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History of tax theory and reform concepts

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Abstract

Tax is a fascinating policy space that brings together a mix of economic, social, legal, accounting and administrative policy issues, heavily overlaid with the political process. It is also contentious. A country's tax system establishes how the burden of funding government services is shared in a community and changes to that are transparent. There is a lot at stake. The tax system has multiple objectives and policy inter-relationships. Tracing the history of tax theory illustrates how these considerations have been balanced by societies and their governments. Tax theory matters because consideration of tax reform requires a view of what the tax system should look like. The art of tax reform then, is about getting from where we are to where we want to be. The benchmark for the theoretically ideal tax system, though, has been much debated in the development of modern tax systems and this paper canvasses those issues.

Keywords: tax, economic, public finance, government

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History of Tax Theory and Reform Concepts

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The Purpose of a Tax System

Taxation is defined as a compulsory unrequited payment to government.[i] The compulsory element is enforced by legislation and a tax administration body. The unrequited element means the taxpayer does not receive anything directly in return, although all taxpayers are presumed to benefit from government more indirectly. The main purpose of a tax system is for general revenue raising, but it is also used at times to deliberately alter economic outcomes and to modify a society's income distribution.

General Revenue Raising

The traditional purpose of taxation has been to raise revenue to fund government operations.[ii] At a minimum, organised societies require that governments maintain law and order, provide defence forces and deliver basic public services. In reality, societies in developed economies have come to expect much more in areas such as health, education, transport, economic management and support for disadvantaged groups.

Governments in market economies can access the funds they need in different ways - they can commandeer resources, they can print money, and they can borrow, but there are limitations on how much these can be exploited. For government operations over time, well-designed taxes are a more equitable, efficient and sustainable source of funds. Taxation has thus become the main way in which governments transfer the necessary resources from the private sector to fund their operations. Governments also typically still have some non-tax revenues, such as profits from state-owned enterprises, royalties, fees and fines.

Australian governments raise around $700 billion pa in tax revenue[iii], which is 82 per cent of their total revenue and nearly 30 per cent of GDP. Tax policy is about designing the mechanisms for this large transfer of resources from the private sector to the public sector - broadly, how to do it most efficiently, equitably and simply. As we will see, though, this is not a straightforward task.

Altering Economic Outcomes

The starting presumption for tax policy makers in market economies is that freely functioning markets generally allocate resources efficiently. An objective of tax policy, therefore, is to extract the necessary resources from the private sector in a way that minimises distortions to this. At times, however, market outcomes will not be considered socially optimal; for example where characteristics of public goods (including externalities) and merit goods are present.

Public Goods

Public goods exhibit characteristics of consumption being non-rivalrous and non-excludable. Non-rivalrous consumption occurs where the marginal cost of consumption by additional consumers is zero.[1] Non-excludable consumption occurs where it is not possible to charge free-riders.[1] The presence of these characteristics would indicate a polar extreme case of a pure public good, to be contrasted with the polar extreme case of a pure private good. Real-world items of supply such as defence, justice systems, transport infrastructure, health and education partially exhibit such characteristics. These spillover characteristics may also occur in the form of negative externalities, such as with pollution.

With markets assumed to treat items as purely private, they are not equipped to produce socially optimal quantities of items with significant public good characteristics. These situations are more typically addressed on the expenditure side of the Budget or by regulations, but at times the tax system is also used to offset these distortions in order to achieve more socially optimal outcomes. An example is where the impact of environmental externalities from market activities is not accounted for by the parties to the transaction. A 'Pigouvian' tax is a tool that governments can use to correct for such distortions, effectively to provide an offsetting distortion.

Merit (or demerit) good characteristics[iv] may be present where individuals are considered to not be making decisions in their own best interests. While such issues can also be addressed on the expenditure side of the Budget, with regulatory instruments and with information campaigns, taxes may be used to alter behaviour. Tobacco and alcohol excises, for example, are partly rationalised to discourage people from harming themselves by the consumption of addictive products.

Modifying Income Distribution

The tax system may also be used as a social policy instrument, including to alter the distribution of resources in a society. While the optimal distribution of resources is subjective,[v] governments, representing the societies that elected them, may consider the pre-tax distribution that would be determined by market outcomes to be unfair.

The tax system, in conjunction with transfer payments, provides a means of directly altering the distribution of income, consumption and wealth. Through the application of progressive tax rates, a post-tax distribution that is less uneven than the pre-tax distribution can be engineered, with revenues from the tax system used to finance benefits and payments skewed to less well-off individuals. While progressive income tax rates provide the main tax mechanism for modifying income distribution, more targeted provisions may be used for specific socio-economic groups, such as families, retirees, homeowners or people with disabilities. Care needs to be taken, however, in providing such assistance through the relatively blunt tax system, with the expenditure side of the Budget generally better suited to targeted assistance.[vi]

The Development of Tax Systems

The nature of the tax systems we have now is a product of how and why taxes developed through history, driven by the evolution of governments' revenue needs and the economies they governed. From primitive crop sharing and forced-labour arrangements, more sophisticated forms of taxation emerged as trade developed and economies monetised. Modern tax systems with broad-based income and consumption taxes developed from the nineteenth century.

To understand how tax systems developed, it is first necessary to understand how governments developed.

The Origins of Government

A definition of government is the system or group of people governing an organized community, generally a state.[vii] Historians distinguish between tribal societies based on kinship and territorial nation-states. Other distinguishing characteristics of nation-states are a centralised source of authority (government) backed by a means of coercion, stratified social structures and more elaborate forms of religious beliefs.[viii]

In *The History of Government From the Earliest Times,* Samuel Finer dates the first recordings of government to around 3200 BCE in the southern Mesopotamia and Nile Valley areas of the Middle East.[ix] These city-states had a shared religion, a ruler and a permanent administrative apparatus, but only a limited private sector with land and production centrally owned or controlled.[x] The transition from tribal communities to organised states was also beginning elsewhere. In China, records of an organised society begin with the Shang dynasty from around 1700 BCE.[xi]

In Europe, following the early Greek societies, the formation of the Roman Empire installed a dominant ruler whose territorial authority was enforced by a powerful army. The nation states that shaped Europe's current territorial structure evolved following the fall of the western Roman Empire in 476 CE, with the geographical boundaries of modern Europe only taking firm shape from the fifteenth century.

In *The Origins of Political Order*, Francis Fukuyama describes the formation and development of states, and governments, as revolving around warfare, religion and economics.[xii] Tribal warfare may have contributed to the formation of states with conquering tribes establishing administrative and religious structures to manage their new territories. Evolving agricultural practices also required organised social structures to manage large-scale irrigation projects and allow for specialisation of labour. There is also evidence that areas cultivating storable grains were the first to emerge as states given the appropriability of the crop for tax collectors supporting an elite.[xiii]

With the development of nation-states and the formalisation of governments came the need to develop laws and legal infrastructure as a basis for social and economic stability. The rule of law placed both requirements on citizens and limits on the power of rulers. Laws have derived both organically from the will of the general community and legal precedent, such as English common law, and formally, as legislated by governments and parliaments.

The concept of a social contract between citizens seeking self-preservation and a sovereign with absolute power offering protection was developed by Thomas Hobbes and others as the modern state took shape in the sixteenth and seventeenth centuries.[xiv] One of the rights that citizens gave the state in this social contract was the right to tax.[xv]

The Origins of Taxation

The development of nation-states and governments drove the need to access public resources in an organised way to finance expenditures in the governed societies.

