The price of civilisation

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Carved into the plinth of the Internal Revenue Service building in Washington D.C. are the words "Taxes are the price we pay for civilization" – a quote from Justice Oliver Wendell Holmes. As those words may have inspired Presidents Roosevelt, Johnson and Carter, they have surely riled the "tax revolt" Presidents such as Hoover, Reagan and Bush.

It is easy for critics of government to present taxes as waste, as something we have to "give" to the government, as if government is some kleptocracy, rather than the means we use to fund and provide for our shared services – our common wealth. Some economists talk about the "deadweight" loss of taxation – referring to all the extra big screen TVs, $7000 barbeques and designer watches – we could have enjoyed if only those horrid people had not taken away our money and wasted it.

There are fewer voices, however, pointing out what we lose if we pay too little to support our common wealth – public schools, universities, hospitals, roads, parks, public transport, public broadcasting, defence, weather forecasting – to name a few. And we seldom stop to think what it would be like to live in a society without the support of a social welfare system.

Our enjoyment of life comes from a mix of private and public goods. There's little pleasure in being able to afford a fine house if it's in a filthy congested city where urban gangs have staked out their territories. There's little pleasure in owning a BMW 760 if there are no proper roads. Few would choose what John Kenneth Galbraith described as private affluence in the midst of public squalor.

Yet, that is the direction in which critics of so-called "big government" want to push us – a life with a diminished shared wealth.

Some would cope, particularly the super-rich, such as those 8000 Australians with declared annual incomes above one million dollars; they have the means to live a life apart from the local community. Who needs clean beaches when you own an island? Who needs public hospitals when an executive jet can take you to a clinic in Switzerland?

The rest of us, 21 992 000 lesser mortals, rely on public services.

The super-rich have influence, as we saw in the campaign against the mining tax, and they include in their ranks media proprietors, but on their own they can hardly mount the numbers for a tax revolt. They can, however, muster support from the discontented – the embittered "battlers", whose material aspirations are always just beyond their means, who see private schools and private health insurance as a means to set themselves apart from the proletariat (unaware of the public subsidies for those private activities) and who can be easily convinced by beat-up stories that their taxes are being wasted.

This movement, cobbled together from the super-rich and the embittered, still does not constitute a political majority – only a third of Australians believe their taxes are too high –

but they formed a firm basis for the Coalition to campaign in the 2010 election about stopping the "the waste, the debt and the big new tax", and for the government to have been so fearful that they dared not even promise a carbon tax during the campaign. More recently they have been in the forefront of opposition to a levy to pay for damage caused by natural disasters; their preference is to cut other government investments, on the basis that government is too "big" – without defining what they mean by "big" government.

The myth of "big government"

Although some will claim with a certainty usually seen in religious fanatics that government is "too big", it is never possible to say categorically that any country has a government which is "too big" or "too small". In fact, there is no clear notion of the "size" of government. It is not uncommon to find a government which is "small" in terms of its economic activity, but "large" in terms of its suppression of civil liberties: military dictatorships typically fit this pattern. By contrast the Scandinavian governments are large players in their economies, but they are minimalist in terms of constraining civil liberties.

Attitudinal research in Australia shows we are amenable to spending more on public services. If researchers go forth and ask Australians "do you want to pay more taxes?", the answer is fairly predictable: only 2 percent of taxpayers believe they are paying too little tax. If, however, such questioning is linked to specific areas of public expenditure, there is a reasonably strong willingness to accept increased taxes – in the order of 60 percent. (Details of these surveys, the most recent of which were conducted in 2008, can be found at the Australian Social Science Data Archive, http://nesstar.assda.edu.au.)

There are several explanations why we may have different views on taxes in general and on taxes for specific purposes. One explanation, frequently put forward by those opposing increased public expenditure, is that people believe that if taxes are increased, someone else should bear the burden. But even when researchers ask "would *you* be willing to pay more for public services?", there is still a positive response. Also, the belief that the burden should be re-distributed is not unreasonable: people are well aware of tax breaks that favour the well-off, including privileged treatment of family trusts, low taxes on speculative capital gains, tax subsidies for geared investment in housing, tax breaks for private health insurance, and a set of tax privileges for superannuation and retirement incomes that favour the well-off.

