

Taxation with Misrepresentation

Australia's Revenue Lobby in Denial

The well-off are paying a lot of tax, explains
Sinclair Davidson

The revenue lobby has propagated a range of myths over the years in order to sustain Australia's high tax regime. The first myth is an absolute denial: that Australia is a 'low-tax' economy. Comparisons with other regional economies, and even the OECD, however, show this argument to be false.¹ A second myth is that high progressive personal taxes compensate for 'regressive' indirect taxes. A third myth is that taxes only appear to be high, but avoidance is so common that, in fact, taxes on the rich are low. In any event, progressive taxes are 'fair'. The 'rich' can afford to pay more, and so on. Readers will note, however, that each argument is a retreat from a previous position. Ultimately, however, these myths are an inter-related web of distortions, evasions, and half-truths designed to stifle public understanding and rational debate on the tax burden borne by Australians. The level of confusion is so great that the Greens were able to state in their 2004 election economic policy 'At present, Pay As You Go (PAYG) taxpayers on low

to middle incomes pay more tax in proportion to their income than people on high incomes'.²

In my monograph 'Who pays the lion's share of income tax?' I asked, and answered, James Buchanan's question, 'Who finally pays for the public expenditures that are financed through the income tax?'.³ The answer, in short, is that high-income earners, the top 25 percent of the income distribution, pay 64 percent of income tax, net of rebates, credits and Medicare. This analysis, based on Australian Taxation Office (ATO) data, caused some discussion and consternation among elements of the revenue lobby. Wayne Swan, quoted in the *Canberra Times*, said that 'Basically, these people are Neanderthals who want a system where average people work for nothing and pay all the tax. They

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have one mantra: lower wages, higher taxes for low-income earners. They should go back to the Dark Ages where they belong'.⁴ John Quiggin opined that 'it appears as if Davidson is entirely unaware that the vast literature on tax incidence even exists'.⁵

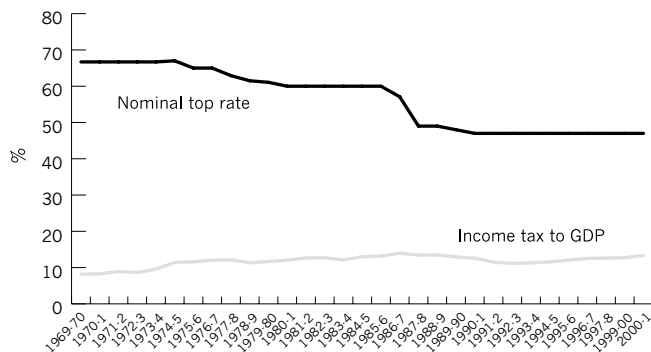
Two arguments, in particular, were reiterated: progressive income tax compensates for regressive indirect taxes and tax avoidance and evasion are so common that the tax burden is not high. Both of these arguments, however, are false and in this article I demonstrate that they are yet more attempts to misrepresent the reality of high taxation.

Who bears the burden of taxation?

The single largest component of Australian taxation is the personal income tax. Figure 1 shows the top marginal tax rate and the income tax to GDP ratio over the period 1969-70 to 2000-01. In that time, the top marginal tax rate has declined from 66 percent to 47 percent (excluding levies). The income tax take of GDP has increased from 8.16 percent to 13.33 percent. Over the same period, personal income tax, as a proportion of total tax, had increased from 37.3 percent to 40.8 percent.

'Who pays the tax?' is a simple question. Economists, however, tend to provide complex answers. Many economists might answer this question by undertaking a tax incidence analysis.⁶ This type of analysis involves estimating the distribution of tax by income class, but it can be misleading. For example, incidence studies do not actually answer the question, 'Who pays the tax?' Rather they provide information on the impact various taxes have on individuals, or households, by income class. To the extent income is not the

Figure 1: Nominal top marginal income tax rate and income Tax to GDP, 1969-70 to 2000-01

