 1966; Foster and Stewart (1991), *op cit*, Table 5.9, for 1966 to 1985; Australian Bureau of Statistics (1997), *Australian National Accounts National Income and Expenditure*, Cat No. 5204.0, July, for 1989-90 and 1994-95.

changes appear to reflect a policy of offsetting declining import tariff revenues through increasing sales taxation.[74]

5 Does the wholesale sales tax have no logic, no design, and no relevance to current economic and social circumstances?

Reflecting on the title of this paper, one merit of the WST might be its longevity. The tax has survived for more than six decades because its original design responded to Australian social values and the country's political economy. Will the same be said for the proposed GST in the year 2068?

The Commonwealth Treasurer has argued that the present wholesale sales tax should be abolished because it has `no logic or design'. This paper has challenged that assertion, showing it to be historically wrong, and superficial. It also suggests that the historical interpretation by the Commonwealth Treasury,[75] on which the Treasurer's arguments are based, misrepresents the origins of sales tax exemptions and multiple rates.

The Treasury interpretation of sales tax history in the 1930s and 1940s imposes a contemporary (and somewhat distorted) theoretical ideal for consumption taxation on the sales tax policymakers of the past. Such a conception of the perfect sales tax was explicitly considered and rejected at the time. This survey of the history and design of the WST suggest that such a model, which implies a GST on necessities such as food, may not be politically viable in Australia unless Australian society and attitudes have changed considerably in recent years.

This brief history shows that

- Tax fairness was a critical issue for Labour Prime Minister Scullin in designing the 1930 sales tax. Wide acceptance of certain basic equity principles for indirect taxation in Australia in 1930 resulted in the Commonwealth Parliament exempting half the potential sales tax base from the original 2 1/2% levy. The same equity principles underpinned the decision to introduce multiple rates in 1940. Exemptions from sales tax were mainly for food and other items considered `necessities' for working class households such as utilities and fuel. By 1940, these accounted for around two-thirds of the value of exemptions.
- `Fair' taxation encompassed more than just progressivity. It included other values, notably fairness to those supporting dependants, and to those facing higher than usual health or medical expenses due to ill-health or disability. Medicines were exempted for most of the period under study.
- It also incorporated non-taxation of socially valuable activities such as charities. Also implicit in the parliamentary debates was a recognition of the importance of

[74]See ABS (various years), *Taxation Revenue Australia,* Cat No. 5506.0.

[75]Commonwealth Treasury (1998), *op cit*.

the fiscal incidence of taxation. That is, the fairness of the tax depended on what the money was used for.

- An appropriately modified WST (which exempted `essentials') was Scullin's preferred new revenue source in 1930 because it:
  - replaced, rather than added to, revenues from customs and excise taxes, and approximately replicated their wide incidence. While indirect taxation was potentially regressive, customs and excise taxation in Australia has since Federation exempted the conventional necessaries of the working man like tea and kerosene;
  - avoided double-taxing a tax field being increasingly occupied from the late 1920s by state governments - low and moderate wage incomes - through bringing lower incomes into the federal income tax. Two or three years into the Depression, states were collecting half their income tax revenues from the new flat rate and proportional income and weekly wage taxes.
  - permitted the less well off population to largely escape the sales tax by avoiding consumption of `non-necessaries'. By contrast, an income or wage tax on the Basic Wage could not be avoided by living more frugally (although it could be avoided by not working), and was thus seen as less equitable than the modified sales tax;
  - was less likely to discourage work effort during the high taxation of the World War II, because the tax was less visible to workers than an income tax on their wages. Maintaining adequate work incentives was a concern of policy advisers contemplating introducing substantial income taxes on the ordinary wage earner. This group was more likely than the salaried or well-paid middle- and higher income taxpayers to reduce work effort in response to income taxation;
- Protecting the real living standards of ordinary wage earners, along with wage policy considerations, also appear to also have been a factor in the Scullin Labour Government exempting Basic Wage items from sales tax. During the Depression, workers would have been unlikely to be able to recoup the loss of purchasing power through wage increases. Sales tax rises on `essential' items were also avoided during WWII and later, to avoid fuelling inflation in increasingly tight wartime and post-war labour markets.
- Historically in Australia, the Commonwealth government has increased the yield of the sales tax by lifting the tax rate, rather than by widening the base. Broadly speaking, sales tax reductions have taken the form of wider exemptions rather than lower rates. (However, use of sales tax rate changes for economic management in the 1950s and 1960s makes the picture more complex).
- The present narrow base of the WST does not result from erosion by `rent-seeking' lobby groups in the post war period as assumed by many commentators. It mainly reflects the design principles implanted during the 1930s and early 1940s, the period covered by this study.
  - As a share of GDP, the sales tax base is little different now from what it was in 1945. The 6 percentage point decline in the share of the sales tax base in GDP since 1931 is substantially accounted for by the 15 percentage point fall in the GDP share of private consumer spending (PFCE) over that period.

