



COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

SENATE

SELECT COMMITTEE ON A NEW TAX SYSTEM

Reference: A new tax system

WEDNESDAY, 3 FEBRUARY 1999

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SENATE
SELECT COMMITTEE ON A NEW TAX SYSTEM

Wednesday, 3 February 1999

Members: Senator Cook (*Chair*), Senator Ferguson (*Deputy Chair*), Senators Conroy, Gibson, Murray, O'Chee and Sherry

Participating members: Senators Brown, Colston, Harradine and Margetts

Substitute member: Senator George Campbell

Senators in attendance: Senators George Campbell, Conroy, Cook, Ferguson, Gibson, Murray, O'Chee and Sherry

Terms of reference for the inquiry:

- (1) That a select committee, to be known as the Select Committee on a New Tax System, be established to inquire into and report, on or before 18 February 1999, on the economic theories, assumptions, calculations, projections, estimates and modelling which underpinned the Government's proposals for taxation reform, contained in *Tax reform: not a new tax, a new tax system*.
- (2) That, in conducting its inquiry, the committee examine the following matters:
 - (a) the estimated levels of revenue to be generated or foregone due to the proposed changes, including the estimated level of revenue to be generated by imposing a goods and services tax (GST) on the basic necessities of life (such as food, clothing, shelter and essential services) and books;
 - (b) the effects of the proposed changes on:
 - (i) national Gross Domestic Product,
 - (ii) national export performance and national debt,
 - (iii) the national Consumer Price Index, and
 - (iv) the distribution of wealth in the Australian community;
 - (c) the effects of the package on future federal budget revenues, expenditures and surpluses, including a critical assessment of the economic assumptions underpinning the Treasury's projections in this regard;
 - (d) the effects of the taxation and compensation package on disposable income and household

spending power for a range of 'cameo profiles', including but not limited to those presented in the proposals, under the following scenarios:

- (i) a GST extended to the necessities of life (such as food, clothing, shelter and essential services), and

 - (ii) a GST not extended to the necessities of life (such as food, clothing, shelter and essential services);

 - (e) with the aim of identifying families and groups who may be disadvantaged by the Government's proposals, focusing on lower and fixed income individuals, families with dependent children or adult members, groups and organisations, and those with special needs, such as people with disabilities;

 - (f) the assumptions made as to consumption and saving patterns and the cost of living for the various 'cameo profiles';

 - (g) whether the stated objectives of the package can be met by using an alternative and fairer approach; and

 - (h) such other matters as the committee considers fall within the scope of this inquiry.
- (3) That the committee also inquire into and report, on or before 19 April 1999, on the broad economic effects of the Government's taxation reform legislation proposals with regard to the fairness of the tax system, the living standards of Australian households (especially those on low incomes), the efficiency of the economy, and future public revenues, including:
- (a) the effects on equity, efficiency and compliance costs of including, or not including, food or other necessities of life in the GST, together with any related adjustments to the package if food or other necessities of life were GST zero-rated;

 - (b) the effectiveness of the package in easing the poverty traps facing people on low incomes, and reforming and streamlining tax and income support for families with children, taking into account the static and life-cycle impacts on families with children;

 - (c) options for amending the income tax schedule to make it more equitable;

 - (d) the findings of the Tax Consultative Committee chaired by David Vos;

 - (e) options for improving the effectiveness and fairness of the tax system and reducing inequitable or unreasonable tax avoidance and minimisation, including consideration of alternative areas for tax generation, either where there are current tax concessions or where Australia's taxation system does not address major tax potential, and without limiting the foregoing, the consideration of taxation of foreign companies operating in Australia, including the relative merits of resource rent taxes, royalties or land taxes as compared to company tax in securing a fair compensation to Australia for use of its resources, whether the 150% tax concession for research and development should be restored and whether small companies should be allowed to be taxed as partnerships.