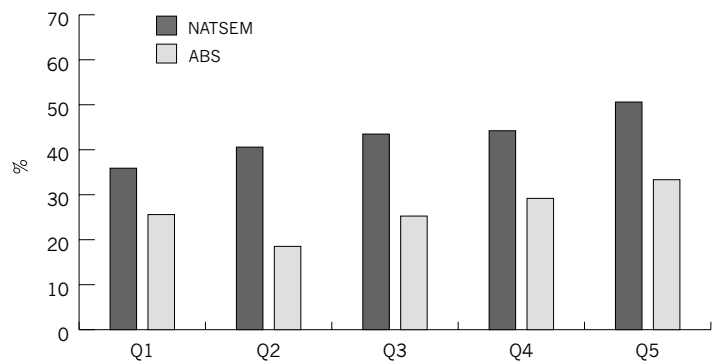


Source: OECD and Parliamentary Library.

base for all taxes, a distorted view of the tax system can emerge and, I shall argue, does emerge. This distortion arises due to 'sin taxes', which are levied in order to raise the prices of some goods.

The Australian Bureau of Statistics (ABS), and Ann Harding and Neil Warren of the National Centre for Social and Economic Modelling (the NATSEM study) have produced Australian tax incidence studies. In criticising my monograph, John Quiggin made the argument that income tax is progressive in order to compensate for regressive indirect taxes.⁷ In fairness to Quiggin, this argument does have a respectable pedigree.⁸ As his evidence, Quiggin cites the NATSEM study.⁹ Taking their results at face value the NATSEM study, apparently using data from 1996-97, reports the tax burden for low-income households (the bottom 20 percent) to be 36 percent of gross income and 51 percent of gross income for high-income households (the top 20 percent).¹⁰ Quiggin, at his website, argues that

Figure 2: Total tax as a percentage of gross income



Source: ABS Cat. 6537.0 and NATSEM.

these two numbers (36 percent and 51 percent) are 'roughly proportional'.¹¹ The ABS, using 1998-99 data, reports that the lowest 20 percent of households pay 26 percent of gross income in total tax, while the top 20 percent pay 33 percent of gross income in total tax.¹² Results for all household quintiles are shown in Figure 2. In comparison, my result seems alarmist.

Before looking at the detail of the data underpinning these results, we need to examine the concepts 'income' and 'total tax'. Both studies include private income (that is, income earned from employment etc.) and benefits from the welfare system in calculating gross income. For low-income

households, the welfare system contributes the bulk of all income. I estimate, using the ABS data, that for 60 percent of households, government benefits (excluding health and education) are greater than total tax.¹³ To paraphrase James Buchanan, these households do not pay for the public expenditure that is financed through tax. Only households in the top two quintiles pay more in tax than they receive in benefits. In other words, all public expenditure, net of welfare, is paid for by 40 percent of households.¹⁴

The NATSEM study recognises the difficulty in dealing with various definitions of income and so calculates tax as a proportion of household expenditure. Total tax makes up 32 percent of low-income household expenditure and 87 percent of high-income household expenditure. Private income, however, only makes up 12 percent of low-income household expenditure, but comprises 171 percent of high-income household expenditure, because they earn more than they spend. The Australian tax and welfare system is a merry-go-round. A large portion of government benefits is spent paying (indirect) taxes. Taxes are collected from high-income individuals, paid as benefits to low-income individuals so that those same individuals can pay tax. Peter Saunders writes, 'The welfare state is mainly a system for recycling our own money back to us.'¹⁵ While this activity may sustain a vast bureaucracy, it does not seem to be consistent with efficiency or economy in tax collection.

Taking the data at face value, it seems that the Australian tax system is progressive, and remains progressive even after indirect taxation is accounted for. Quiggin's argument is not supported by the data.¹⁶ Both the ABS and the NATSEM study concluded that the tax system, overall, is progressive. The NATSEM study concludes:

The overall impact of the tax system appears to be progressive, as the progressive impact of income taxes is not fully offset by the regressive impact of indirect taxes. This conclusion appears to hold irrespective of whether the measure of the economic resources of households is gross income, equivalent gross income, current weekly expenditure or equivalent current weekly income.¹⁷

Sin taxes

The technical detail in the NATSEM study is worth examining. Though it is a well-executed study, observers should be aware of the caveats the authors introduce, and their data description. The general caveat, in part, reads as follows:

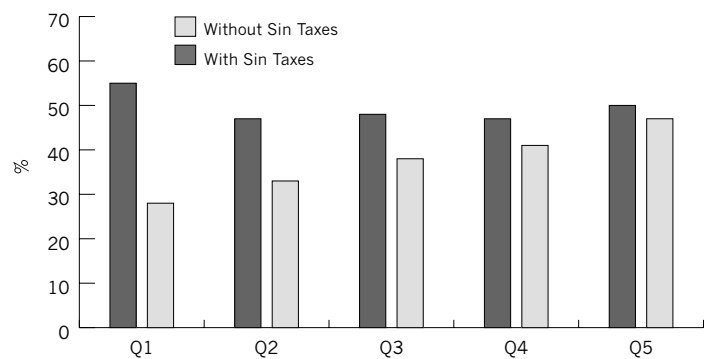
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NATSEM research findings are generally based on estimated characteristics of the population. Such estimates are usually derived from the application of microsimulation modelling techniques to microdata based on sample surveys.

These estimates may be different from the actual characteristics of the population because of sampling and nonsampling errors in the microdata and because of the assumptions underlying the modelling techniques.

The data used in the study are actually from the 1993-94 ABS Household Expenditure Survey.¹⁸ The authors report that 'The deficiencies of this survey as a basis for estimating the incidence of taxes are *well known* and *severe*' (emphasis added).

Figure 3: Impact of 'sin' taxes



Source: NATSEM.

For example, survey respondents under-report 'sin taxes', and the data do not include 'lumpy income items such as capital gains'. How important is this omission? The NATSEM study makes the point that indirect taxes are regressive, 'the poor pay a high proportion of their income as such taxes than do the rich . . . because those on higher incomes save more of their income'.¹⁹ A large component of the return to saving, however, is going to be the 'missing' capital gains—which are taxed. In other words, tax (and, also income) for high-income households is understated.

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NATSEM undertook an analysis of the likely impact of under-reporting by grossing up reported alcohol and tobacco expenditure and calculating total taxes including the grossed up 'sin' taxes. I have graphed the results in Figure 3, comparing households that consume both alcohol and tobacco to those that consume neither alcohol nor tobacco. The comparison is very interesting. For those households that minimise their 'sin' taxes the Australian tax system is very progressive. Indeed, based on an analysis such as this one could almost claim that the only regressive component of the Australian tax system is the 'sin' taxes.

The tax system including 'sin' taxes appears to be regressive. Not too much can be made of this though—the extent of under-reporting introduces bias and the NATSEM assumptions may not reflect the 'true' incidence of alcohol and tobacco consumption. What is important, however, is the progressivity of the tax system sans 'sin' taxes. To the best of my knowledge, no one in the revenue lobby advocates restoring progressivity in the tax system by abolishing 'sin' taxes.

Taking into account that the data itself suffers from severe problems, what did the authors actually do? The data actually relate to the 1993-94 financial year and was 'aged' to 1996-97 using changes in national averages of income and CPI, and then re-weighted using 1996-97 population characteristics.

Welfare payments were 'imputed' and income tax liabilities were 'modelled' and 'imputed'. For example, consider the treatment of corporate tax. They assume the economic incidence of this tax is 50 percent on shareholders and 50 percent on consumers.²⁰ This assumption is likely to overstate the tax liability of low-income households. In short, a lot of guesswork went into the model and many, many simplifying assumptions made. The caveats are important and the results are likely to be sensitive to underlying assumptions and 'imputations'. At a minimum, tax for low-income households is likely to be overstated, while tax for high-income households has been understated. Quiggin, and the revenue lobby, would rather use this study, than the ATO data, to show that progressive income tax 'compensates' for regressive indirect taxes.²¹

What about tax avoidance and evasion?

Tax avoidance consists of those activities where income and assets are legally transformed from a high-tax incidence to a low(er) tax incidence. The revenue lobby likes to emphasise tax avoidance as high-income individuals have greater scope for this type of activity than low-income individuals. Tax evasion is the illegal non-payment of taxes. The potential for tax evasion is probably evenly spread across the income spectrum. It is concentrated in those areas where individuals are able to access the cash economy, or otherwise conceal economic activity from the ATO. Many PAYG taxpayers would not be able to engage in tax evasion.

