PROPOSALS TO INCREASE TAXES

INCREASES in taxes, both direct and indirect, are being advocated in academic and other economic circles as a means of reducing spending and thus curbing the flow of imports. A proposal to raise income taxes sufficiently to produce an extra £100 million of government revenue is being widely discussed.

The theory behind raising taxes is that people and businesses will be left with less money to spend and that this will, therefore, ease the pressure of demand coming from the private sector of the economy for both personal needs and investment. If, however, the government chooses to devote the extra tax proceeds to its own purposes, such as public works, there would be no net reduction in spending. Demand would be merely transferred from the private to the public sector of the economy. Admittedly, most advocates of increased taxes have in mind that additional tax revenues will remain unspent, and, thereby, ensure a genuine deflationary budget surplus.

One weakness of the whole proposition to increase taxation lies in the assumption that it must drain off excess purchasing power. This is not necessarily so. Because of political pressures, there is an almost irresistible temptation for governments to spend all that they get in tax revenue—and sometimes more. A classic instance was the 1951/52 budget which raised taxation heavily for the very purpose of reducing spending; but the need to buttress the works programmes of the States led to an over-all increase of £200 million in government expenditure.

With less money available for Government loans (as a result of tax increases) the Commonwealth Government may be sorely tempted—and ultimately persuaded—to make up for the deficiencies by using its newly acquired tax revenues. Clearly, if political pressures force the Government to draw upon the proceeds of increased taxation, spending is not reduced but is simply transferred, in the first place, from private individuals to government authorities. Furthermore, if one accepts the diagnosis that it is primarily development expenditure, and not spending on consumption, which is at the root of the balance-of-payments difficulty, diversion of resources to public capital projects, at the expense of consumption, will, in the end, only serve to aggravate the external unbalance.

BUT the reaction by governments to increased tax revenues is only one aspect of the problem. What of the community's private habits? There is a strong, and entirely natural, tendency on the part of everyone to strive to maintain the standard of consumption to which they have become accustomed. Keynes himself pointed this out and attributed great importance to it: ". . . a man's habitual standard of life usually has the first claim on his income and he is apt to save the difference which discovers itself between his actual income and the expense of his habitual standard; or, if he does adjust his expenditure to changes in his income, he will over short periods do so imperfectly. Thus a rising income will often be accompanied by increased saving, and a falling income by decreased saving, on a greater scale at first than subsequently." If incomes are reduced by higher taxes, then it is certain that individual outlays will be, to quite a large extent, maintained by the diversion of savings and by attempts to increase borrowing. Statistics recently made available by the United Kingdom Central Statistical Office provide a striking illustration of this point. (See page 110.)

The proportion of income saved is, of course, influenced by a variety of factors, but it can hardly be mere coincidence that the low level of savings and the relatively high level of consumption expenditure during the years 1948 to 1951 should also be a period of exceptionally heavy taxation. The figures show that, following reductions in taxation in 1952 and subsequent years, the proportion of income (before tax) devoted to consumption declined, and savings staged a remarkable recovery.

Taxes, Personal Savings and Personal Expenditure in United Kingdom as % of Personal Incomes.

	Personal Income Taxes and Taxes on Expenditure	*Personal Savings*	*Personal Expenditure*
1948	30.3	0.5	85.1
1949	28.3	0.1	84.2
1950	28.0	0.13	85.3
1951	28.6	0.9	84.1
1952	26.7	4.8	81.4
1953	25.3	5.5	81.4
1954	25.4	5.3	81.5

Note:—The figures do not add across to 100%, mainly because not all taxes on expenditure are paid by persons.

The history of the post-war years has also shown that many taxpayers are able to use their bargaining strength in a fully extended economy to circumvent any attempt to reduce their actual spending power. Confronted with smaller *net* incomes (i.e., incomes after tax), employees strive to increase their *gross* incomes by pressing for higher wages and salaries, and self-employed persons tend to raise their prices or fees. For all these reasons the projected reduction in spending is certain to be, at least in part, frustrated.

THERE is another important aspect. Until recently, economists were usually ready to concede that increases in direct taxation had harmful effects on work incentives and on enterprise, and thus on efficiency and production. Moreever, under present circumstances, these effects would make themselves felt at the precise time when improvements in productive efficiency and reduced costs have become a matter of paramount concern.

The advocates of higher taxes reject this view. In support of their stand they have impetuously quoted the United Kingdom Royal Commission on the Taxation of Profits and

Incomes, obviously failing to make a proper assessment of the Report and of the matters with which the Commission was specifically concerned. The main objective of the Royal Commission was to investigate the existing *system* of taxation of profits and income, *taking for granted the total weight of taxation.* Since total tax revenues were not to be reduced, any comments made on the disincentive effects of the rates of taxation were a secondary consideration, and were, in their own words, "little except general reflections", and not firm conclusions. For example, in discussing Pay-As-You-Earn as a machine for collecting tax from wage and salary earners, the Commissioners emphasised that P.A.Y.E. had been blamed for defects more properly the result of the total burden of taxation, which was assumed in their deliberations. Other extracts reveal that the Royal Commission was well aware that high rates of tax might have a harmful effect on productive effort. For instance, the Commissioners were agreed that heavy taxes were likely to make a man "disinclined to take on something out of his usual course" and probably tended to "repress effort and to discourage the taking of risks."