- Economic change has affected the scope of the sales tax, but these changes in the importance of private consumption and the role of government would have similarly reduced the potential GST base.
  - A declining private consumption share rather than an increasing services share of GDP is the main factor in the historical decline of the sales tax base. However, from the early 1980s, expansion of services has contributed several percentage points to the declining WST share of GDP.
  - despite the effect of the growth of services, sales tax revenues reached historical peaks during the 1980s and 1990s, as revenues were increased by widening the base, and raising the rate of sales taxation. Sales tax collections appear to have largely offset the declining share of import tariff revenues in taxation over the last two decades.
- The taxable share of wholesale sales was already less than 50% when the sales tax was introduced in 1931. It declined further to around 32% by the early post-war period. Taxable sales remained around the same share of total wholesale sales for at least the next three decades for which official data is available.

The above examination of the history of the sales tax shows that social values were very important in designing the tax, and were not overridden by administrative priorities favouring simplicity and comprehensive coverage. Efficiency and simplicity are not the only concern of economists and economic policy.

While it is true, as Treasury says, that `what may be a luxury ... can evolve over time',[76] this is not a new problem. Since the inception of the sales tax, for example, there have been fierce debates about what is a basic food and should therefore be exempt. Classifying goods as `non-essential' requires judgements which produce different classifications in the 1990s than in the 1940s. However this need not allow administrative concerns about defining `non-essentials' or `luxuries' to override social values favouring preferential treatment of (whatever are deemed to be) `essential' expenditures. The economic costs of administration and compensating businesses for compliance costs are likely to be less than the economic costs of ameliorating the undesired distributional effects of an `unadulterated' GST.

The exemption of food and essentials from the WST reflected strongly held values about fairness in taxation, and can not be lightly dismissed or swept away in the design of a replacement for the WST. `Fair' taxation can often only be achieved through additional complexity.

The findings of this paper, that equity concerns have been fundamental to the design and evolution of the sales tax, puts the onus on those of the `rent-seeking' school to provide empirical support for their alternative view. The onus is also on those adhering to the rent-seeking model to show how they would prevent the presumed latter-day counterparts to these rent-seeking groups from similarly corrupting the proposed single-rate, comprehensive GST.

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[76]Commonwealth Treasury (1998), *op cit*, p29.

The conceptions of equity implanted in the current sales tax are evidently complex. Replacing exemptions for food and essentials with nothing more than means-tested assistance to narrowly- defined categories of social security and family assistance recipients risks losing sight of the more complex and richer set of distributional criteria and social values reflected in the present tax system.

The latter approach also ignores the issue of the public's trust (or lack of trust) in governments. Sales tax exemptions for food and other essentials of wage earner households survived both Depression and total war in Australia, despite the compelling revenue needs of those times. The Scullin government perhaps anticipated that such a structural element of the sales tax system was less vulnerable to the vagaries of future governments' annual Budgets, or to erosion by inflation, than direct `compensation' for sales tax for socially protected groups. Likewise, it can be argued, exempting food from the GST provides a more durable and certain guarantee that indirect tax reform is not a Trojan horse for major unheralded distributional shifts over the coming several decades of life of the new GST. This is especially so given the evident tendency for governments to raise tax rates over the long life of its predecessor, the wholesale sales tax.

Sales tax exemptions helped ensure the mass of wage earners contributed to public revenues but without generating work disincentives. Imposing the more visible income tax on low and moderate wage-earners risked discouraging work effort.

Indeed, exempting necessaries from consumption taxation is likely to be more economically efficient as a strategy for tax equity than direct compensation through the income tax and social security system.[77] To show that the Howard government's approach to ameliorating the regressive effects of a GST is less distorting than using exemptions to the same ends, the marginal deadweight losses from exempting food from GST must be shown to be greater than for exposing a greater population to potential poverty traps and high effective marginal tax rates through the proposed compensation package. The high effective marginal tax rates, work disincentives and poverty traps arising from the present interaction of income support payments with the income tax system is already a major issue in the Australian tax debate. Increasing the level and coverage of such payments to `compensate' for GST will bring many more into the net, and will have significant economic efficiency costs which may well exceed those resulting from certain exemptions from the GST base.