- (f) the potential for tax avoidance and evasion, including an examination of the effects on the cash economy, and the potential impact of electronic commerce on the future viability of a GST;
- (g) the effects on compliance costs;
- (h) the potential for reducing payroll tax, including by providing incentives to create long-term employment and by replacing payroll tax with a carbon tax;
- (i) whether there are other means available for rebating or reducing the indirect taxes or excessive user charges embedded in exporters costs;
- (j) excises, including those on fuel, tobacco and alcohol - identifying the industries which benefit, and to what extent, from the proposed changes to taxes on fuels;
- (k) the effects on interest rates;
- (l) the effects on investment, in both physical and human capital formation;
- (m) the effects on small business;
- (n) the effects on the non-profit sector, including the total amounts of money contributed by the sector, administrative costs, impacts on the viability of the organisations, and the consequent effects on the wellbeing of the community;
- (o) the effects of the GST on particular industries, including:
 - (i) key service industries such as tourism,
 - (ii) the Australian automobile and related industries, having particular regard to the effects of changes to fuel excises,
 - (iii) other 'invisible' export industries, such as education and financial services, and
 - (iv) the international competitiveness generally of Australian industries;
- (p) the implications of not requiring that the GST component of goods and services be itemised on receipts;
- (q) the effects of the taxation reform legislation proposals on rural and regional stakeholders, including:
 - (i) the effects on particular regions,
 - (ii) the effects on rural and regional communities of different tax regimes on fuel - especially the cost of transport of goods to rural communities,
 - (iii) the effects on primary industry of replacing the current sales tax exemption on agricultural machinery with a GST, and
 - (iv) the effects of imposing a GST on food and other necessities of life on remote communities, including Aboriginal and Islander communities;
- (r) the effects of the Government's taxation reform legislation proposals on state and local government administration, including:
 - (i) the effects of the package on future federal-state financial relations and the capacities of state and local governments to adequately finance their respective responsibilities in both the short-term and the long-term, including the effects of

the proposed transfer of responsibility for local government financial assistance to the states, and whether it discriminates between states,

- (ii) the implications for specific purpose programs,
 - (iii) mechanisms required to lock in commitments made by federal and state governments with regard to the new arrangements,
 - (iv) the implications for future federal-state financial relations of not extending the GST to the necessities of life (such as food, clothing, shelter and essential services) and books, and any adjustments to the proposed arrangements which would be required to federal-state financial relations,
 - (v) the implications of the package for the quality and affordability of public utility services and for the public utility concessions for social security recipients,
 - (vi) the effects of application of the GST, and of changes to tax status, on local government and its activities, particularly commercial activities,
 - (vii) the implications for the delivery of Commonwealth Government services, including employment services, welfare and other social and cultural services, and
 - (viii) the extent to which the proposed compensation arrangements are secure from change to below adequate levels;
- (s) the adequacy of measures to ensure that consumers fully benefit from the abolition of existing taxes;
- (t) the effects of the taxation reform legislation proposals on legal and constitutional matters, including:
- (i) the constitutionality of the proposed mechanism for future changes to the GST, including whether such changes would present a significant hurdle to future increases, or reductions if deemed necessary to stimulate the economy,
 - (ii) the constitutionality of the proposed reorganisation of federal-state tax arrangements and whether the powers and functions of states and territories are materially affected by this reorganisation, and
 - (iii) the effects of the proposals on the cost of access to justice; and
- (u) options for amending the proposed legislation to improve its fairness or efficiency.
- (4) That, in reporting on the matters referred to in paragraph (3), the committee have regard to the reports of the references committees referred to in paragraph (17) and integrate the findings of those committees into its final report where relevant.
- (5) That the committee consist of 7 senators, 3 nominated by the Leader of the Government in the Senate, 3 nominated by the Leader of the Opposition in the Senate, and 1 nominated by the Leader of the Australian Democrats.
- (6) That the committee may proceed to the dispatch of business notwithstanding that not all members have been duly nominated and appointed and notwithstanding any vacancy.
- (7) That:
- (a) senators may be appointed to the committee as substitutes for members of the committee in respect of particular matters before the committee;
 - (b) on the nominations of the Greens or independent senators, participating members may be appointed to the committee; and

- (c) participating members may participate in hearings of evidence and deliberations of the committee, and have all the rights of members of the committee, but may not vote on any questions before the committee.
- (8) That the committee shall elect as its chair a member nominated by the Leader of the Opposition in the Senate.
- (9) That the committee shall elect as its deputy chair, immediately after the election of the chair, a member nominated by the Leader of the Government in the Senate.
- (10) That the deputy chair act as chair when there is no chair or the chair is not present at a meeting.
- (11) That the committee have power to send for and examine persons and documents, to move from place to place, to sit in public or in private, notwithstanding any prorogation of the Parliament or dissolution of the House of Representatives, and have leave to report from time to time its proceedings and the evidence taken and such interim recommendations as it may deem fit.
- (12) The quorum of the committee shall be a majority of the members of the committee.
- (13) The committee set 29 January 1999 as the date for receipt of submissions.
- (14) That the committee hold hearings in each state and territory as required.
- (15) That the committee be provided with all necessary staff, facilities and resources and be empowered to appoint persons with specialist knowledge for the purposes of the committee with the approval of the President.
- (16) That the committee be empowered to print from day to day such documents and evidence as may be ordered by it and a daily Hansard be published of such proceedings as take place in public.
- (17) That the following matters be referred to references committees in accordance with the schedule below for inquiry and report by 31 March 1999, and that in undertaking these inquiries the committees have regard to the report of the Select Committee referred to in paragraph (1) and consult widely, holding hearings in each state and territory, as required. Submissions to these inquiries are to be made by 29 January 1999.

