Chapter 2

The role of taxation in public finance

Contents

2. THE ROLE OF TAXATION IN PUBLIC FINANCE

SUMMARY

Communities face important choices about how particular goods and services should be provided. In broad terms, these choices can be private provision, regulation, or government provision. The choices have significant impacts on measures of the size of government expenditure or government revenue.

This report follows long-standing practices used by international organisations when making cross-country comparisons.

In 2003, Australia had the third lowest government expenditure as a proportion of GDP of 28 OECD countries (Mexico and Turkey do not provide comparable data) and the second lowest of the OECD-10.

The primary reason that Australia was the third lowest spending, yet eighth lowest taxing OECD country, is that many of the higher spending countries were running fiscal deficits in 2003.

The unweighted average fiscal deficit across the 28 OECD countries was 1.9 per cent of GDP. As the two largest economies in the OECD (the United States and Japan) have large fiscal deficits, the weighted average fiscal deficit in the OECD was 4.0 per cent of GDP.

2.1 INTRODUCTION

This chapter discusses the choices faced by governments and people about how to organise and manage key elements of their society and the economy. These choices are divided into three major categories for the purposes of discussion in this chapter — private provision, government regulation, and government expenditure programs funded by taxation revenue.

One of the three choices is to use government expenditure programs to deliver services funded primarily through taxation revenue. The chapter will outline the links between government expenditure and revenue, and some principles involved when considering tax policy design.

2.2 COMMUNITY EXPECTATIONS OF THE ROLE FOR GOVERNMENT

In liberal democratic societies, the community makes choices about how they want their society and economy to operate. One of the most fundamental choices is the balance between private and public provision of services.

Governments have a role in establishing elements of the framework which allow people to make choices. The minimal list of these usually include elements such as the establishment of the rule of law to protect the security of individuals, and the establishment of property rights, as well as the creation of legal systems for enforcement of agreements between parties.

Beyond this basic framework, communities may have very different expectations about what is best left for individual decision-making through private markets and private institutions, whether it is more appropriate for governments to require certain types of behaviour (for instance, wearing of seat belts), or whether governments should directly provide such services, either with payment or without.

2.2.1 Private provision

Communities may decide that many goods and services should be provided through private means including through private markets. Beyond the creation of the basic framework required to allow societies to operate (such as the rule of law), these market choices are fundamentally voluntary, private decisions. Much of the drive in recent decades in Australia towards freeing up markets is a belief that individuals are generally best placed to decide what is best for themselves.

The public/private balance and views on the role of government also extends into a broad range of social issues. There are debates in many societies about the appropriate roles, obligations and responsibilities within and between individuals, families and government.

Societies which choose high levels of private provision will have low levels of government expenditure and revenue. Individuals would still need to consider whether to purchase health insurance or self-insure if there were few public hospitals, or whether to accumulate a high proportion of their wages into private savings if there was no government support for the unemployed or the elderly. The potential for self-provision of such services should be considered when making comparisons between countries with very different balances between private, regulatory and government provision. Such issues are not pursued in this report.

2.2.2 Regulation

Another approach that communities can use to deliver social and other policy objectives is to mandate or regulate certain behaviour. Regulation is often used to achieve the community's social, environmental and economic objectives. It is typically used to set benchmarks for corporate governance and behaviour; ensure community safety and security; and to set standards and rules in relation to environmental objectives. The use of minimum wage laws in Australia is an example of an economic regulation that has an important impact on both individuals and businesses.

Box 2.1: Australia's Superannuation Guarantee

Discussions have occurred in the Australian community and through the press as to whether the Superannuation Guarantee (SG) payment is classed as a tax and should be included as such in this study.

The first point to note is that, under the OECD definition (as well as the IMF and World Bank), the SG would definitely not be classified as a tax. The definition used by the OECD and others is based around any such tax being an unrequited transfer to government and the SG does not fall into this category. The funds do not go to the government but are owned directly by individuals to be used or invested by the individual as he/she sees fit within the limits imposed by the private superannuation fund. Even at death, the balance of any funds are then owned by the individual's family or nominated beneficiaries.