Tax What You Can Measure

In their entertaining gallop through the history of taxes over the ages, *Rebellion, Rascals and Revenue*, Michael Keen and Joel Slemrod note that ideally revenue would come from outsiders, pointing to plunder from military victories as an early form of tax on foreigners.[xvi] As societies and governments became more developed, more stable forms of taxation evolved. A fundamental starting point was that taxes needed to be levied on things that could be measured, and to raise substantial revenue, those things needed to be in good supply.

Early forms of such revenue raising were crude and ad hoc, reflecting undeveloped economies and financial systems. Agriculture and labour were relatively measurable activities. Early Chinese and Japanese governments appropriated a proportion of crops as tax.[xvii] Salt taxes were substantial revenue raisers in France (the gabelle) and elsewhere.[xviii] Labour taxes were initially imposed as an equal amount per person, or through a requirement to do some work for the government.[xix]

By the late sixteenth century, governments' revenue needs went beyond the irregular fighting of wars and crude tax bases and more modern tax systems that could provide reliable sources of revenue began to develop in medieval Europe. The development of trade offered a natural tax base, with borders providing a convenient point for collecting taxes. Trade was substantial and measurable, and also a way to tax foreigners.[xx]

The development of more structured and monetised economies facilitated the evolution of more substantial tax bases, such as domestic excises on commodities and stamp duties on government-authorised contracts, as well as more sophisticated tax administrations.[xxi]

Access to a sound financial base became a source of power for governments and the key to successful military operations. Britain's geo-political strength from the seventeenth century derived from the strength of its economy and its ability to raise revenue to finance wars.[xxii] This played out further in the wars in Europe in the eighteenth century, including the introduction (albeit temporarily) of an income tax in Britain in 1799 to help finance its war with France.

As the role of government expanded it developed broader welfare functions, and to an extent replaced elements of that which had previously been provided by institutions such as the Church. Tithes collected by the Church were consequently supplanted by government taxes.

Tax and Democracy

The development of more ubiquitous tax systems changed the relationship between governments and citizens. As taxes were levied more broadly, negotiations over their extraction led to demands for a greater say by citizens in how this was done, and rulers had to cede some power as democratic societies evolved.[xxiii] Governments' need to garner majority support for their tax policies in turn necessitated a sense of fairness in tax design. Keen and Slemrod observe that the nineteenth century hence 'saw the emergence in the West of a stable, adequate, and broadly consensual tax structure.'[xxiv]

In *Tax & Government in the 21st Century,* Miranda Stewart describes the development of the 'tax state' whereby a sovereign was able to raise sufficient tax revenues to consolidate, stabilise and centralise government.[xxv] By the beginning of the twentieth century the tax state had become established across the Western world as part of a fiscal bargain between governments and taxpayer citizens that has since underpinned successful democracies.

Death and Taxes

Benjamin Franklin
13 November 1789
(5 months before his death)

Our new Constitution is now established, everything seems to promise it will be durable; but, in this world, nothing is certain except death and taxes.

However, this fiscal bargain is a delicate balance. Citizens will broadly accept taxes to fund public services (so-called taxpayer morality) so long as they are seen to be fair, but a perceived lack of fairness adds to resistance and even conflict. The 1773 Boston tea party was partly a protest against British tax on imports of tea, which subsequently escalated into the American War of Independence. In Australia, a dispute about gold-mining licence fees in Victoria culminated in the loss of thirty lives at the 1854 Eureka Stockade battle. In these historical anecdotes, other factors are of course also at play. As Keen and Slemrod say 'Tax does not explain everything. But just as tax mistakes can have horrendous consequences, so we believe that good tax design and administration can deliver enormous benefits'.[xxvi]

Fairness in the Fiscal Bargain

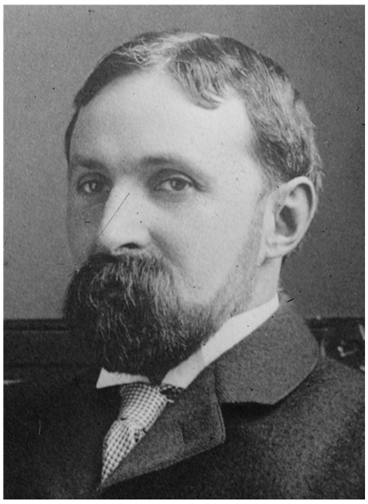
With the need for a sense of fairness being central to the development of tax systems, there has been considerable debate about how to define this, centred around two possible principles.

The benefit principle views taxes as payments for public services and so seeks to align taxes with benefits received. The conceptual origins of this approach lie in the social contract theory of government where taxes are payments for state-provided services such as the protection of people and property. While this principle was influential in early tax design when the role of government was limited, as government services expanded, the attribution of benefits became more problematic. The modern definition of tax as an unrequited payment implies a move away from this principle. The use of hypothecation of some taxes, or even soft hypothecation such as with Australia's Medicare levy, though, has some flavour of the benefit principle.

The ability-to-pay principle seeks to align taxes with a measure of taxpayers' economic wellbeing and so their capacity to pay tax, disconnected from benefits received from government. Conceptually this approach is supported by the notion of equal sacrifice and the diminishing marginal utility of money, as originally articulated by Jeremy Bentham and John Stuart Mill.[xxvii] But it requires a way to identify and measure this ability, with wealth, income and consumption the obvious candidates.

Both principles influenced the early development of tax systems and continue to inform the design of individual taxes. By the nineteenth and twentieth centuries, however, with governments taking broader roles, ability-to-pay became the more influential driver of the design of broad-based taxes.

The Price of Civilisation



Taxation is the price which civilized communities pay for the opportunity of remaining civilized.

Albert Bushnell Hart
1854 - 1943

Adam Smith, in his 1776 treatise *The Wealth of Nations*, laid out four maxims for the design of taxes: equality, certainty, convenience of payment, and economy in collection. The first maxim, equality, was expressed as follows: 'The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue they respectively enjoy under the protection of the state.'[xxviii]

This maxim alludes to both principles, but the specific reference to abilities was significant. It also nominates revenue (income) as the measure of ability-to-pay. The maxim refers to the payment of tax in proportion to abilities, but in a subsequent discussion of the taxation of housing, Smith provides support for progressivity: 'It is not very unreasonable that the rich should contribute to the public expense, not only in proportion to their revenue, but something more than in proportion.'[xxix]

Charles Bastable, in his 1892 work *Public Finance*, evaluated the two principles for assessing fairness. While the benefit principle was conceptually attractive in its connection of the tax and expenditure sides of the Budget, with the poor being more reliant on government support it implied regressivity. In the equality of sacrifice tradition, he considered that ability-to-pay provided a better basis for assessing taxation, but eschewed progressive rates as presenting excessive 'political, moral and economical'[xxx] difficulties. He thus favoured the intermediate approach of taxation that was proportional to income.

Holding to this ability-to-pay framework,[xxxi] in his 1928 *A Study in Public Finance* Arthur Pigou distinguishes two relevant factors which he terms the distributional effects and the announcement effects (the ways in which people modify their conduct in response to a tax). Considering these equity and efficiency concepts in income tax design, though, he concludes that distributional issues can dominate.

While perceived fairness was paramount and came to be seen mainly through the ability-to-pay prism, in the absence of sophisticated ways to measure this proxies were required. Britain's long-standing window tax (1697 - 1851) was a classic example of this, where the number of windows was considered a readily measurable proxy for wealth.