Another explanation, most frequently put forward by academic researchers, is that people don't trust governments to spend their taxes in accordance with their preferences. In part this is in recognition of the power of lobbies to divert public funds to private purposes. It is also because of acute awareness of government waste. Governments operate with the scrutiny of public audit offices, parliamentary committees and a vigilant press; private sector waste is far less visible. Also, the media has been too lazy in challenging Tony Abbott's three word slogans; his slogan during the election was "stop the waste", his slogan on his return from London was "profligate labo(u)r governments", in the hope that our government can be tainted by the previous UK Government's high public debt (he is still to learn that Australia is a sovereign country), and his slogan in relation to a carbon price and a flood levy is "big new tax". The only way for a government to avoid waste is to do nothing.

Perceptions of waste are heightened by a paradox in people's perceptions. People are aware of government cutbacks; older Australians can recall free universities, free prescription pharmaceuticals, a time before there were toll roads and even a period when pensions were exempt from means testing. They also know, however, that their taxes have not been falling: in fact, taxation revenue (Commonwealth, state and local) has been steadily rising over the last 50 years from about 22 percent of GDP to 30 percent of GDP at present. People are paying more but getting less.

The explanation is not waste; rather it is a fundamental shift in government outlays, particularly by the Commonwealth. Table 1 shows how social security (pensions and other personal benefits) and health care have absorbed more and more of the Commonwealth Budget, leaving far less for other areas of expenditure. There are many explanations for this shift. Ageing is the main explanation, but the other main casual factor is an increase in what may be called "middle class welfare". As our economy has opened up to competition our income disparities have widened, in part because of under-investment in our human and physical capital. As a result, governments have had to rely more heavily on personal cash benefits ("transfer payments" in the language of economists) to help close the income gap.

Table 1. Commonwealth Budget outlays

	1972-73	2010-11
Health	8%	14%
Social security and welfare	21%	29%
All other purposes	71%	57%
Total	100%	100%

Social security and health care tend to benefit specific population groups, while other programs, such as education and transport, tend to have widespread benefits, but these are the very programs that tend to be squeezed in government budgets. It is no wonder then, that most Australians feel that they are paying more and getting less in return. What they may not fully appreciate is that this is a direct result of the "small government" fad. Had we raised the taxes to invest in education, transport infrastructure, public health, energy and other productive public assets, we could now have an economy with less need for social security because more people would have well-paid employment.

Why we need to spend more

In light of this squeeze, it is hardly surprising that Australians would like to see more spent on public services. The priority areas are generally health and education, with environmental protection closely behind, followed by infrastructure. (Recent polling research has found that about two thirds of the electorate are in favour of a price on carbon.) Willingness to pay for defence tends to vary with the perceived threat level, and responses to questions about social security depend on framing – we are much more willing to pay for "pensions" than for "social security" or "unemployment benefits".

The other indicator of a gap in is to compare Australia's taxation and public expenditure with comparable countries. By such comparisons we have a small public sector and are correspondingly lightly taxed.

Table 2, using taxation data from the OECD, shows that at 30 percent of GDP Australia is lightly taxed in comparison with comparable countries. The table also shows the World Economic Forum's global competitiveness rankings, just to dispel any notion that high taxes are detrimental to economic growth. In fact the highly taxed northern European countries – Denmark, Finland, Germany, Netherlands, Norway and Sweden – all rank ahead of Australia on global competitiveness.

Table 2. Taxation and global competitiveness

	Tax revenues as% of GDP 2008	Global competitiveness ranking 2010
Japan	27.9	6
United States	28.3	4
Korea	28.7	22
Switzerland	29.7	1
Australia	30.6	16
Greece	31.3	83
Ireland	32.2	29
Canada	33.3	10
Poland	33.5	39
New Zealand	36.0	23
Germany	36.2	5
Czech Republic	36.4	36
Slovak Republic	36.4	60
Portugal	36.6	46
United Kingdom	36.6	12
Luxembourg	36.9	20
Spain	37.2	42
Netherlands	38.0	8
Hungary	39.3	52
Iceland	41.4	31
Austria	41.9	18
Finland	43.0	7
Italy	43.3	48
Norway	43.4	14
France	43.6	15
Belgium	44.4	19
Sweden	48.2	2
Denmark	48.9	9
OECD total	36.0	

There are qualifications to be made in interpreting such data. A comprehensive coverage of issues in interpretation is given by TaxWatch http://www.taxwatch.org.au. One of the main qualifications is that most other countries have some form of social security taxation to finance unemployment and retirement incomes, while Australia covers at least part of this requirement with compulsory superannuation; for comparison therefore we would have to add one to two percent to our tax take to cover this “privatised” tax.