A close reading of those sections of the Report dealing with the effects of taxation on the higher income groups seems to indicate that the experts themselves were far from united on the question of taxation and incentives, and could only come to agreement by the deliberate use of phraseology which was open to contrary interpretations. Certainly there are sentences in the Report which, taken out of their context, might be quoted in support of the view that heavy taxes have little or no effect on incentives. Equally there are sentences which could be used to support the precisely opposite point of view. But—and this is most important—the Commission was careful to avoid committing itself to any firm conclusion that a *rise* in tax would have no adverse effect on incentives to effort:—"The evidence which has been presented suggests that marginal rates of tax are not at present a serious disincentive to effort in the lower income groups; but it is possible that present rates may not be disincentive, *while a rise in the rates would still have a* disincentive effect." (The italics are ours.)

APART from all this, the Commission was concerned with the existing British tax structure and its relationship to the British economy, and not with the establishment of general principles of taxation of universal application. Even had the Commission concluded that a rise in tax rates *in Britain* would have no adverse effect on incentives to effort—which it did not— it would be totally wrong for advocates of higher taxes in this country to apply the conclusion to Australian conditions.

In Australia, the great bulk of personal income tax is paid by employers, farmers and other self-employed persons, business executives and professional men, most of whom fall within the middle and higher income brackets. In the year 1952-3 (latest for which figures are available) the top 25% of Australian taxpayers (with incomes of £900 a year and over) paid three-quarters of all income taxes on persons. Additional taxation on this group is not likely to bring about any significant reduction in the total level of spending. The weight of numbers means that the bulk of consumption spending comes from the 75% of taxpayers in the lower income brackets. In addition, the top 25% are more likely to draw down their savings than reduce their standards of consumption. This is supported by the British statistics quoted above. Moreover, increased taxes on this group, which comprises those in positions of executive responsibility, may have a serious impact on their incentive to introduce projects for increasing productivity and thus reducing costs. The answer to the external trade problem must eventually be found partly in positive measures for increasing farm production. Higher levels of taxation can only serve to anger and discourage export producers.

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Apart from higher direct taxes, increases in indirect taxes, particularly on so-called luxury items and on goods with a large import content, have been proposed. Governments should be extremely wary of these ideas. The consequences of imposing higher sales taxes, for instance, are by no means so certain and direct as they may, at first sight, seem.

It needs a very stiff increase in sales tax, on say a motor car or a fully automatic washing machine, to deter people in the middle and higher income brackets. On the other hand, if those in the lower income ranges find the article in question now beyond their pocket, they are highly likely to turn their spending in other directions. There is, thus, in their case no necessary reduction in total spending, and, as we have already seen, the upper incomes are far more likely to save less rather than spend less.

THE idea that a rise in sales taxes should be used to dampen down total spending represents a new and rather revolutionary departure in economic theory. Up to the present—apart from their revenue-raising effects—increases in indirect taxation have been levied for two main purposes: First, to reduce the consumption of certain commodities, notably liquor and tobacco, whose excessive use might be socially undesirable; and second, to divert the use of resources from less essential channels to those regarded as more essential. To be effective in reducing total spending, sales taxes would need to be imposed on a large proportion of all items entering into consumer expenditure. This is just what has been done in the recent British budget. Apart from the strong, political opposition which such a move in Australia would certainly arouse, the automatic link between wages and prices in this country would render such a measure of extremely dubious value.

As the effect of increased sales taxes is to raise prices, it is probable, as with higher income taxes, that people will be led to seek increased incomes in compensation. Higher prices and costs are, of course, the very thing which Australia, in its present circumstances, most needs to avoid. The Butler supplementary budget in Britain, which has imposed stiff purchase taxes on a wide range of commodities, has been severely criticised on just these grounds.

ALL in all, the economic effects of increased taxes are far from as obvious as their supporters, with an extraordinary lack of economic sophistication, seem to assume. The theorists in these matters seem to forget that there is, in economics, often a vast difference between *what should happen,* according to abstract reasoning, and *what, in fact, does happen.* Economics is, after all, something more than an exercise in simple arithmetic.

It might legitimately be asked whether increased taxes are being proposed entirely dispassionately, or at least partly because they accord with the socialist doctrine of levelling down and of more government controls. A government believing in the principles of free enterprise should at least move cautiously on a matter so close to the heart of its fundamental faith. If the community's spending must be curtailed —and in view of the adverse trade balance there seems no escape from it—then there are more certain, more effective and less harmful means than tax increases.*

* See article "Consumption or Development?" (page 97).

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