Window Tax

* In response to the window tax some landlords filled in windows to avoid the tax.

The development of economies and financial systems in the nineteenth and twentieth centuries enabled more certain measurement of income and wealth and so more sophisticated tax systems. The expanding role of income tax also enabled more progressive tax systems consistent with an ability-to-pay principle, as income tax revenue replaced more regressive tariffs and excises. Further, the revenue-raising power of broad-based income taxes facilitated expansions in the role of government, including the development of the modern welfare state. The size and nature of government was changing.

Tax and the Economy

More recently, concerns about the economic efficiency effects of taxes have become prominent. While the administrative and compliance costs of taxation were long recognised, the economic costs came to the fore in the twentieth century. Pigou identified the nature of the issues in 1928 and as tax burdens increased there was a greater realisation, and ability to quantify, the extent of economic distortion caused by a tax system.

As Josiah Stamp observes in his 1936 *The Fundamental Principles of Taxation:* 'Taxation is now rapidly developing from a merely unpleasant incident into a dominating feature of daily life, and those features which hitherto have been of little interest, because they have been too small to matter, now become of great importance; the blemishes which were insignificant may now be intolerable simply because in the magnitude of the burden they have become sufficiently magnified or intensified to be within the range of ordinary human feeling.'[xxxii]

With taxes driving wedges between consumer and producer prices, the distortions caused by differential taxes became better understood and a presumption in favour of broad-based taxes with lower tax rates developed. This would be the dominant theme of the tax literature in the twentieth century.

Optimal Tax Theory

This presumption in favour of broad uniform taxes was challenged by the early optimal tax theorists who argued that if full comprehensiveness is not feasible given practical and political constraints, the case for equal taxation of the remaining items is compromised.

An early strand of optimal tax theory dealt with commodity taxation where it was argued that efficiency would be enhanced by taxing more elastic items less and more inelastic items more. Frank Ramsey thus posited in 1927 taxing goods at different rates conversely related to their price elasticity.[xxxiii] While such Ramsey pricing was not considered practical, Ian Little demonstrated in 1951 that as leisure cannot be taxed directly, departures from comprehensiveness in the taxation of other items can be justified, with complements to leisure taxed more highly.[xxxiv]

These challenges to comprehensiveness were countered in a 1964 Arnold Harberger paper that used mathematical and diagrammatic (supply and demand curve) analysis to illustrate how the tax wedge between consumer and producer prices leaves a deadweight loss triangle. With the excess burden (the area of the triangle) varying with the square of the tax rate, there was a presumption in favour of broad-based taxes, which enabled lower tax rates for a given revenue task.[xxxv] This broader tax base/lower tax rate approach would also support equity and reduce incentives, and opportunity, for tax avoidance and evasion. This was not to argue that some departures from comprehensiveness weren't warranted, but the case needed to be particularly robust and there needed to be strong information to justify it.

Optimal tax theory has since developed more broadly to consideration of how to maximise efficiency and social welfare subject to the objectives, such as income redistribution, and constraints, such as economic distortions, of a tax system.

Public Choice Theory

While public finance theory provides a sound tax policy foundation, and a general presumption in favour of tax base comprehensiveness, real world policy making occurs in a political framework. James Buchanan and Geoffrey Brennan's 1977 depiction of a revenue-maximising or leviathan government was a case in point. In this world they argued that narrower-based taxes would restrict the tendency of a revenue-maximising government to raise tax levels excessively.[xxxvi] While these are legitimate concerns, underlining the importance of considering tax policy in an institutional framework, setting tax limits provides a more direct way to control the size of the public sector.[xxxvii]

Further, there has been significant focus on the size of government and the tax burden in policy debates over recent decades. The tax burden in Australia has in fact been broadly stable, averaging around 28 per cent of GDP since the mid-1980s, making the current debate around spending pressures in the areas of health, aged care, disability support and defence especially pertinent if an increase in the tax burden is contemplated.

More broadly, the size and role of government influences the nature of the tax system that funds it. Up until the early twentieth century, tax in western economies was generally less than 10 per cent of GDP, mainly funding core public goods such as defence, justice and basic infrastructure.[xxxviii] The twentieth century saw growth in the social provision of a range of individualised services and benefits, largely in education, health, care services and transfer payments, necessitating a tax take of generally more than 30 per cent of GDP. As such, the fiscal relationship between government and citizens is now characterised by a large transfer from citizens to government in taxes, with around three quarters of that being returned to the same or other citizens in direct transfer payments or in-kind assistance for private needs.

The Modern Tax System

With the presumption in favour of broad-based income taxes largely established, developed economies underwent a series of base-broadening reforms from the 1970s to the 1990s, cementing income tax as the main revenue raiser and driver of progressivity in the tax system.

The other key tax development in the twentieth century was the advent of broad-based indirect consumption taxes to take some of the revenue-raising weight off income tax. The value added tax (VAT) was developed in Europe in the middle of the twentieth century and adopted by the European Economic Community in 1970. It has since been implemented in all other Organisation for Economic Co-operation and Development (OECD) countries, with the exception of the United States, where the states and some local governments alone impose single point retail sales taxes.

These developments gave us the shape of the modern tax system in developed economies, with taxation firmly established as the main revenue source for governments. In OECD countries income tax is now the dominant tax with taxes on goods and services playing a supplementary revenue raising role. While some of the earlier tax bases - such as tariffs, excises, stamp duties and forms of wealth taxes - remain to an extent, they have a variety of purposes and are partly explained by the 'old tax is a good tax' adage. Their revenue-raising role, though, has been largely supplanted by the broad-based income and consumption taxes.

Modern Public Finance Theory

This history of tax system development shows the issues that societies valued in democratic negotiations over tax design. Governments needed tax bases that were measurable and plentiful to provide stability of revenue flows, without imposing undue distortions to economic activity. Tax administrations needed simplicity and understandability to enable efficiency of collection. For the public, the most obvious sentiment was the need for a sense of fairness.

The modern public finance literature has distilled these issues into criteria for assessing taxes. At a high level, taxes need to reliably raise the revenue governments need in a way that is acceptable to the public and which minimises economic distortions and compliance costs.

Haig-Simons Income Definition

The seminal academic contributions to tax design in the early twentieth century came following the United States' Sixteenth Amendment to the Constitution in 1913, which gave Congress full power to tax income.[xxxix] There was a lack of an established economic definition of income, which Robert Haig, writing in 1921, sought to address (building on earlier work by German economist Georg von Schanz (1896)). Proceeding from the economic concept of income as a flow of satisfactions or utility, he offered a practical monetary definition of taxable income: 'Income is the money value of the net accretions to one's economic power between two points of time'.[xl]

Henry Simons, in his 1938 *Personal Income Taxation,* then provided a methodology to measure this net accretions concept of taxable income. Fundamentally, income is equal to consumption plus additions to net wealth in a period. A comprehensive definition of income was needed to reliably measure ability-to-pay, and under this definition, all forms of income would be taxed equally, including accruing capital gains, bequests and imputed rent on homes. 'The broadest and most objective income concept provides the base for the most nearly equitable levies'[xli] wrote Simons. While he based his arguments on the equity dimension, a comprehensive tax base was also seen as important for neutrality of the tax system.