| Committee | Matters for Inquiry |
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| Community Affairs | The impacts of the Government's taxation reform legislation proposals on the living standards of Australian households (especially those on low incomes), including: |

- (a) the scope and effectiveness of the proposed arrangements on charities, child care services, aged care services, welfare services, local government human services and all not-for-profit organisations in maintaining the quality and affordability of essential community services, including the implications for the public funding of these services and the implications for the commercial activities of these organisations, and whether unconditional GST-free status should apply to *bona fide* charities;
- (b) a detailed examination of the zero-rating of health services, including an examination of which services should be zero-rated;
- (c) the effects on community sector organisations of changes to their tax exempt status, and of the compliance costs of the proposed tax arrangements;
- (d) the effects of the proposed private health insurance rebate;
- (e) the effects on people with disabilities;
- (f) the effects on public, community and private housing, including the levels of rents; and
- (g) options for amendments to improve the fairness or efficiency of the proposed legislation.

Employment,
Workplace Relations,
Small Business and
Education

The employment incentive and education impacts of the Government's taxation reform legislation proposals, including:

- (a) the scope and effectiveness of the proposed zero-rating arrangements for education in maintaining its quality, accessibility and affordability;
- (b) the effects on employment;
- (c) the effects of the proposed GST treatment on the quality, accessibility and affordability of employment services;
- (d) the effects on education of imposing a GST on, or zero-rating or exempting books and associated education resources;
- (e) the effects on education of imposing a GST on ancillary resources, services and commercial activities, including the effects on overseas students;
- (f) the effects of the proposed changes to the tax system on employment;

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| | <ul style="list-style-type: none"> (g) the effects on wage costs, particularly if the basic necessities of life are taxed; (h) the scope and effectiveness of changing the unemployment benefits, pensions and Newstart Allowance 'tapers'; (i) the effects of the proposed changes to the tax system on training and adult education; and (j) options for amendments to improve the fairness or efficiency of the proposed legislation. |
| <p>Environment, Communications, Information Technology and the Arts</p> | <p>The broad effects of the Government's taxation reform legislation proposals on the environment, the arts and information technology, including:</p> <ul style="list-style-type: none"> (a) the environmental effects, and likely impacts of changes to fuel excises, particularly but not only diesel, and the replacement of WST with GST on vehicles and other transport services including: <ul style="list-style-type: none"> (i) possible increases in greenhouse gas emissions, (ii) increases by amount and type of air pollution, (iii) the effects on public and rail transport, (iv) the effects on alternative energy use in transport including, but not limited to, compressed natural gas, (v) the changed effects on native forests of logging or woodchipping due to the tax package, and (vi) the changed effects of mining in environmentally sensitive areas due to the tax package; (b) the environmental effects of the replacement of Wholesale Sales Tax by the GST and associated changes in fuel excises on electricity and natural gas; (c) the impacts of the proposed tax changes on the prices and existing and potential use of renewable energy particularly but not only solar energy technology and energy efficiency equipment; (d) the environmental effects of any changes to taxes on exports; (e) the consistency or otherwise of the proposed changes in taxation and excise arrangements with Australia's international treaty obligations, including its obligations under the Framework Convention on Climate Change; |

- (f) options for a tax system which better achieve environmental objectives, including incentives for fuel efficiency and alternative energy sources, such as measures which promote both environmental protection and employment generation;
- (g) the extent to which environmental impacts were considered in the drafting and final copy of the Government's tax package;
- (h) the scope of any consultation on environmental matters with experts in Environment Australia or any other Government departments other than the Treasury and Finance departments;
- (i) the impact of a GST on ticket sales for the performing arts;
- (j) the effects of a GST on the transfer of grant monies for arts projects;
- (k) the effects of the tax proposals on sponsorship provided by the private sector to individual artists and arts organisations;
- (l) the extent to which the package will block consideration and introduction of 'ecotaxes';
- (m) the effects of a GST on not-for-profit conservation and arts organisations; and
- (n) options for improving the environmental effects of the package.