As Ken Davidson has pointed out in the Spring issue of *D!ssent*, Australians have not complained about an increased compulsory diversion of their wages to superannuation, presumably because it has been met favourably by the financial sector: had the government’s policy been a three percent increase in payroll tax to fund public investment or public pensions, there would have been howls of well-orchestrated media protest, because the financial sector would have been deprived of their commissions.

The other main qualification concerns the US in particular. It is always held up as a low-tax-high-competitiveness example. (Neoliberals are apt to brush aside its near-death experience during the Global Financial Crisis.) But the US has a peculiar (and expensive) form of funding health care, mainly through employer contributions to health insurance firms, entrenched in enterprise agreements. The Obama reforms, if they are not blocked by the forces of self-interest, will add legislative backing to such deals, and will make it compulsory for most people to hold private insurance. In effect, the USA has resorted largely to a “privatised tax” to fund health care – a tax which does not show in official statistics. Also, in the USA, there are often layers of state and local charges on companies which appear in accounts under headings such as “developer contributions” rather than as taxes.

Furthermore, we can reasonably expect, in the wake of the Global Financial Crisis, that many OECD countries, including the larger economies, will have to increase their taxes to pay off their accumulated deficits. The average public sector debt in the OECD is in the order of 50 percent of GDP, and in the large low-tax economies, USA and Japan, public debt is expected to peak at 90 percent of GDP and 150 percent of GDP respectively. (Australia’s peak will almost certainly be less than 10 percent of GDP.) Some countries, like the UK, may resort to extreme fiscal stringency, but in order to avoid social unrest there will have to be some degree of tax increase.

That isn’t to suggest Australia has a healthy public balance sheet. Our debt may be low but, on the other side of the balance sheet, our public assets are in poor shape – and have been rendered into even worse shape by the storms of the recent summer. One factor contributing to Australia’s low ranking in the global competitiveness index is the poor state of our infrastructure, particularly our surface transport and internet bandwidth. In the 2010 federal election transport infrastructure – both urban and rural, and both passenger and freight – was clearly an issue, and the Treasury briefing for the returning government (the “Red Book”) identified the funding of infrastructure as a major budgetary challenge. The summer floods have made the situation worse; it is therefore irresponsible for a government, or an opposition aspiring to government, to suggest cutbacks in other public investments to pay for flood damage.

A feature of the Australian economy is that the machinery and skilled personnel which could be building new urban subways and long haul railroads are heavily committed to digging up minerals and building railroads to take our iron ore and coal to export ports. Our lightly-taxed mining sector is tying up resources badly needed for other purposes.

Tertiary education is another area of unmet need. While most developed countries fund tertiary education primarily from public budgets – the OECD average is 73 percent –

Australia funds only 48 percent of education from public budgets, a proportion which has been falling over the years. Over the 11 years to 2006, while other developed countries increased their public funding of tertiary education by 47 percent (in real terms), Australia's increase was only 6 percent. It may be argued that private funding can fill the gap, but, quite apart from equity implications, high private costs of education discourage many able people with limited means from studying (while privileging the well-off but less able), resulting in a lost opportunity to improve our human capital – and, in the long run, putting even more pressure on public budgets to supplement the incomes of those who have missed out on education.

Another demand on public revenue will be to transform our economy away from its high carbon-intensity. While most such re-structuring will involve private investment, there will be inevitable demands on public funds. For example, if we are to exploit our inland resources of solar, wind and geothermal energy there will need to be investment in new transmission lines, which, for reasons to do with network economics and risk, are unlikely to be provided by private investors. Also, the regional consequences of climate change are likely to require adjustment assistance in the form of compensation or adjustment assistance for lost livelihoods in some of our agricultural and horticultural communities – a point which has risen to prominence in relation the Murray-Darling Basin..

All these areas of public expenditure are important to our long-term prosperity, for they are about increasing our national productivity, particularly in preparation for a time when the resource boom will have run its course. Income from our natural resources is masking a poor recent record on productivity. We have been wrung out about as much as we can from the reforms of the Hawke and Keating Governments. The last 15 years of the Howard, Rudd and Gillard Governments have been characterised by a fear of reform and of the wrath of interest groups.