This Haig-Simons comprehensive income tax base ideal was broadly accepted by economists, but it has limitations, not least being the need to adjust capital returns for inflation so as to only tax real income. Practical constraints have also hampered its full implementation. In areas such as capital gains and imputed rents, political and administrative restrictions have required compromise. Its practical limitations have been criticised by non-economists. Boris Bittker provided a legal perspective on the problems with defining taxable income, also observing that the Haig-Simons approach was of limited help with key design features such as the tax unit and the time period for tax assessments.[xlii]

Overall, though, by the 1960s there was a broad academic consensus for comprehensiveness as the ideal income tax benchmark, with some departures for practical and optimal tax considerations.[xliii] A similar presumption for the taxation of consumption was established by Irving Fisher in the 1930s (discussed below). Comprehensiveness was considered to provide the best basis to achieve both equity and efficiency goals. These considerations added to the longer-standing presumptions in favour of revenue adequacy for governments and simplicity and certainty for taxpayers.

Tax Reform Criteria

Richard Musgrave synthesised the academic work on public finance theory in his 1959 treatise *The Theory of Public Finance,* which articulated a full framework for consideration of both the tax and expenditure sides of the Budget. Tax design was founded on Haig-Simons comprehensiveness, with Musgrave arguing the inclusion of all accretions to wealth 'in whatever form they are received or from whatever source they accrue'[xliv] supported both equity and economic efficiency where 'the excess burden of more general taxes tends to be smaller than that of selective taxes'.[xlv]

This work was refined in the 1973 *Public Finance in Theory and Practice* textbook by Richard and Peggy Musgrave which states 'The good tax system should be designed so as to meet the requirements of equity, efficiency, and ease of administration'.[xlvi] With comprehensiveness of the tax base taken as the best approach to achieve these three criteria, the tax reform mantra became to broaden the base and lower the rate.

These criteria evolved through academic debate and different tax review processes, whether that be regarding income or consumption as the tax base. They have been modified in various ways, including through the further development of optimal tax theory and considerations of real-world institutional settings, but as a framework, within the general requirement for revenue adequacy, the central three criteria of efficiency, equity and simplicity remain the starting point for tax reform considerations, with other criteria added at times in different tax reviews.

Efficiency

Well-functioning markets are presumed to allocate resources efficiently. It is assumed individuals make consumption decisions that suit them, and businesses find the most efficient means of production. As far as possible, the tax system should not interfere with these choices; that is, there is a presumption in favour of tax neutrality which is generally supported by a comprehensive tax base with all items taxed at the same rate. Tax reform that removes impediments to a well-functioning market is hence seen as a potential driver of improvements in economic productivity.

This presumption is qualified, though, when markets are not functioning well. Most obviously, individuals and businesses may not make socially optimal decisions where there are externalities that are not accounted for in their market transactions. In these circumstances, some departure from comprehensiveness may be justified to offset that externality – so-called Pigouvian taxes that attempt to internalise the externality. Pollution is the classic example.

As previously discussed, optimal tax arguments have also been used to partially qualify the presumption in favour of taxing all items at the same rate, with the argument that in the face of constraints to full comprehensiveness, efficiency may be enhanced by appropriately differential taxation.

Fairness

In the ability-to-pay framework, fairness is considered in two dimensions: horizontal equity and vertical equity. In the determination of comparative equity, income has generally been used as a proxy for ability to pay (although, as discussed later, consumption and wealth are also options).

Horizontal equity requires that individuals in a similar economic situation, and so having a similar ability-to-pay, should pay a similar amount of tax. A key implication of this principle is that different forms of income, such as cash and non-cash remuneration, should be taxed equivalently.

Vertical equity requires that individuals in different economic circumstances, and so with different abilities to pay, should pay appropriately different amounts of tax. This is generally taken to support progressive taxation, with higher-income earners paying a higher rate of tax. The exact degree of progressivity is subjective and appropriately determined by the political process.

In assessing fairness, a tax system should be considered as a whole, as it is each individual's total tax contribution that matters most for fairness. This is particularly relevant in the consideration of vertical equity where individuals income tax is the main driver of progressivity with other taxes, such as indirect consumption taxes, less suited to that purpose. Transfer payments, and other expenditures, are also instruments for pursuing vertical equity objectives – indeed the tax-transfer system should be thought of as a whole with transfer payments effectively being negative taxes.[xlvii]

The choice of tax unit and the time period for measuring income also becomes important in a progressive tax structure. In regard to the tax unit, a key question is whether the individual or the family is seen as the best benchmark for assessing ability to pay. Australia's choice of the individual for income tax purposes means that families with the same total income but different splits across spouses will pay different amounts of tax, although measures have been adopted in both the tax and transfer systems to mitigate this. Regarding the time period, a year is typically chosen for income tax purposes, but this requires averaging provisions for those with lumpy incomes.

Intergenerational equity has also become an issue of policy concern, with recognition that economic, fiscal, environmental and social damage by one generation is leaving an unfortunate legacy for future generations.

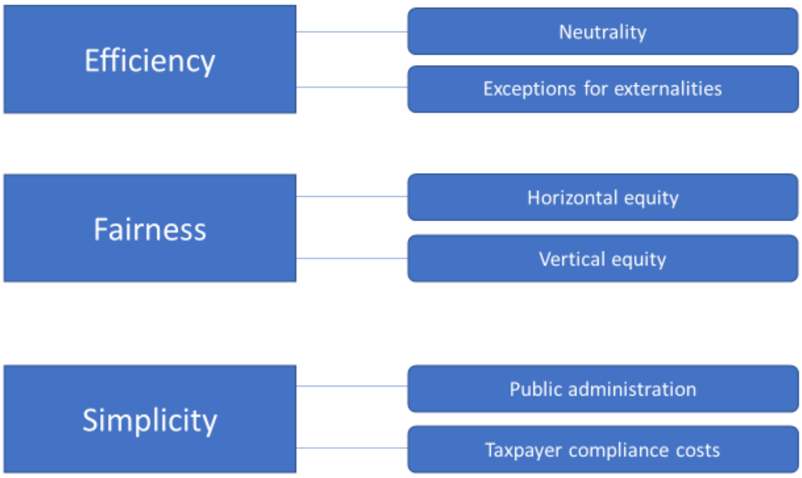
Simplicity

Simplicity also has two dimensions: official administration costs and taxpayer compliance costs. A simple tax system minimises these.

Administration costs will in part depend on the design and complexity of tax laws. A tax based on an uncertain definition of income will likely be more costly to administer than one based on a clear definition without exemptions. Compliance costs will also be impacted by tax design. If the tax law is complex and contains variations in treatment of income sources, it will be more time-consuming and costly for taxpayers to comply with. The high reliance in Australia on tax agents is indicative of a relatively complex tax system.

Advances in IT and data management have enabled tax administrations to take some of this complexity away from taxpayers; for example the use of pre-filled electronic tax returns and one-touch payroll in Australia. Within-year Pay-As-You-Go withholding arrangements also facilitate the collection within-year of income taxes with an assessment period of a full year.

The Big 3 Tax Criteria



Other criteria have also been used in different circumstances.

Revenue Certainty and Sustainability

Governments need confidence in the certainty and stability of their revenue flows in order to manage their overall operations and budgets. As we have seen, a key driver of modern tax system development was the need to replace less regular forms of government revenue. As such, revenue adequacy can be thought of as an overarching requirement of a tax system.