In defining a total reward package to individuals, most businesses in Australia include SG, along with base salary plus any incentives, as part of that total salary package.

Right through this review, the authors have been willing to test the validity of a strict OECD definition if it was considered that some variation gave a clearer or better comparison. In this instance, there is an arguable proposition that SG is a mandated impost on employers and thus compares to the social security charges, which are also a mandated impost, and are included in the OECD figures (and definitions) as a tax. Where these social security charges differ, however, from the Australian SG is that these social security charges go to the government and are then distributed to individuals as some form of social security, but they do not necessarily equate to the original impost, nor do any equivalent balances revert to an individual's family or beneficiaries.

If, however, the authors elected, for the sake of comparison, to add the SG to existing figures two major problems are encountered in making a proper benchmarking comparison.

First, if the SG was added to the figures in this study, we should then, for proper comparison, adjust the comparator countries with similar regulatory requirements which are imposed, but which currently are not included (by OECD definition) in these countries' figures because they are not defined by the OECD as taxes (for instance, the compulsory Swiss health insurance requirement and the Netherlands 'mandatory' private savings arrangement). To add one non-defined set of figures to one country without adding similar non-defined figures to the other countries, would not allow a true benchmarking comparison.

Secondly, we do not have a clear figure for the 'impost' of the Australian SG which we should add. Some proportion of these payments would have otherwise accorded with voluntary decisions by people to provide for their retirement. Over 50 per cent of full-time Australian employees were already receiving superannuation contributions prior to the introduction of the SG. Putting money into superannuation is a very effective investment. The voluntary element (or what would have happened anyway) should be taken out of any definition of this 'impost'.

Box 2.1: Australia's Superannuation Guarantee (continued)

If it were possible to calculate and add the appropriate figures to both Australia and the comparator countries, it is uncertain if Australia's relative position based on this calculation would change.

Therefore to allow consistent comparison throughout this report, and given the uncertainty about whether it would make any overall difference to relative positions anyway, we have elected to follow the clearly defined OECD definition of tax classification.

Many societies use regulations to promote the provision of various forms of life and health insurance, as well as the provision of certain income support measures. In these situations, governments may not be directly involved in any of the related financial flows that the regulation imposes. Governments can still achieve social policy objectives that would otherwise be supported or delivered by either private choices or by the government. An example of regulation in Australia which requires some form of levy or transfer from employees to other private individuals is the enforcement of child support payments. Other examples of regulatory requirements are minimum wage laws, occupational health and safety regulation and environmental regulations.

There are other situations where regulations can also improve public outcomes. Examples include where there are information failures or demonstrated myopic behaviour. The presence of externalities may also indicate that some form of pricing or regulatory approach may be desirable. When considering such regulatory responses, the potential benefits should be weighed against the costs that regulation places on businesses, consumers, governments and the wider community. These costs flow not only from compliance costs, but also from the fact that regulation causes businesses to adjust their activities in ways that distort market outcomes, and may make some activities unviable and some previously unviable activities viable. These potential impacts highlight the importance of well-designed regulation.

In many cases, communities can choose between government regulation and public provision. Communities which rely to a greater extent on regulation will have lower reported expenditure and taxation levels in international comparisons.

2.2.3 Government provision

Communities may decide that they want particular activities not only regulated by government, but actually provided by government. Some goods and services are generally considered as best provided by government (a minimal list would include defence and foreign affairs). Other areas of government provision are debated more extensively, such as the appropriate degree of government involvement in the provision of health care or education. Taxation revenue is used to finance such government expenditure.

The OECD defines a tax as a compulsory, unrequited transfer to the general government sector. This definition is based on a system of national accounts reporting adopted by member governments over the last half century. Taxes are unrequited in the sense that the benefits provided by government to taxpayers are not necessarily in proportion to their contribution.

The key characteristics of this definition of a tax are that, to qualify as a tax, payments must be both compulsory and an unrequited transfer to government. If only the first condition is met, it is not a tax and therefore falls into the category of regulation outlined above.