These budgetary pressures are in addition to the ongoing budgetary pressures of ageing, which will continue to place demands on our health care and age pension budgets. Some may advocate shifting responsibility for health care funding on to private insurers, but, as experience in the USA shows, and as described in previous editions of *D!ssent*, private insurance is a much more expensive way to fund health care than public insurance, without any therapeutic or other economic benefits.

There may be some expectation that private superannuation will relieve pressure on public pensions, but it will be many years before any more than a small number of retirees have adequate balances in their personal accounts, and it is possible in time the disparities in retirement incomes resulting from excessively generous tax breaks for superannuation will require a boost in the pension just to keep disparities in retirement incomes within limits.

How to pay – taxes and other means

So, if we want more public investment and more publicly-funded services, how might we collect funds? When we think about taxes we tend to think about personal income tax, but there are many other options. After all, personal taxes – personal income tax and the GST –

collect only half of all tax revenue, and there are non-taxation sources of public revenue as well, including returns from financial investments and user charges.

One outcome from the close election is a commitment that the Parliament will re-visit the Henry Review on Australia's Future Tax System. It may be recalled that when the Commonwealth released the Henry Review in May 2010 the Government's reaction was to rule out what it saw as some of the Review's more politically difficult recommendations, including bequest taxes, extensions of land tax, modest increases in capital gains tax, reductions in tax breaks privileging "negatively geared" personal investments, and making contributions to superannuation less regressive. In fact, it is possible that the Parliament will even re-visit some of the tax concessions excluded from the Henry Review's terms of reference, including the Howard Government's abolition of tax on retirement incomes.

The only difficult recommendation which the Government has tried to pick up was a 40 percent resource rent tax – subsequently watered down and narrowed in scope. The Government failed to explain the purpose of this tax, which is primarily to act as a counter-cyclical measure. It should collect high revenues when commodity prices are high, and, as it was originally envisaged, it would have returned revenues to the mining sector in times of depressed prices. It is primarily a mechanism of fiscal stabilisation, not a means of raising revenue in the long-term. It's a worthwhile tax, but it cannot be counted on for a long-term revenue stream, and there is a strong case against including it in the Government's fiscal projections.

So, in conclusion, what are the most promising candidates for boosting public revenue? Let me gather them in five categories – better fiscal discipline, removal of rorts, investment returns, user charges, and new or extended taxes.

1. Fiscal discipline:

There are areas of public expenditure that fail the tests of market-failure. Governments often subsidise gala events such as sporting activities. They pledged large amounts to host the 2022 soccer World Cup, for example, even though there is no economic reason why governments should subsidise spectator sports any more than it should subsidise rock concerts; they do not fit economists' criteria of public goods. Similarly there is no case for many industry subsidies.

One of the victims of neoliberal "reforms" of the 1980s and 1990s was to reject established theories on the economic role of government and, ironically, that has resulted in many instances of governments remaining or becoming involved in activities which are not economically justified.

2. Removal of rorts:

There are plenty of candidates. Among personal rorts there are rebates for private health insurance and generous subsidies to private schools, generally favouring the well-off. Superannuation tax concessions, both in the contribution phase and in the pension phase, favour high-income and high-wealth individuals. Successive governments have left in place generous concessions for family trusts. One of the more irresponsible moves of the Howard Government was the change to capital gains taxes in 1999 – a set of changes which abolished tax neutrality by halving the tax on short-term speculation, while increasing the tax on long-term patient investment.

Removal of some rorts may have only a modest effect on public revenue. For example, restoration of neutrality in capital gains taxation would remove economic distortions without necessarily collecting more revenue. But if people are to comply with taxation policy, and are not to mount political opposition to tax reform, the tax system must be perceived to be fair.

3. Investment returns:

It may come as a surprise to many to learn that the Commonwealth has been in "structural deficit" since 2006-07 – a period which includes the last two Howard/Costello budgets. A budget may be in a cash and even an accrual surplus, as these budgets were, but if the surplus results from temporary revenues or savings, the budget may be in structural deficit. One way to make use of a temporary surplus is to invest in a wealth fund, and to use the earnings of the fund to supplement taxation revenue. In this regard Norway provides an example with its *Statens pensjonsfond utland*, an example which could be followed by Australia's resource tax.