- (18) That the provisions of the bills implementing the proposed new tax system stand referred to the previously mentioned committees for inquiry and report in conjunction with the terms of reference authorised by this resolution, as soon as the bills have been introduced in the House of Representatives.
- (19) That when the bills referred to in paragraph (18) are first introduced in the Senate and a motion is moved for the second reading of the bills, debate on that motion shall be adjourned at the conclusion of the speech of the senator moving the motion and resumption of the debate shall be made an order of the day for 19 April 1999 without any question being put.

WITNESSES

| | |
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| BURN, Dr Peter, Secretary, Business Coalition for Tax Reform | 600 |
| CLAUGHTON, Mr Kenneth Lindsay, Member, Melbourne Indirect Tax Cell of the Taxation Centre of Excellence, Australian Society of Certified Practising Accountants | 558 |
| DIXON, Professor Peter Bishop, Director, Centre of Policy Studies, Monash University | 520 |
| DRUM, Mr Paul Joseph, Senior Tax Counsel, Australian Society of Certified Practising Accountants | 558 |

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|---|------------|
| MORTON, Ms Joycelyn Cheryl, National Vice President Intellectual Capital, Australian Society of Certified Practising Accountants | 558 |
| QUIGGIN, Professor John Charles (Private capacity) | 583 |
| RYAN, Ms Angela Mary, Director, Taxation, Australian Society of Certified Practising Accountants | 558 |
| RYAN, Mr Fergus, Chairman, Business Coalition for Tax Reform | 600 |

Committee met at 9.14 a.m.

CHAIR—Welcome. Today the committee continues its inquiry into the first stage of the proposed changes in the Australian taxation system. During the first stage the committee will focus on the economic theories, assumptions, calculations, projections, estimates and modelling which underpin the government's proposals for taxation reform.

In the second stage of the inquiry the committee will examine the broad economic effects of the government's taxation reform legislation proposals. It will take regard to the fairness of the tax system, the living standards of Australian households, especially those on low incomes, the efficiency of the economy and future public revenues.

The Senate referred the inquiry to the committee on 25 November 1998. The committee expects to report on the first stage by 18 February this year. For three related inquiries by the references committees on community affairs; on employment, workplace relations, small business and education; and on the environment, communications, information technology and the arts, the scheduled reporting date is 31 March 1999. This committee will then report on the second stage of its inquiry by 19 April 1999, taking into account the findings of the references committees. This committee has called for submissions by 29 January 1999 and so far has received well over 1,000.

This is the second public hearing to be held by the committee in Melbourne in the course of this inquiry. In addition to this hearing, the committee will be conducting other public hearings in the capital cities and in some major regional centres. The committee does not intend to release all submissions as yet, except for the submissions by witnesses who are giving evidence today. Is it the wish of the committee that submissions 78, 78A, 104, 104A, 205 and Professor Dixon's report dated 25 January 1999 be made public? I now declare that those submissions to this inquiry, together with their attachments, be released.

For the record, this is a public hearing and, as such, members of the public are welcome to attend.

Before we commence taking evidence, let me place on the record that all witnesses are protected by parliamentary privilege with respect to submissions made to the committee and evidence given before it. Parliamentary privilege means special rights and immunities attached to the parliament, or its members and others, necessary for the discharge of the functions of the parliament without obstruction and without fear of prosecution. Any act by any person who operates to the disadvantage of a witness, on account of evidence given by him or her before the Senate or any committee of the Senate, is treated as a breach of privilege.

[9.19 a.m.]

DIXON, Professor Peter Bishop, Director, Centre of Policy Studies, Monash University

I welcome Professor Dixon from Monash University. For the *Hansard* record, would you please state your name and the capacity in which you appear? I now invite you to make an opening statement and explain the work that you have done on behalf of the committee.

Prof. Dixon—I am the Director of the Centre of Policy Studies. The centre was commissioned to write a report on the economic effects of the government's tax package to assist this inquiry.

CHAIR—It may be that you are appearing today with Mark Taylor—there is a great deal of interest here.

Prof. Dixon—Fortunately, my colleague Brian Parmenter has turned up and can perhaps put some slides on for me.