The history behind the sales tax suggests that the comparative invisibility of indirect taxation and its effects on price relativities, compared to the visibility of income tax and means-tests allows appropriate design of indirect taxes to provide some greater degree of policy freedom in meeting conflicting policy criteria of equity and efficiency, compared to loading all distributional objectives onto the progressive income tax and social security system.

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[77]Even if the wider and richer range of distributional goals of the WST identified above can be translated fully into direct, means tested compensation payments which is unlikely. For example, income alone is likely to provide little information to target transfer payments to those supporting children, or those with high pharmaceutical or health expenses. Exemptions can be an additional instrument for achieving social equity goals, which are not limited to progressivity or `vertical equity'.

Conclusion

Social protections and equity objectives are deeply embedded in our tax system in ways that have not been understood or acknowledged. Selective commodity taxation, achieved in part through certain exemptions from sales tax, has been a subtle strategy for reflecting social values about `fair taxation' in Australia's tax system. These insights provide some explanation of the paradox noted by Gilbert in 1943, of Australia's heavy reliance on (potentially) regressive indirect taxation despite the parliamentary strength of the labour movement. It also gives a deeper understanding of the protective institutional pillars in the `wage earner' state.[78]

These design features risk being swept away in the quest for the supposed Holy Grail of tax reform in Australia - a single-rate, comprehensive GST.

This study shows it is incorrect to suppose that `rent-seeking' lobbying eroded Australia's WST base - sales tax was introduced amidst a strong concern for social equity, and its exemptions and multiple rates entrenched social values protecting vulnerable groups. It is likely it achieved these distributional goals more reliably and more effectively than through comprehensive sales taxation offset by compensating direct transfers.

The design of the sales tax allowed these socially protected groups including the poor, the aged, Basic Wage earners, the ill or disabled, and those financially burdened by dependents, to contribute `a fair share' to public revenue without compromising their `health or efficiency.' This followed on a long tradition in Australia of raising revenue through indirect taxation of indulgences. The sales tax base as it is today is little different from how it ended the 1940s, after its basic structures were put in place in the circumstances surveyed in this paper. Apart from the expansion of services since the 1980s, economic change has not eroded the tax other than in ways which would have also affected a GST.

The relative stability of the sales tax structure since the 1940s also reinforces the point made by Head, that the taxation system has `quasi-constitutional' elements to it.[79] The observed stability in the basic structure of the revenue system is easily explained and justified, as major reform risks opening up a Pandora's box of controversy over hard won compromises on income distribution. This has important implications: there is little to be gained from a reformed and more efficient tax system unless it can be expected to apply without substantial variation over a considerable period.

> `Long term stability in the tax structure is ... of great importance in discouraging socially wasteful rent-seeking activities of lobby groups and vested interests seeking to change the tax system between major structural reforms. There is

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[78]Castles F. (1985), *The working class and welfare: reflections on the political development of the welfare state in Australia and New Zealand, 1890-1980,* Allen & Unwin in association with Port Nicholson Press, Wellington New Zealand and Sydney.

[79]For example, see Head J. (1983), `Issues in tax policy for the 1980s' in J. G. Head ed. (1983), *Taxation issues of the 1980s,* Australian Tax Research Foundation, Sydney, and Head J. and Krever, R. ed. (1997), *Taxation towards 2000,* Australian Tax Research Foundation, Sydney.

accordingly much to be said for the view that major tax reform exercises should be few and far between'.[80]

This suggests the need for developing some considerable degree of social consensus for `a new tax system' to reduce the likelihood of major changes after its introduction.

The argument that the tax system has quasi-constitutional elements also highlights the transitional costs of major changes to basic tax rules and structures. Some win and some lose - some of these distributional consequences will be judged obnoxious to public opinion, and transitional relief or offsetting compensatory measures will be legislated to ensure the reform package is broadly consistent with prevailing notions of equity. If the revenue or efficiency costs of transition or compensation measures are too great, the tax reform journey may not be worth it.

It has been said that `large scale and disruptive reform should reliably promise large benefits'.[81] This paper suggests that the reforms proposed under the GST package may well leave Australians with a tax/transfer system which less reliably or completely meets their distributional concerns.