These arrangements are summarised in a stylised way in Table 2.1, which shows the classification based on whether an action is voluntary or compulsory and whether any funds go to private individuals/institutions or to government.

Table 2.1: Classification of financial transfers

	Financial transfers from the private sector	
	To the private sector	To the government sector
Voluntary transfer	Private	Non-taxation revenue
Compulsory transfer	Regulation	Taxation revenue

At a more detailed level, non-taxation revenue can include a series of user fees, charges or fines related to the provision of a government service (for example, passport fees) and various types of royalty payments to government for the use of natural resources.

The remainder of this chapter, consistent with the terms of reference, will consider government expenditure and revenue issues.

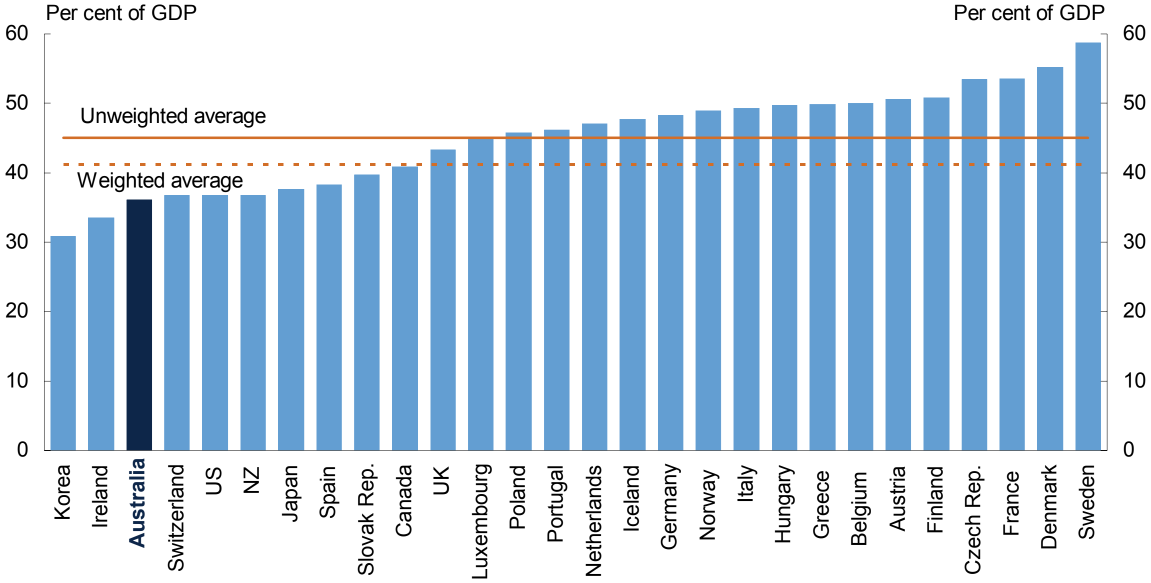
2.3 GOVERNMENT EXPENDITURE

The major differentiating factor between the tax burden in different countries over time is the amount of expenditure on government programs which each country's citizens demand. Financing this expenditure is, after all, the primary purpose of taxation.

As explained in Chapter 1, the approach in this report has been to compare Australia to developed countries (the OECD-30). The report also covers a group of countries with similar expectations regarding government provision of goods and services, as measured by government expenditure or revenue as a proportion of GDP (the OECD-10).

Australia has historically had relatively low government expenditure. In 2003, Australia had the third lowest government expenditure as a proportion of GDP of the 28 OECD countries with available information and the second lowest of the OECD-10 (Chart 2.1).

Chart 2.1: General government expenditure
OECD-30, total government expenditure as a proportion of GDP, 2003



Source: OECD *Economic Outlook* No. 78, 2005.

Government expenditures as a proportion of GDP are higher in developed countries, including developed non-OECD countries in the Asian region, than they are in developing countries. Given that citizens in advanced industrial democracies tend to demand greater social expenditure by government, it should be expected that aggregate level comparisons would point to lower government expenditure, and lower taxation, in developing countries when compared with a developed country such as Australia. Specific examples of this are provided in Chapter 12.