Further, fiscal policy is an important lever for governments' macroeconomic management, and this requires an ability to manage the budget aggregates. In pre-Keynesian times, this generally meant seeking to match revenue and expenditure to balance the Budget, regardless of the economic cycle. After the Great Depression, a Keynesian policy approach has seen the use of fiscal policy both as an automatic stabiliser and a mechanism for governments to provide discretionary fiscal stimulus or contraction, with tax policy an important part of this.

Public Acceptability

To be sustainable, taxes ultimately need a level of public acceptability. Most obviously this goes to the fairness criterion, but a broader sense of a well-designed tax system aids taxpayer acceptance of, and willingness to pay, taxes. The early 1980s breakdown of 'taxpayer morality' in Australia was a case where public acceptability of the tax system was damaged, with the sight of some taxpayers manipulating the form of their income to avoid or evade tax leading to a loss of confidence in the integrity of the tax system and resentment by wage earners about their tax obligations.

Plucking the Goose

The art of taxation consists in so plucking the goose as to procure the largest quantity of feathers with the least possible amount of hissing.

Jean-Baptiste Colbert
French Minister of Finances
1665 - 1683

A related concern is the importance of taxpayer confidence in the integrity of government more broadly and an acceptance that public funds are well spent.

Tax Allocation

An issue for governments operating at multiple levels, such as federations, is the optimal jurisdictional allocation of taxes and possibly tax sharing arrangements. One argument is that relatively mobile tax bases, such as capital, are best managed at the national, or even international, level given the issues with jurisdictional tax competition and potential tax avoidance where taxpayers can exploit jurisdictional differences. Relatively immobile tax bases, such as land, are then seen as better suited to lower levels of government.

Aspects of the benefit principle may also be relevant. Accommodation taxes, for example, are argued to be suited for local governments as a way of charging visitors for the amenities they enjoy.

Other

Tax reviews have at times added other criteria for their tax reform assessments, although generally as some variation of the above criteria. The Australia's Future Tax System review, with its consideration of the tax and transfer systems, included policy consistency to stress the importance of tax and transfer policies being internally coherent.

Trade-offs between Criteria

In the consideration of actual tax policy issues, at times there will be an alignment between these criteria, but at other times they will conflict, and trade-offs will be required. It is argued, though, that a comprehensive tax base approach helps minimise those conflicts.

Under the comprehensiveness approach, there is a general consistency between horizontal equity and neutrality, with the equal treatment of different forms of income or consumption largely supporting each. There may, though, be conflict between the simplicity and equity objectives where finely-tuned policies targeting vertical equity may imply more complex tax laws.

Tax policy considerations can help articulate and quantify some of these trade-offs, but governments are ultimately charged with making the judgements, informed by public debate. An optimal tax theory approach uses a specific social welfare maximisation framework to address such trade-offs.

A Tax System Designed on Purpose

The nation should have a tax system which looks like someone designed it on purpose.

William Simon
USA Secretary of the Treasury
1974 - 1977

Tax Avoidance

An important practical consideration is the insidious impact of tax avoidance and evasion undermining the achievement of tax system objectives. Fundamental concepts of efficiency and equity are compromised where some taxpayers can avoid or evade their tax obligations. In efforts to combat this, elements of the tax law have become highly complex.

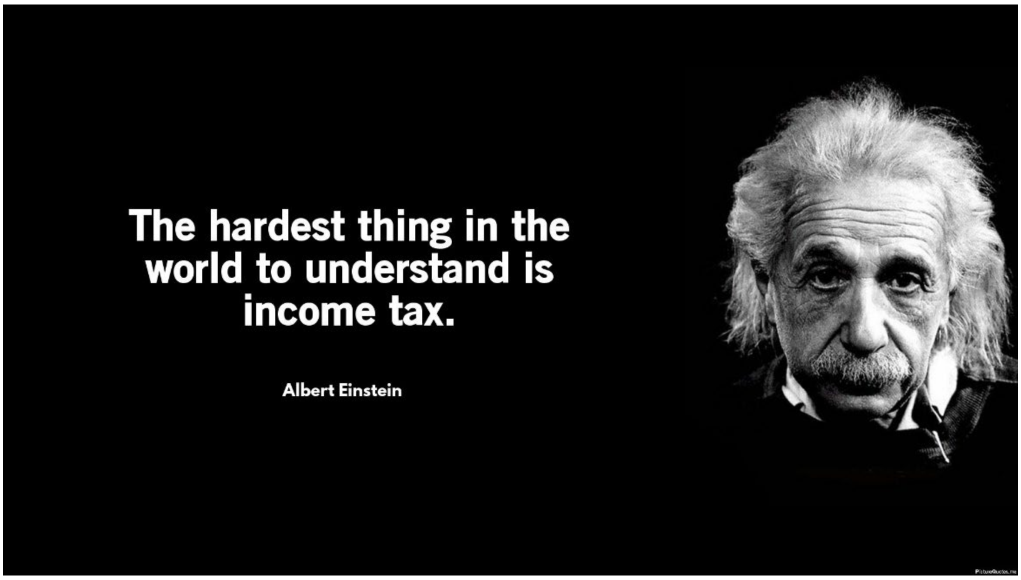
The Tax Base

The discussion so far has largely focussed on the use of income as the proxy tax base for assessing ability-to-pay. While that has generally been the approach adopted in modern tax systems, consumption also provides a potentially broad measure of economic wellbeing. Wealth has been another prominent tax base through history, but it has limitations, including that being a stock rather than a cash flow can constrain the owner's ability to make regular tax payments. I will briefly consider the issues at stake in the choice of tax base.

Income

From Adam Smith's 1776 *Wealth of Nations* onwards, income has been seen as a good proxy for an individual's command of resources and consumption possibilities, and hence their economic wellbeing and ability to pay tax. Initially, though, this was contentious. In the days before modern financial and accounting systems it was argued that income was too complex a concept that couldn't be reliably measured. Further, the disclosure of one's income was considered personally intrusive and potentially too pervasive, with leviathan concerns.

Albert Einstein (1879-1955)



Crises precipitated change, however, with war finance and other national needs cementing income tax as a revenue raiser. The United Kingdom imposed income tax temporarily in 1799 and then permanently from 1842. The United States didn't do so permanently until 1913 (following the Sixteenth Amendment). The Australian colonies introduced their income taxes in the late nineteenth century and the Commonwealth did so in 1915. As economies and financial systems developed, it became possible to measure income more reliably and income tax became the dominant tax revenue for governments.

The Haig-Simons definition of comprehensive taxable income gave it a sound conceptual base, but practical constraints limited its full application. The measurement challenges are generally manageable with labour income but have proven more difficult with capital income where accruals issues and inflation effects need to be confronted. Directly measuring individuals' income also facilitated progressivity, with the use of progressive tax rate structures well established by the start of the twentieth century.[xlviii]

Consumption
Consumption is the obvious alternative measure of an individual's economic wellbeing and ability to pay tax. It provides a measure of actual consumption, rather than potential consumption.

Direct Consumption Tax
The use of consumption as a direct tax base for individuals was expounded by Fisher in the 1930s, Nicholas Kaldor in the 1950s and James Meade in the 1970s. A direct measure of individuals' annual consumption would enable the application of progressive tax rates, as is done with income tax.