The revenue lobby often minimises and obscures the difference between tax avoidance and tax evasion. This point is well illustrated by an ATO press release, which reads in part, 'Three advisers to a *tax-minimisation scheme* have been jailed in the West Australian Supreme Court for five years each for attempted tax fraud of around \$26 million' (emphasis added).²² Compare that with the words of Judge John McKechnie, 'At the heart of this case was fraud, *not* a tax-effective scheme' (emphasis added).²³ The impression from the ATO press release and reading the newspaper is very different. The ATO give the impression that the advisors were jailed for tax avoidance, whereas the judge makes very clear that the case was not about avoidance at all.

It is common, however, for the revenue lobby to confuse, deliberately or otherwise, the issues. Consider the following quote in John Quiggin's book *Taxing Times*:

The other main development of the 1970s was the rise of the tax avoidance industry. Rising tax rates and a decline in business morality contributed to the growth of tax avoidance. However, the tax avoidance industry was largely the creation of one man, Garfield Barwick. As Chief Justice of the High Court, Barwick popularised the term 'tax avoidance'—in contrast with outright evasion—as a euphemism for methods of dodging tax that relied on artificial legal devices.²⁴

It is incorrect to argue that tax rates were rising in the 1970s. Figure 1 shows, if anything, that personal income tax rates fell in that period (though the tax burden rose due to inflation-driven bracket creep). Similarly, Quiggin provides no evidence of 'a decline in business morality.' Overall, the quote is misleading. For example, we get the impression that 'tax avoidance' was invented, in Australia, by an activist judge, Garfield Barwick, in the 1970s. The notion that Barwick was an activist judge is incorrect. Barwick's judgements were in the finest tradition of the common law. The words of the highly regarded US judge, Justice Learned Hand (1947) are instructive here:

Over and over again, courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.²⁵

Similarly, Lord Tomlin in the House of Lords had ruled, most conclusively and until 1977 binding on Australian courts, as follows:

Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however

unappreciative the *Commissioners of Inland Revenue* or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.²⁶

Lord Clyde, also of the House of Lords, had argued several years earlier:

No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property to enable the Inland Revenue to put the largest possible shovel into his stores.²⁷

The notion that tax avoidance, or 'strict literalism' was invented or promoted by Barwick is a myth. Under the common law, and in a society governed by the rule of law, it is nonsense to argue that

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individuals should maximise their tax burden. Geoffrey Walker has already argued these points, and in particular condemns the rise of 'direct bureaucratic rule', the collapse of the rule of law in tax matters and the decline in the separation between the three branches of government in revenue matters.²⁸

Quiggin tells us that Parliament rejected Barwick's interpretation of the law and endorsed Murphy's views 'that legal interpretation should be based on the intentions of Parliament'. In response to this type of argument the famous banker, J.P. Morgan argued, 'If the Government objects to tax [avoidance] it should change the law. Congress should know how to levy taxes. It is not up to us taxpayers to repair the mistakes of Congress.'²⁹ To argue against tax avoidance requires citizens to comply with a stricter interpretation of the tax law than the Parliament has the political will to impose. Given the obvious relations between the ATO, Treasury and Parliament, and the extraordinary broad powers the ATO has to pursue revenue, it is reasonable to believe that the existing tax laws minimise avoidance.

Tax evasion is a more complex issue. Evasion may range from failure to declare income through to complex criminal behaviour. The ATO provides detailed information on its attempts to overcome both avoidance and evasion. In 2003-04, the ATO identified \$6.4 billion in compliance liabilities and collected about \$4.5 billion from compliance activities.³⁰ The operating budget for the ATO in that financial year was \$2.2 billion. Fifty percent was spent on compliance, however, the proportion spent on anti-avoidance and anti-evasion activity

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is not clear. The question is, 'How much more revenue is there to collect?' Christopher Bajada has estimated the underground economy to be 15 percent of GDP.³¹ Assuming that this entire amount is otherwise legal activity, a tax take of 23 percent and an economy of \$750 billion, this amounts to \$26 billion. The ATO has substantial room for improvement. If, however, most of the underground economy is activity the government would rather suppress than tax, then the ATO may have little room for improvement.