2.4 The objectives of taxation

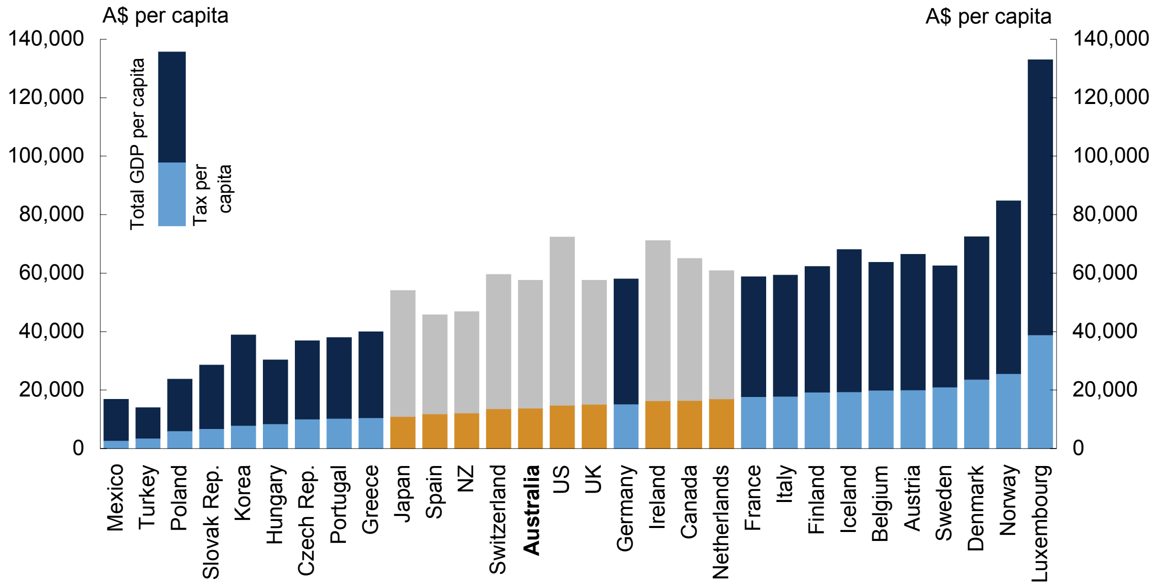
The fundamental purpose of taxation is to finance government expenditure. Beyond this primary purpose, modern tax systems are also guided by principles of efficiency, equity and simplicity. There are instances when these three principles conflict, and there are also instances when the principles conflict with the revenue raising purpose of taxation. Differences in public choice outcomes between countries reflect the different history and circumstances of each country, and there are many different approaches that can be taken to balancing the objectives of public policy.

The tax system can be used for purposes other than revenue raising. In certain situations, imposing a tax may potentially increase efficiency if markets fail to price factors such as pollution or congestion, or the health costs of particular types of behaviour such as cigarette smoking. Such costs external to the market mechanism are referred to as 'externalities'. Some OECD countries have imposed specific taxes in an attempt to use market prices (inclusive of the price-correcting tax) to allocate resources efficiently, taking into account some of these externalities.

The relationship between taxation revenues per capita and the level of GDP per capita are shown in Chart 2.2. As indicated in the chart, Australia collects less tax per capita than the United States. The reason the United States has a higher taxation revenue per capita than

Australia, but a lower taxation revenue as a proportion of GDP, is because it has higher levels of income. Similarly, New Zealand collects less tax per capita than Australia, but has a higher tax to GDP ratio, because Australian incomes are higher than in New Zealand. The chart also indicates the similarities with the OECD-10 grouping and Australia — in terms of tax per capita, ten of the comparator countries are within a band of 11 countries (Germany being the exception).

Chart 2.2: Tax per capita as a proportion of GDP per capita[(a)]
OECD-30 and OECD-10, 2003



(a) Calculated using OECD data and IMF purchasing power parities.
Source: Australian Treasury estimates.