Australia has gone in the other direction, however; rather than investing we have divested. At one stage governments owned many business enterprises, and the dividend streams were useful supplements to government revenues. Many of the privatisations of the last thirty years have been economically defensible: for example, the case for public ownership of an airline may have been strong in the early postwar years but it has not been necessary in more recent times. Some industries, once considered to be natural monopolies, can be subject to competition: a case in point is provided by retail telecommunications.

There are other industries, however, which should not have passed out of public hands, including water and electricity supply, where commercial objectives of profit maximisation necessarily conflict with conservation and public revenue objectives. In a competitive environment (which is hard to achieve for such geographically-bound industries), low prices encourage excess-consumption. On the other hand, if firms can exploit their monopoly power, there may be some conservation of resources, but the monopoly profits accrue to the investors rather than to the public. Regulators' permissive pricing of electricity utilities have tended to encourage the latter outcome.

4. User charges:

One of the Henry Report's recommendations was for motor vehicle taxes to be replaced, in time, with comprehensive road user charging. This would place a charge on vehicle *use* rather than vehicle *ownership,* and would spread the costs of road wear and environmental degradation more rationally and fairly. Australia has some of the world's lowest taxes on gasoline, and they have been falling in real terms since the Howard Government abolished indexation of excise in 2001.

Economists have traditionally regarded roads as "non-excludable", meaning that it is impractical to charge road users directly. Instead governments have relied on proxy charges, such as fuel taxes and registration fees. In recent times state governments have allowed the private sector to construct a number of toll roads in urban areas. These have provided physical infrastructure, but there are severe economic distortions when a tolled road is provided within an otherwise "free" network: the toll road remains under-utilised and alternative untolled roads attract heavy traffic, with associated costs of pollution and congestion – "deadweight loss" in economists' terms. Also, tolling is quite impractical for long-distance roads.

The Henry Report recognises that technologies will allow for all road use to be charged, doing away with other transport taxes. Politically, such charging may be hard to sell, particularly in country regions, but if congestion and pollution costs are properly covered, the highest charges would be for urban peak time travel, and country users could even find themselves paying less than they do at present.

5. New taxes:

The stand-out candidate is a carbon tax. Even if Australia opts for a cap-and-trade system rather than a carbon tax, there will be revenue from the auctioning of permits. While some revenue will necessarily be directed to helping individuals and firms adjust to changed energy prices, there should still be funds to supplement general taxation revenue.

Another candidate is inheritance tax, as suggested in the Henry Review. Governments aren't attracted to inheritance taxes, in part because they are slow to realise revenue. There are historical objections to inheritance taxes, because, in times past, parents tended to die when their children were at the phase of life when their demands were heaviest. With longer life expectancies these days, parents tend to die when their children are past that period of greatest need. With proper consideration for genuine hardship, such as may exist in some family businesses, it should not be difficult to introduce an inheritance tax.

Finally, there is recourse to traditional taxes, including income taxes. The accepted wisdom is that it is difficult to tax businesses and those on high incomes, because firms and businesses are internationally mobile. In 1970 the top individual marginal tax rate was 68 percent and the corporate tax rate for public companies was 47.7 percent. These rates are now 45 percent and 30 percent (falling to 29 percent) respectively. The Henry Review reflects the accepted wisdom, suggesting that taxes should be concentrated more on non-moveable resources, such as minerals and land. There is merit in this argument, but in the light of the Global Financial Crisis it may be wise for policymakers to reconsider the accepted wisdom, for, as pointed out above, many countries could be forced to raise their personal and corporate tax rates. Moving a company to Ireland to take advantage of its ten percent corporate tax rate looks less attractive than it did three years ago.

Of course proposals to increase taxes will be met with protest. Business executives with seven figure salaries will find ways of framing their personal greed in terms of the public good. The Opposition, particularly the present Opposition, will mount a campaign of fear and hysteria. As demonstrated by recent history, Coalition parties in Opposition try to make the country ungovernable so that they can associate the resulting chaos with the government. A savage cutback in public services and an

> economically crippling failure of our infrastructure would be politically ideal for the Opposition.
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> The Government, including those on the cross-bench who keep it in power, should anticipate this tactic and work to capture the high ground in the tax debate. That means leadership, in terms of sharing with the community the options we face, and presenting taxes not as a burden to be borne but as a means of enjoying a richer common wealth.

Perhaps a first step may be to carve a statement in the base of our Treasury building.