Overhead transparencies were then shown—

Prof. Dixon—This slide tells the story so far, up to when I appeared before you on 18 December. These are the highlights from what we will now call the central Monash simulation. It showed that the government's package would do damage to tourism, education and exports. There would be gains to traditional exporters—mining and agricultural industries—and also to manufacturing exports. There would be mixed effects on consumer goods industries—motor vehicles would win; beer and cigarettes would lose. There would be a short run boost in employment—in the first year, about 30,000 jobs. That is about a four per cent increase in employment.

CHAIR—I am sorry, could I just interrupt for a moment. I do not want to cut across you, particularly in the early stages, but in order that the work you are explaining is properly understood and absorbed, it is probably advantageous for those members of the public and of the fourth estate who are here to see your slides as well as the committee.

Senator FERGUSON—Could I make the suggestion that copies of the slides be incorporated in *Hansard* so that when people are reading the transcript they can actually see the charts that have been referred to by Professor Dixon.

Prof. Dixon—I have got a few spare copies.

CHAIR—I will take that as a motion. Is it the wish of the committee that the documents be incorporated in the transcript of evidence? There being no objection, it is so ordered.

The documents read as follows—

Prof. Dixon—We will work through the rest of these points showing the story so far. There is a short run boost in investment, a long run increase in the capital stock, a decline in the terms of trade—that means that the prices at which we could export things are reduced relative to the prices at which we import. That is associated with the increase in exports and it is also associated with the switch in the composition of exports away from services towards goods—good prices are falling on world markets relative to service prices. And there is little change in economic welfare. Murphy got a small plus and we got a small minus, but there is nothing much in it in the long run.

Let us look at the second slide. Remembering that in the central simulation there is an increase in employment in the short run, the key assumption is that wages are bargained in after-tax terms. That means that workers are very concerned with how much their wage will buy after they have paid their income tax. In the package, wages—wage demands—are damped by the cuts in income tax being offered by the government. On the other hand, they are stimulated by the increases in indirect taxes. So there are two forces working on wage demands: one is the cut in income taxes, which damps wage demands, and the other is the increase in indirect taxes—mainly consumption taxes—which increases wage demands.

The employment gain reflects the idea that the package is not balanced, that the cuts in income taxes outweigh the net increase in indirect taxes, so there is a move towards fiscal deficit in the package. It turns out that if the increase in indirect taxes were exactly balanced with the reduction in income taxes, the package would be slightly job reducing. But it generates jobs entirely because it is unbalanced—there is a deficit there. That really says that if you just wanted to generate jobs you could do it without any changes in indirect taxes. You could do it simply by cutting income tax, if you were prepared to move the budget towards deficit.

For the contract that we did at the Centre of Policy Studies, we were asked to look at six types of sensitivity to our central simulation. In sensitivity 1, something goes wrong with the wage process. What goes wrong is that people do not recognise the role of income taxes—the cut in income taxes—so they continue to look at wages as being geared to the CPI, so the cuts in income taxes no longer have a dampening effect on wage demands. Wage earners are not prepared to allow wages to fall relative to the CPI.

With wages no longer damped by income taxes but with the increase in indirect taxes continuing to stimulate wage demands, the package generates considerable employment loss in the short run. So instead of 30,000 jobs gained in the short run, the package turns around to 100,000 jobs lost in the short run. If this package is to be implemented, it is very important that the labour market recognises that the cuts in income taxes are compensation for the jump that will take place in the CPI.

The second sensitivity analysis was to do with education and tourism exports. You would remember that in our first paper there was considerable damage to tourism and education. That is because the prices of holidays and the price of education in Australia in foreign currency terms will rise with the implementation of the GST. The controversial question is how you translate the increase in the costs to tourists and the costs to students of their stay in Australia into a reduction in numbers.

The parameter that is involved here is an export elasticity. In our central simulation we used negative three, which gave something like these results here. It gave a reduction in tourism exports of 11 per cent and a reduction in education exports of 9.5 per cent. In the sensitivity analysis we switched to negative two, which is also compatible with the historical record of what we know about these elasticities. I was urged by some commentators to use even lower numbers than negative two.

Senator FERGUSON—Could you explain in lay terms what you mean by the use of the terms ‘negative three’ and ‘negative two’.

Prof. Dixon—What that means is that if the costs to foreigners of their holiday in Australia, in their currency, goes up by one per cent and the costs of alternative holidays everywhere else in the world—in New Zealand, Hawaii, California and so on—and in their own countries are not changed, so all that has happened is that the costs of their Australian holidays have gone up by one per cent, then the numbers that come are reduced by three per cent.