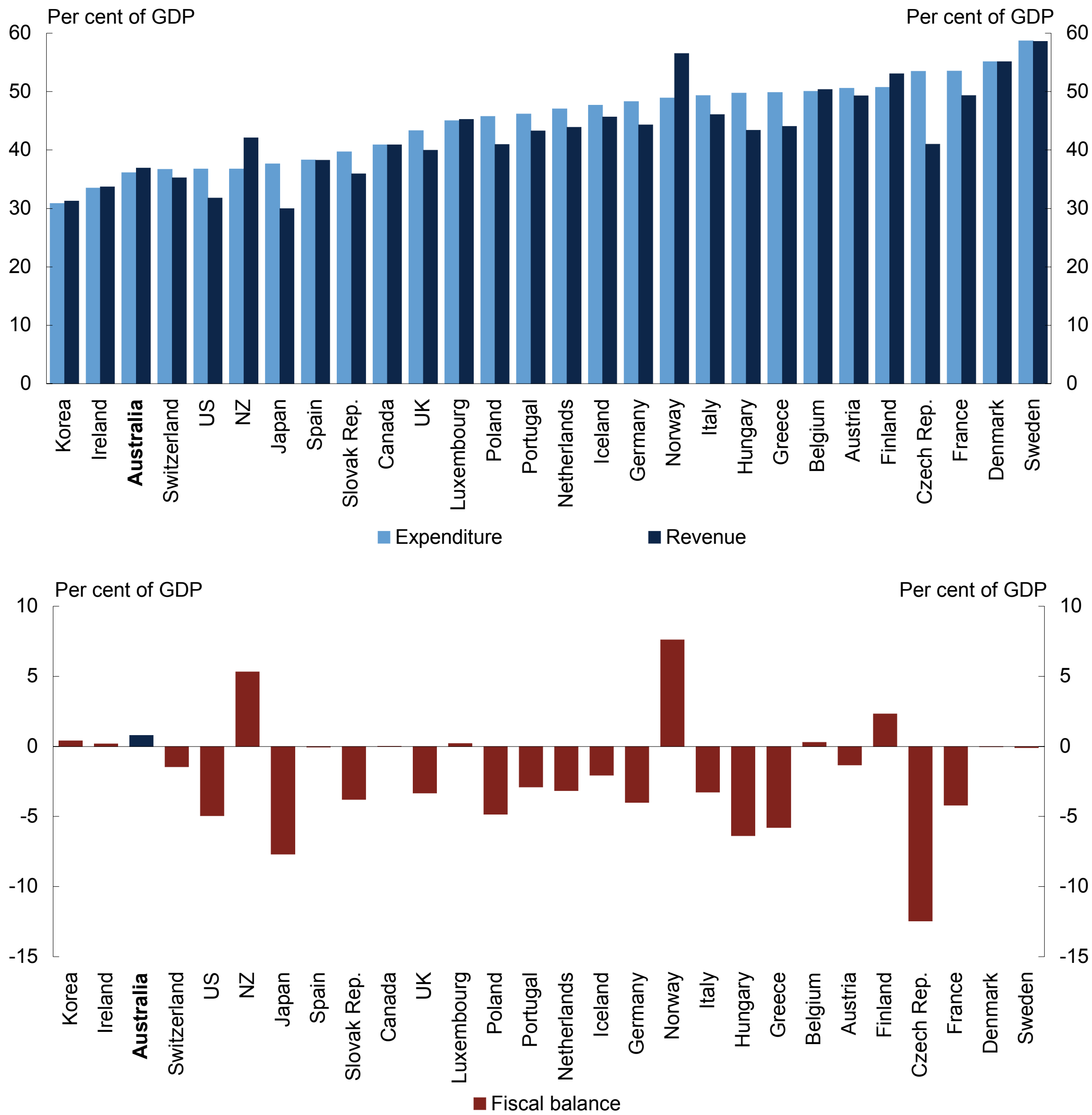
2.5 ALTERNATIVE FISCAL POLICY POSITIONS

Different fiscal strategies between countries make simple comparisons of their tax burdens challenging. All governments have choices to make in terms of overall levels of expenditure and the taxation revenue necessary to finance that expenditure. The implications of any imbalances between expenditures and revenues over time are discussed in Box 2.2.