With income being the sum of consumption plus savings, the difference between the two alternatives comes down to whether to tax savings. Conceptually, it is argued that consumption is a superior tax base in that it is neutral between current and future consumption. An income tax effectively taxes savings twice, once when the income is earned then again when it is saved, creating a disincentive for savings.[xlix] As a tax base, consumption is also conceptually equivalent to labour income, with both bases not taxing the return from savings, ie capital income. There is hence an equivalence between a consumption tax and a payroll tax.

A consumption tax approach also provides practical advantages. Fisher established that personal consumption can be measured by a pure cash-flow calculation, taking receipts from all sources, current or capital, and subtracting all non-consumption outgoings. John Head observed: 'Since the whole calculation is based on a realisation or cash flow principle, difficult problems of determining accruals in such areas as capital gains, pension rights and depreciation, which greatly complicate the comprehensive income tax, simply do not arise.'[l]

Indirect Consumption Tax
The practical use of consumption tax has been largely limited to indirect taxation, where flat tax rates are necessarily applied.[li] They have been used to provide support to progressive direct income taxes by taking on some of the revenue raising burden.

An indirect consumption tax, or sales tax, is imposed at one or more stages of the production and distribution chain. It was first used in Spain in the fourteenth century (the alcabala) and taxes at the manufacturing or wholesale stage were subsequently adopted by many countries.[lii] Australia introduced its wholesale sales tax in 1930.

The VAT was established in the middle of the twentieth century as a multi-stage sales tax that taxed just the value added at each stage of the supply chain.[liii] The initial development of a VAT was credited to two people, independently, in the early twentieth century. Wilhelm Von Siemens, a German businessman, designed a VAT as a way to resolve the cascading problems associated with the existing turnover taxes. Thomas Adams, an American, also designed a VAT as an alternative to the corporate income tax.[liv] A VAT was first used by France in its West African Ivory Coast colony in 1954 and in France itself in 1958. It was adopted by the EEC countries from 1970 and has since been implemented in all OECD countries except the United States.[lv]

A single-point retail sales tax has the same potential tax coverage as a VAT but collects all of its tax at the final point of retail sales. The VAT is claimed to have stronger self-enforcement features, with the invoicing at each stage, but consequently also has higher compliance costs.[lvi]

The Choice between Income and Consumption

The choice between income and consumption as the better tax base revolves around the taxation of savings and the associated intertemporal issues. As flagged, conceptually, taxing the return on savings is argued to double-tax savings and so discriminate against future versus current consumption. As such, consumption is generally recognised by tax economists as the conceptually superior base, but its narrower coverage would require the application of higher tax rates. There are also arguments about the non-monetary benefits of accumulated savings that would go untaxed, and as such a supplementary wealth tax is generally proposed.

In reality, the income taxes applied by governments around the world only partially tax savings. Real-world tax systems, while income tax in name, are in fact hybrids of the conceptual income tax and consumption tax models. The Australian income tax system, for example, departs from a full income benchmark by only partially taxing returns on the main forms of savings: superannuation, owner-occupied housing and capital gains.

The more significant issue at stake is the importance of comprehensiveness of the tax base, whether that be income or consumption. Further, under the real-world hybrid approach, consistently taxing different forms of savings is important to avoiding distortions to how people save. Head says 'The most fundamental proposition in the modern tax policy literature, stemming from the pioneering work of HAIG, SIMONS, FISHER and the subsequent generation of tax scholars, is the crucial instrumental role of a broad tax base.'[lvii]

Tax Mix Switch

It is sometimes claimed that a tax mix switch from income to consumption would reduce workforce disincentives. This, however, is largely a misconception. Two issues get confused in proposals for a tax mix switch from a direct progressive individuals income tax to a flat indirect consumption tax. To the extent that there is an economic efficiency effect in such a tax mix switch, it derives from the switch from progressive to flat rate taxation, not the switch from income to consumption. Any economic efficiency enhancement then needs to be balanced against the reduction in progressivity. The difference between income and consumption is savings, so the main issue at stake in a tax mix switch between the two tax bases is the intertemporal one of current versus future consumption.

The 2011 Mirrlees review observed 'So increasing taxes on goods and services reduces the pay-off to working more in the same way that increasing direct taxes does – a fact overlooked by those who argue we should move away from income tax and towards indirect taxes to preserve work incentives.'[lviii]

The table below provides a taxonomy of direct and indirect income and consumption taxes. Direct taxes allow the application of progressive marginal tax rates to individuals. Indirect taxes, by not applying directly to individuals, are necessarily levied at flat tax rates.

Income vs Consumption and Direct vs Indirect Taxes

	Income	Consumption
Direct*	Individuals Income Tax	European Pension Schemes**
Indirect*	Payroll Tax	VAT

* A direct tax applies directly to the taxpayer that it relates to, eg individuals income tax, land tax. An indirect tax applies to a taxpayer different to the one the tax relates to, eg VAT, payroll tax.
** Contributions are made to a public scheme and hence not taxed, with individuals taxed on their pension streams at their marginal tax rates.

A tax mix change that may improve economic efficiency is one that switches from relatively distorting taxes, such as transaction taxes, to relatively neutral taxes, such as taxes on land, inheritance and economic rents.

Business Income

Business income is in economic substance just a subset of individuals income. The relevant tax unit for assessing ability-to-pay is the individual owner of the business income, with any interposed entity such as a company just a legal construct for the conduct of the business. As such, the conceptual ideal is for any business income in a year to be notionally allocated to the individual owners and taxed at their marginal tax rates. In the case of company income tax this would involve full integration with the individuals income tax, effectively partnership treatment.

Difficult issues arise in an international setting, however, where some of the owners of a business are non-residents and the cost of capital is set globally. The taxation at the entity level may be the only opportunity to tax non-resident investors on that income in the source country, with the true effective tax rate being dependent on the tax arrangements in the investor's resident country. The notional distribution of non-distributed company income may also raise cashflow difficulties for some domestic shareholders.

Australia's dividend imputation system provides partial integration of the company and individuals income tax systems for resident shareholders and so some greater alignment of the taxation of debt and equity finance. Non-resident shareholders, though, do not receive dividend franking credits and so the 30 per cent company tax may be their final tax in Australia. With the required rate-of-return on investments effectively set as the after-tax return in international capital markets, the provision of full franking credits to Australian residents then creates a bias for them to invest domestically.

With non-resident shareholders not receiving franking credits, they are left to face the full company tax rate, which amounts to an effective tariff on imported equity capital, leaving Australian corporates with an artificially high proportion of domestic shareholders and a higher cost of capital.[lix]

The taxation of multi-national enterprise (MNE) income also confronts difficult issues of globally mobile capital and international competition. MNEs have been able to exploit differences in tax regimes across countries to artificially reduce their tax liabilities, a stark example of how tax avoidance practices undermine the achievement of tax system objectives. This has been a focus of recent tax reviews and work at the international level by the OECD.

Issues also arise where there are economic rents associated with particular activities such as the extraction of natural resources or where monopoly or oligopoly structures persist, for example due to prudential regulation of the financial sector. In these situations, there is a case to tax above normal returns without creating economic distortions.

Wealth

Wealth is a stock, representing accumulated income and windfall gains. If income or consumption is taxed comprehensively it could be argued that there is no case for taxing wealth. But it can also be argued that additional benefits stem from wealth over and above the direct consumption possibilities, in terms of personal security and prestige, such that a full assessment of economic wellbeing warrants some additional taxation. This would be particularly the case with a consumption tax, where there is no additional tax on savings. Further, there are intergenerational equity concerns with large untaxed wealth transfers through inheritance. A wealth tax may be applied as an annual charge at year's end, or at one lifetime event, such as death.