The scope for both tax avoidance and evasion is largely a function of the complexity of the tax system itself. Geoffrey Walker has documented the complexity of Australian tax law. There is, however, a further complication. As Blum and Kalven indicate:

It is remarkable how much of the day-to-day work of the lawyer in the income tax field derives from the simple fact that the tax is progressive. Perhaps the majority of his problems are either caused or aggravated by that fact.³²

A proportional tax system would reduce much of the complexity of the current system, reduce the costs of compliance, and reduce the incentives to avoid and evade tax. To the extent policy elites have chosen an inefficient tax system, they are choosing to impose high costs on the economy.

Conclusion

The revenue lobby in Australia have succeeded in maintaining a barrage of arguments in favour of progressive income tax. The facts, many of them set out here and in other CIS publications, do not sustain those arguments. The top 25 percent of income earners pay 64 percent of the personal income tax. This result, based on ATO data, stands up to criticism. The argument that low and middle-income earners pay more of their income in taxation than high-income earners is simply false. It is not even 'roughly proportional'. Arguments about tax evasion and avoidance are red herrings. Even if evasion and avoidance were serious problems the top 25 percent of income earners still pay 64 percent of personal income tax and 40 percent of households still pay all tax net of welfare. Nobody should be surprised that high-income earners pay more in tax than low-income earners. That is how a progressive tax system is meant to operate. The revenue lobby's arguments do not stand up to scrutiny. Through their campaign of confusion and obfuscation, however, they are able to sustain a policy of taxation with misrepresentation.

Endnotes

- ¹ P. Saunders and B. Maley, *Tax Reform to Make Work Pay*, Policy Monograph 62 (Sydney: The Centre for Independent Studies, 2004).
- ² The Greens National Economic Policy. www.greens.org.au/policies/economics/taxandvenue.
- ³ See S. Davidson, *Who Pays the Lion's Share of Personal Income Tax*, Policy Monograph 63 (Sydney: The Centre for Independent Studies, 2004); James M Buchanan, 'The icons of public debt', in *Debt and Taxes: Volume 14, The Collected Works of James M Buchanan* (Liberty Fund: Indianapolis, 2001)
- ⁴ A. Fraser, 'Wealthy pay most of our tax: report', *The Canberra Times* 3 June 2004, p. 9.
- ⁵ Quiggin maintains a web-log at www.johnquiggin.com. His discussion of my CIS monograph can be found at www.johnquiggin.com/archives/2004_06 (Fun and Fury, Part II).
- ⁶ I will discuss, in some detail, two such studies below. The classic US study in this field is by Pechman and Okner who found that the US tax system was 'essentially proportional for the vast majority of families' (p. 10). J. Pechman and B. Okner, *Who Bears the Tax Burden?* (Washington, D.C.: The Brookings Institution, 1974).