The report provides an overview of the fiscal position of different countries. It uses 2003 for making international comparisons as that is the latest year for which there was detailed taxation revenue data available for the OECD. In 2003, most OECD countries were running fiscal deficits. In contrast, Australia was one of nine countries with a fiscal surplus.

This difference in fiscal position is an important aspect of understanding Australia's relative tax burden. The primary reason that Australia in 2003 was the third lowest spending, yet eighth lowest taxing country, is that many of the higher spending countries were running fiscal deficits. The fiscal position for the 28 OECD countries is depicted in Chart 2.3. Comparable data is not available for Mexico or Turkey, so they are not shown in the chart.

Chart 2.3: Fiscal position of OECD-30
Expenditure, revenue and fiscal balance as a proportion of GDP, 2003

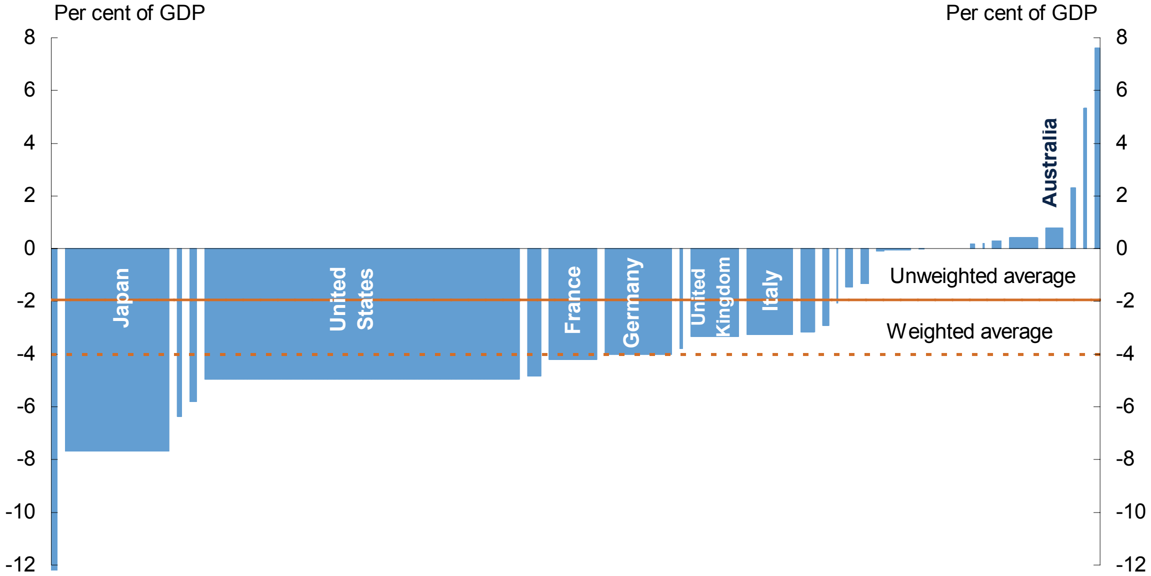


Source: OECD *Economic Outlook* No. 78, 2005.

The unweighted average fiscal balance of the 28 OECD countries was a deficit of 1.9 per cent of GDP. As the two largest OECD countries both have large fiscal deficits, the weighted average fiscal deficit is 4.0 per cent of GDP. An illustration of how the weighted average fiscal deficit is derived is provided in Chart 2.4.

Chart 2.4: Fiscal balances of OECD-30

Balance as a proportion of GDP, weighted by GDP at purchasing power parity[a], 2003



(a) Refer to Box 3.1 for a discussion of weighted and unweighted averages.
Source: Australian Treasury estimates.