The package potentially has adverse economic efficiency consequences because it leans on a substantial program of means-tested social security and related payments for its overall fairness. High effective marginal tax rates arising from pervasive income testing, and higher (usually income) taxation to finance such social equity measures, have significant economic efficiency costs. The relevant issue is whether these efficiency costs exceed those of instead using multiple rates of indirect tax or exemptions to achieve the desired social distributional outcomes. Because of the high economic efficiency costs of the `compensation' needed to make a GST including food publicly palatable, the net economic efficiency gains from reform are finely balanced and uncertain.[82]

Erosion of elements of the tax system which protect Australians' conceptions of fair taxation is a more certain outcome of the present reform exercise. There is a warning for Australia in the experience of the US during the 1980s, where the `tax reform' process allowed legislatures to bypass important questions about the desired distributional effects of taxation.[83] Tax reform in Australia should not be a Trojan Horse for substantial unannounced shifts in the distribution of taxation.

This paper has drawn on historical quotation from the designers of the sales tax to support a `benevolent government' interpretation of tax design, at least in the early to middle part of this century. This contrasts with the rent-seeking model currently in

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[80] Head and Krever *op cit* (1997), pxiv.

[81] Aaron H. (1996), `Tax reform: pitfalls and opportunities' in H. Aaron and W.G Gale, (1996), *Economic effects of fundamental tax reform*, Brookings Institution, Washington.

[82] Aaron (1996) *op cit*.

[83] It has been observed for the US, that rather than tax reform simply legitimising the effect of tax loopholes and inflation in reducing the progressivity of taxation, there should be an explicit legislative review of this central issue (Musgrave R. A. (1987), "Short of euphoria" *The Journal of Economic Perspectives* **1**(1), pp65-67).

vogue and apparent in the Commonwealth Treasury's interpretation of history. A response from the rent seeking school to these public utterances of the tax designers would be; `well they would say that, wouldn't they!'. The rent seeking school would expect base motive to be dressed up as high purpose, and would characterise the public record as a selective view of history. It is true that what went on behind the scenes could be less benign, and may be misrepresented by the public utterances of the key players. However, the evidence presented in this study on the stated objectives of those who gave the sales tax its present form places the onus on those of the rent-seeking school to test their case against the historical facts.

Of course, social values and political institutions may have changed. However, there remains the possibility that simply wiping the indirect `tax slate' clean with an untarnished, new tax may not result in durable reform. The opposition to a GST on food that is evident in public surveys suggests many Australians still view taxing household `necessities' especially food as intrinsically unfair. If this is the case, unyielding pursuit of `the perfect tax' through the supposed `ideal' of a single-rate, comprehensive GST may ultimately result in a more bastardised tax than if a theoretically `less than perfect', but more socially defensible and therefore politically robust, GST were introduced in the first place. Unless social values have changed considerably in the last five decades, even an initially comprehensive GST is also likely to be soon modified under public pressure.

An important implication of the `rent-seeking' view of history which presently has currency is that the comprehensive single rate GST is a `clean slate' of indirect taxation reform, which wipes away the results of past special interest lobbying, and allows a fresh start with `a new tax system'. However, those adhering to this view need to explain what will protect their initially exemption-free GST from similar forces and special interest lobbying as supposedly corrupted the sales tax so badly within its first decade or so of existence.

Those who fear exemptions encourage `rent-seeking' might also be asked to show that our present-day parliamentarians and policy processes are less able to resist such pressures than in the 1930s and 1940s.

This points to the fact that it may be preferable to acknowledge social values in the original design of the GST rather than to amend it later. If unrelenting public pressure forces the exemption of food after its introduction rather than as a design feature of the tax, this would set a precedent opening up the field for opportunistic and less justifiable exemptions to the tax. A rigid adherence to comprehensive coverage as a design principle for a GST may make it both unnecessarily regressive, and more vulnerable to corruption through special pleading.

All this is not to say that the present sales tax could not be improved, or is better than an appropriately designed broader based consumption tax such as a GST. However, both the base broadening and equity benefits of the GST arise substantially from its application to services, and to including value-added beyond the wholesale stage in the tax base.

The emphasis placed on the political difficulties or risks of allowing GST exemptions such as for food to make the tax fairer for families and lower income earners seems somewhat misplaced in the light of the contribution such exemptions could make to ensuring the tax system is more robust and certain in its distributional consequences, especially in the face of inevitable uncertainties about future GST increases and Budget cuts to compensation and social services.