General wealth taxes have not been substantial revenue raisers and have declined in use across OECD countries, a consequence of design and administration issues as well as capital flight concerns.[lx] Recurrent land and property taxes, though, are widely used consistent with the idea of land being immobile and the source of substantial economic rents. Henry George (1829-1897) railed against the immorality of landowners benefiting from the actions of others that increased their land values and advocated for land tax to address that.[lxi]

Australia does not apply general wealth taxes, but it does have land tax and property rates at the state and local government levels. Inheritance taxes were abolished by the states and the Commonwealth from the late 1970s. Head says: 'The states admittedly can plead that they were forced to this course by the pressures of interstate tax competition. The Commonwealth decision, first to ignore the Asprey recommendations and then to follow the states' example and abolish federal estate tax, remains, however, totally incomprehensible, short-sighted and irresponsible.'[lxii]

Other

A variety of other taxes are used to raise revenue and for additional purposes. Generally, they have a limited connection to ability-to-pay but invoke other objectives including aspects of the benefit principle, such as road-user charges. Some persist on the flimsy rationale that an old tax is a good tax.

Stamp duties are transaction taxes that originated in Europe in the seventeenth century due to the ability to identify and measure a taxing point – the transaction price – but they are generally considered inefficient given the disincentive they create to transact. Excises on specific products, over and above any broad-based consumption tax, are used to influence the consumption of those products, typically for externality or merit good reasons. Tariffs on imports remain significant in some countries, with a mix of revenue raising and industry protection motivations.

Economic rent taxes are used to extract additional revenue from activities where above-normal returns may be persistently present. Most obviously this relates to natural resources and a resource rent tax may seek to tax those above-normal returns.[lxiii] Conceptually they should only apply to the economic rent component of a transaction, over and above the required rate-of-return, and so not impact on its viability.

Assessment
Governments' tax base choices have evolved as the economies they are taxing have evolved, driven by the constraint of taxing what can be measured and revolving around an assessment of ability-to-pay together with other specific motives.

In modern times income tax has come to dominate the tax systems of developed countries given its perceived reflection of taxpayers' ability-to-pay. The reality, though, is that there are substantial deviations from the full income tax benchmark, with key forms of savings only partially taxed, making real-world tax systems a hybrid between income and consumption tax approaches.

In Australia, the taxation of capital gains, owner-occupied housing and superannuation represent the biggest departures from the conceptual income tax benchmark.[lxiv] While this is perhaps rationalised by our uncertainty over whether income or consumption represents the ideal tax benchmark, there are significant differences between the taxation of different savings vehicles that may distort individuals' choices. There are also substantial gaps in the indirect consumption tax bases of most countries. In Australia the goods and services tax (GST) has significant exemptions, including for health, education and fresh food, leaving it to apply to only half of private consumption.

Tax Expenditures
Australia's Tax Expenditures and Insights Statement (TEIS), first published in 1986, provides dollar estimates of tax expenditures, broadly comparable to budget estimates of outlays. A tax expenditure, though, simply measures a deviation of actual legislation from a defined benchmark, with the TEIS using the Haig-Simons comprehensive income definition for income taxes. Whether this is a 'concession' is a subjective judgement that requires consideration of the particular tax policy.

With the TEIS using an income tax benchmark, the largest tax expenditures relate to the taxation of savings: superannuation, owner-occupied housing and capital gains. There are also significant tax expenditures related to the GST exemptions of health, education and food, and the input tax treatment for financial supplies.

Reform: What Is It?
The word 'reform' is used a lot, but not all change constitutes reform. Governments regularly label tax changes that direct the tax burden away from their constituent groups as reform, but that claim needs to be assessed from a whole-of-society perspective. Similarly, income tax cuts that merely return bracket creep[lxv] are sometimes lauded as reform.

A dictionary definition of 'reform' is 'Make or become better by removal or abandonment of imperfections, faults or errors'[lxvi] So there is a presumption of a change made for the better by the removal of problems, which requires an assessment of two things for tax reform: first, that there is a problem in the form of a difference between what the tax law is and what it should be; and second, the law change needs to move the tax system in that direction, assessed against credible criteria such as revenue adequacy, equity, efficiency and simplicity. Given the potential trade-offs required between criteria, though, the characterisation of a policy change as reform is inevitably partly subjective.

An initial pointer to possible areas of reform is provided by elements of Australia's TEIS (see Box above), noting that this is just an estimate of differences between existing laws and the nominated benchmarks. International agencies, such as the OECD and the IMF, provide additional yardsticks to help define what changes would amount to substantive reform.[lxvii] More broadly, the academic literature, think tanks and advisory bodies such as Australia's Productivity Commission provide largely independent assessments of reform directions.

But the economies and societies that pay taxes are complex and tax systems are inevitably imperfect, with tax avoidance practices adding to the malady. Tax reform is about making the process less imperfect, that is to move closer to a theoretical ideal.

In reality, the history of modern tax systems has been characterised by constant tinkering, fixing anomalies or creating new ones, punctuated by irregular major reviews that seek to set up broader tax reforms. While it is generally recognised that an assessment of whether a change constitutes a reform is subjective, and that reform of the tax system is a wider concept than reform of a particular tax, given the starting point for most tax systems tax reforms that will enhance social welfare are typically about making the tax base more comprehensive, enabling lower tax rates, subject to relevant optimal tax and public choice considerations. Ultimately, an assessment of whether a change is reform depends on the weight given to relevant criteria such as revenue adequacy, equity, efficiency and simplicity.

Reform Processes

There are also important process issues to be considered in the pursuit of reform. Public policy making is a change management process that takes different pathways depending on the nature and magnitude of the issues. Most tax policy changes are done piecemeal, as part of the day-to-day operations of government, but when broader tax system changes are being considered a formal review may be warranted. In that case governments have a range of review processes available to them, ranging from fully external to fully internal and with several variations in between. It is critical that a government choose a change management process that is effective and fit-for-purpose.

Microeconomic Reform

Microeconomic reform is fundamentally about policies that improve economic efficiency by the removal of market distortions. While the general starting presumption is that freely operating markets allocate resources efficiently, it is recognised that where markets do not operate efficiently corrective policy actions may be appropriate. Common factors that prevent markets from operating freely are market imperfections (such as monopoly powers), regulations (aimed at some other policy objective) and tax breaks (aimed at advantaging particular groups).

Given that microeconomic reform often involves the removal of a market distortion that was put in place to protect or advantage particular groups, it is politically difficult. Removal of such a distortion will have some dispersed economic efficiency benefit, while the loss is concentrated on those groups – just as putting the distortion in place advantaged them, with the loss to economic efficiency dispersed throughout the wider community.

Further, the consideration of tax reform options is typically best done in the first instance in a revenue-neutral framework, as this forces consideration of the relative merits of how best to raise a given amount of revenue. It is at this microeconomic level that the questions about social equity, economic efficiency and tax administration are most obvious, and hence the questions concerning tax reform are most clear.

Macroeconomic Considerations

At the macroeconomic level, questions arise about how much tax revenue needs to be raised in total and the cyclical use of fiscal policy to impact on aggregate economic activity. With a tax system needing to raise the necessary revenue to fund government operations, the total amount of tax required will depend on the size of government, so a tax system will ideally be able to manage changes to this without major disruption.