- ⁷ There is confusion about the terms ‘regressive’ and ‘progressive’. Strictly speaking progressive taxation implies that tax paid as a percentage of income rises as income rises and regressive tax implies that tax paid as a percentage of income falls as income rises. By these criteria, however, few taxes will be proportional and most taxes (except progressive income tax) would be ‘regressive’.
- ⁸ Friedrich Hayek has indicated this is the *only* valid argument in favour of progression (*The Constitution of Liberty* (Chicago: University of Chicago Press, 1960).)
- ⁹ Quiggin also made this argument in his book *Taxing Times: A Guide to Australia’s Tax Debate* (Sydney: UNSW Press, 1998), p. 21, before the publication of either study.
- ¹⁰ A. Harding and N. Warren, *Who Pays the Tax Burden in Australia? Estimates for 1996-97*, NATSEM Discussion Paper no. 39 (1999). These results are based on an analysis of household income and expenditure. They do not investigate individuals per se. The Australian tax system has individuals as its unit of analysis.
- ¹¹ When challenged on the validity of 36 percent being ‘roughly proportional’ to 51 percent Quiggin backed away from that statement. He, however, has subsequently repeated his ‘roughly proportional’ claim. On June 10, he argued that tax avoidance led to the tax system being roughly proportional for high and low income earners.
- ¹² Australian Bureau of Statistics, *Government Benefits, Taxes and Household Income 1998-99*. Cat. 6537.0 (Canberra: ABS, 2001). I calculated the percentage of ‘Total taxes allocated’ to ‘Gross Income’ to arrive at these statistics.
- ¹³ I have defined ‘benefits’ as all direct benefits (age, disability and veterans pensions, unemployment and family payments and ‘other’) and some indirect benefits (housing benefits and social security and welfare benefits). Specifically, health and education are not included in my calculation here.
- ¹⁴ The ABS, however, do not model all taxes and their analysis is incomplete. The NATSEM study is ‘more’ complete.
- ¹⁵ Peter Saunders, *Australia’s Welfare Habit and How to Kick It*, (Sydney: Duffy & Snellgrove, 2004) p. 168.
- ¹⁶ Quiggin is in a difficult position. He had argued in *Taxing Times* (p. 21) ‘the tax system as a whole is roughly proportional. The progressivity of income tax is offset by the regressivity of most other taxes ...’. He provided no evidence in support of that statement and subsequent evidence contradicts him. Rather than modify his original position, he has chosen to brazen out any criticism.
- ¹⁷ Harding and Warren, *Who Pays the Tax Burden?*, p. 34.
- ¹⁸ The ABS study discussed above is based on the 1998-99 Household Expenditure Survey. The caveats relating to that data are set out in ABS Cat. 6537.0 pp. 44-45.
- ¹⁹ Harding and Warren, *Who Pays the Tax Burden?*, p. 2.
- ²⁰ Corporate taxes are paid either by consumers, in the form of higher prices, or by shareholders in the form of lower returns. Economists have not managed to untangle who pays corporate tax, or the rate at which different individuals pay the corporate tax. A fifty-fifty split, however, is entirely an arbitrary and, as the NATSEM study acknowledges, controversial assumption.
- ²¹ Quiggin, at his web site, writes that ignoring this study is an oversight and even a fallacy. ‘Davidson’s ATO data proves nothing more than that the income tax scale is progressive. The Greens, and many others, assert that tax avoidance is sufficient to offset this progressivity.’ Conveniently, for the Greens, Quiggin also argues ‘This is hard to prove either way, but Davidson has not even addressed the issue’ (see www.johnquiggin.com/archives/001837 Greens Economic Policy Part 3).
- ²² Advisors to tax minimisation scheme jailed for 15 years. www.ato.gov.au/corporate/content.asp?doc=/content/mr2004053.htm
- ²³ Quoted in *The Australian* July, 14, 2004. ‘\$27m tax fraud trio jailed for five years’ p. 7.
- ²⁴ Quiggin, *Taxing Times*, p. 7.
- ²⁵ Judge Learned Hand, *Commissioner vs. Newman*, 159F. 2D 848, 850-851 (CA2 1947)
- ²⁶ *IRC v. Duke of Westminster* (1936) 19 TC 490, [1936] AC 1.
- ²⁷ *Ayrshire Pullman and Ritchie Motor Services v. IRC* (1929) 14 TC 754.
- ²⁸ G. Walker, *The Tax Wilderness: How to Restore the Rule of Law*, Policy Monograph 61 (Sydney: The Centre for Independent Studies, 2004).
- ²⁹ Quoted in J. Coffield, *A Popular History of Taxation: From Ancient to Modern Times*, (London: Longman, 1970). J.P. Morgan used the term ‘evasion’ but, according to Coffield meant the term ‘avoidance.’
- ³⁰ ATO Compliance Program. www.ato.gov.au/taxprofessionals/content.asp?doc=/content/47980.htm
- ³¹ C. Bajada, ‘Estimates of the underground economy in Australia’, *Economic Record*, December 1999, pp. 369– 84.
- ³² Walter Blum and Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, (Chicago, University of Chicago Press, 1953) p. 15.