Box 2.2: The inter-temporal dimension of the tax burden

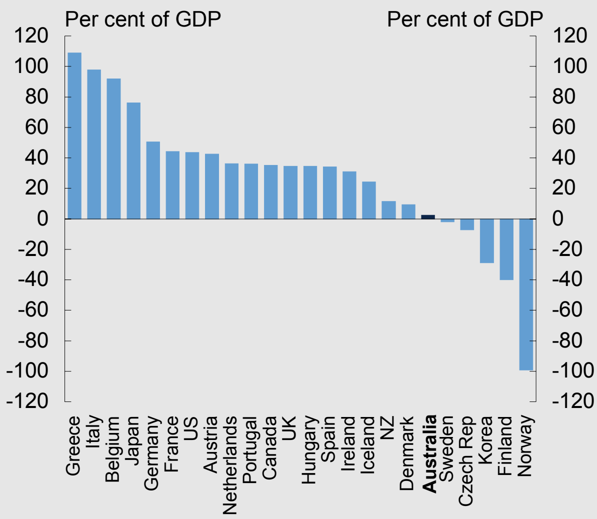
Tax burdens are difficult to compare internationally, even at the highest level of aggregation — total taxation revenue as a proportion of GDP. One area that causes particular difficulty is the inter-temporal dimension of the tax burden, or public finance more generally.

- Countries may choose to have lower tax burdens in the short run, without reducing their levels of expenditure, if they are willing to run budget deficits and accumulate government debt (or conversely, by reducing their holdings of assets).
- Countries with relatively large levels of government debt may need to have a higher tax burden in the future, or reduce expenditures relative to revenues, in order to finance that stock of debt or repay it. Periods of strong economic growth can also help to improve the fiscal position.
- Large fiscal imbalances or large levels of debt may not be sustainable for long periods, and choices may need to be made to reduce expenditures or increase revenues.

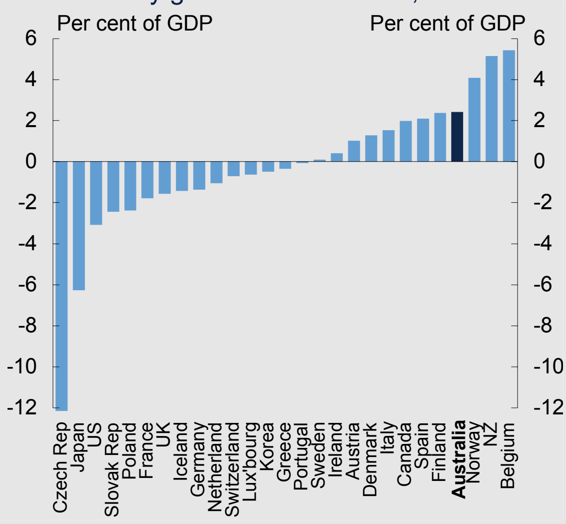
The charts below show that all countries are not in a similar fiscal position. Australia has a low level of government debt compared with most OECD countries and runs a fiscal surplus. Other countries with which Australia's tax burden is frequently compared have very different fiscal positions.

- The United States and Japan are running substantial budget deficits and have significantly higher levels of government debt than does Australia. Consequently, it could be argued that their current levels of tax burden relative to Australia are understated from an inter-temporal perspective.
- In the future, the United States and Japan will need to revise their policy settings by reducing expenditures as a proportion of GDP, raising taxation as a proportion of GDP, or some combination of the two, in order to put their fiscal positions onto a more sustainable footing. Policies to boost their economic growth rates, where feasible, or sell public assets may also play a role in the longer term.
- Interestingly, Australia's very low level of public debt gives it greater future fiscal policy flexibility than most other OECD countries.

Net financial liabilities, 2003[(a)]



Primary government balance, 2003



(a) It should also be recognised that there may be other liabilities that are not reflected. For example, Australia has significant levels of unfunded superannuation liabilities, which are not counted as government debt but have similar characteristics. The Australian Government is using its current strong fiscal position to provide funding for some of those liabilities through the Future Fund. However, other countries have even larger unfunded social security arrangements. Furthermore, the OECD notes that, in many countries, these social security arrangements have a persistent deficit requiring subsidies from general taxation.

Source: OECD *Economic Outlook* 78, 2005.