Fiscal policy is also used as an anti-cyclical tool to manage economic fluctuations, so a tax system needs to be amenable to facilitating reductions in revenue in an economic downturn to stimulate economic demand, and increases in revenue in an economic upturn to offset excess demand. Taxes with comprehensive tax bases are generally best placed to facilitate this.[lxviii]

Assessing Tax Reform

Tax reform is principally a microeconomic issue and so, in the first instance, it is best framed by consideration of how to raise a given amount of revenue in the most equitable, efficient and simple way. To not do so risks confusing tax policy issues and other policy considerations.

For example, proponents of tax concessions for particular activities often argue that they will result in more of that activity. This is generally the case, but it leaves the question of where that revenue shortfall will be made up and which sectors of the economy will lose the labour and capital resources that will shift to the tax-advantaged activity. The decrease in activity or social justice associated with that other tax increase may be greater. The Downing group in Australia made this point: 'Tax reform is not primarily concerned with the total amount of government revenue to be raised. It is concerned very much with the methods by which revenue is raised.'[lxix]

That said, at times, societies, and their governments, may need to contemplate a change in the overall tax burden to match a change in expenditure demands. Most obviously this occurs at times of crisis, such as wars or pandemics, where the nature of the demands on government change dramatically in the short term. There may also be longer-term considerations, such as with the current spending pressures in health, aged care, disability support and defence in Australia where an increase in the overall tax burden may need to be contemplated. Allowing expenditure to outstrip revenue for protracted periods accumulates debt, with intergenerational equity implications.

Finally, tax reform is typically more about the base than the rate. It is differences in what is taxed that is the main cause of inequities, inefficiencies and complexities. In general, the tax base determines the fundamental nature of a tax system, and the rates can be varied to adjust the total amount of revenue required. That said, high tax rates can exacerbate distortions caused by flaws in the tax base and increase the incentives for tax avoidance and evasion.

Conclusions
My forthcoming book *Mixed Fortunes: A History of Tax Reform in Australia* will look at major tax reviews in Australia and internationally, assessing how they have adopted, and influenced, the tax concepts discussed in this paper. We will see that tax reviews in the first half of the twentieth century focussed on fairness and tax administration issues. Tax reviews in the second half of that century added economic efficiency considerations, with a pursuit of comprehensive tax bases to achieve those combined objectives. The limited number of tax reviews so far in the twenty-first century have also been influenced by optimal tax theory considerations.

Crucially, tax reform considerations need to be framed by a whole-of-tax-system perspective, and indeed at times a whole-of-tax-and-transfer-system perspective. Only then can an informed assessment be made of whether potential tax policy changes would improve the overall equity, efficiency and simplicity of the tax system, and hence whether they deserve the moniker of tax reform.

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Notes

[i] OECD glossary of tax terms.

[ii] There are other views, such as the modern monetarist perspective that governments create money when they spend it and the purpose of taxation is the prevention of economic imbalances.

[iii] ABS Government Finance Statistics, 2021-22.

[iv] See discussion of merit good characteristics in Head, 1974, chapter 10, pp. 214-47.

[v] Conceptually defined by a society’s social welfare function.

[vi] Tax breaks typically favour those who pay the most tax, ie higher-income earners.

[vii] Wikipedia, cited 8 July 2022.

[viii] See discussion in Fukuyama, pp. 80-1.

[ix] Finer, p. 99.

[x] Ibid., pp. 113-4.

[xi] Ibid., p. 445.

[xii] Fukuyama, pp. 83-7.

[xiii] Luigi Pascali, *The Origin of the State: Land Productivity or Appropriability?*, Broadstreet, 4 February 2022.

[xiv] See Introduction to Hobbes’ *Leviathan* by A. D. Lindsay, p. xii.

[xv] Fukuyama, p. 82.

[xvi] Keen and Slemrod, p. 25.

[xvii] Ibid., pp. 26-7.

[xviii] Ibid., pp. 29, 56.

[xix] Ibid., p. 27.

[xx] The desire to tax people in other countries perhaps explain the typically bipartisan support for MNE taxation measures. (I am indebted to Andrew Leigh for this observation.)

[xxi] Ibid., p. 29.

[xxii] Ibid., p. 31.

[xxiii] Ibid., pp. 28, 41.

[xxiv] Ibid., p. 30.

[xxv] Stewart, 2023, p. 28.

[xxvi] Keen and Slemrod, p. 22.

[xxvii] Mill, p. 395.
[xxviii] A Smith, 1976, Volume 2, p. 350.
[xxix] Ibid., p. 368. Also, see discussion of this issue in Stamp, p. 39.
[xxx] Bastable, p. 101.
[xxxi] Pigou does not accept the equal sacrifice approach, preferring least aggregate sacrifice (Pigou, p. 61).
[xxxii] Stamp, pp.1-2.
[xxxiii] Ramsey, p. 58.
[xxxiv] Little, p. 584.
[xxxv] Harberger, pp. 25-70.
[xxxvi] Brennan and Buchanan, p. 262.
[xxxvii] See discussion at Head, 1982, p. 196.
[xxxviii] See discussion in Saez.
[xxxix] The USA Constitution previously required direct taxes to be apportioned among the states in proportion to their populations.
[xl] Haig, p. 59.
[xli] Simons, pp. 30-1.
[xlii] Bittker, pp. 961-2 and 973-4.
[xliii] Head, 1982, p. 195.
[xliv] Musgrave, 1959, p. 165.
[xlv] Ibid., p. 157.
[xlvi] Musgrave and Musgrave, p. 236.
[xlvii] Design differences prevent a seamless tax-transfer system, such as differences in the unit, eg individual versus family and the time period, eg year versus fortnight.
[xlviii] Stamp, p. 40.
[xlix] See discussion at Head, 1979, p.10.
[l] Head, 1991, p. 28.
[li] Flat in the sense that rates cannot vary between individuals.
[lii] Cnossen, 1983, pp. 312-3.
[liii] When calculating their VAT liability, registered businesses charge the full tax rate on their sales but claim a tax credit for the amount of VAT already paid on their inputs. In this way, GST is only paid on the net value added at that part of the production/distribution chain. The full accumulated amount of the GST is expected to be ultimately passed on to the final consumer.
[liv] Tax Policy Centre, Urban Institute and Brookings Institute, Briefing Book, sourced 8 October 2020.
[lv] OECD Revenue Statistics, 2022.
[lvi] Cnossen, 1989, p. 327.
[lvii] Head, 1982, p. 194.
[lviii] Mirrlees, p. 30.
[lix] Ken Henry, personal interview.
[lx] OECD, pp. 16-7.
[lxi] See discussion at Keen and Slemrod, pp. 230-1.
[lxii] Head, 1983, p. 14.
[lxiii] Royalties are also charged in Australia for the right to extract natural resources.
[lxiv] See Table 1.1 of the 2023 Tax Expenditures and Insights Statement which shows these areas account for the five largest tax expenditures.
[lxv] The effect where nominal income growth pushes individuals income taxpayers onto higher tax rates (average and sometimes marginal) without an increase in real income.
[lxvi] The Concise Oxford Dictionary.
[lxvii] The OECD country surveys, for example, articulate an economic reform program for a country.
[lxviii] Although a resource rent tax on iron ore, coal and gas would also have macroeconomic stabilisation benefits for a country such as Australia.
[lxix] Downing, p. 5.