Senator FERGUSON—Yes, I see.

Prof. Dixon—The alternative assumption is that the numbers that come are reduced by two per cent. I was urged to use even lower elasticities—that is numbers like negative one. I do not believe numbers as low as that. If one did believe these very low elasticities, then the obvious implication would not be GST, the obvious implication would be to tax tourists.

For instance, if the elasticity was negative one, that would mean that, if we increased the costs to tourists of their holiday by 10 per cent, then 10 per cent less would come but those that came were paying 10 per cent more, so there would be no change in the amount of money we get. We just have 10 per cent less of them. Following that logic, we should have an enormous tax on tourism—get the numbers down to very few, show them a koala bear at the Sydney airport, collect an enormous tax from them and send them on their way. I do not believe that that is how the world behaves, but I do not really know the difference between negative three and negative two.

I do not think that the estimates in the first column of numbers there are really any better than the estimates in the second column of numbers. So tourism exports are still damaged with the lower elasticity by eight per cent; education exports are still damaged by 7½ per cent. Interestingly enough, at the macro level, in the central simulation the long-run welfare effect for Australia was a small negative, a tiny negative. It switches to a tiny positive as you do less damage to tourism, because the terms of trade effects are less. Remember, the terms of trade effects come about because, as you damage service exports and stimulate goods exports, you are moving towards an export mix of goods whose prices are falling on world markets.

Damaging tourism is not a very good idea. If the damage is restricted to this eight per cent in that sensitivity 2 column, the long-run welfare effects of the package switch from being a tiny plus to a tiny minus. That is not very significant, but it just—

Senator FERGUSON—Are they outside the margin of error—those small negatives and small positives?

Prof. Dixon—Yes. The really big result that comes out of this economic modelling—and I claim that Murphy is in this camp too—is that the long-run welfare effects are tiny. They could be tiny plus, tiny minus. You can see that just by fiddling this one parameter in this huge model, these export demand elasticities, we can switch the result from tiny minus to tiny plus.

CHAIR—What do you mean by welfare effects?

Prof. Dixon—The measure is to do with how much consumption we could do in the long run—‘consumption’ is cars, food, clothing and whatever—that is compatible with a given level of foreign debt, given situation on our trade accounts, given ownership of capital. So, holding constant the amount of capital that Australians own, holding constant the trade accounts, how much debt we have got and so on, with the tax reform, according to the central simulation, we would be left consuming slightly less than they otherwise would have been doing; according to the sensitivity to simulation, we would be left consuming slightly more.

The third sensitivity was to do with GST freeing tourism packages. About two-thirds of holiday-makers to Australia come on tourist packages—that is, practically all their expenses in Australia they pay for before they come to Australia. If that was GST free, that would take the GST off about half of their expenditures. About half of their expenditures in the present proposal will be GST free—about half of their expenditures are airline travel. So we have about two-thirds of the holiday-makers coming on packages. If the package was made GST free, that would have the effect of making their hotel bills, various entertainments and so on GST free.

Senator FERGUSON—Does this take into account that New South Wales currently, for instance, has a bed tax?

Prof. Dixon—Is the bed tax to be removed in the package?

Senator FERGUSON—It is under the system, but we are talking about current expenditure. Currently, that would have to be part of their package—

Prof. Dixon—Yes. We are comparing here the situation if the government’s package is implemented with the situation in which it is implemented with this one little wrinkle, which is that the packages are GST free. So, in effect, what happens is that the tourists would now find that their hotel was 10 per cent cheaper than it otherwise would have been, under the government’s proposal.

The part of their expenditure that will be GST free is about half of their expenditure. Half of it was going to be GST free anyway, and then taking the GST off their hotels and various entertainments will GST free up the other half of their expenditure. You have to keep three fractions in mind: about two-thirds of the holiday makers are in this situation anyway and about half of their expenditure would be GSTed under the government’s

package, and it now becomes GST free, and these holiday-makers are about half of the tourists to Australia, that is, short-term visitors. The other half are people who come to conventions or people who are visiting relatives or people coming on business. So this proposal for GST-free packaged holidays affects about one-sixth—if you multiple all those fractions together—of the expenditures by tourists in Australia. It is not a big thing, but it has quite a useful effect.

You can see that instead of the damage to tourism being 11 per cent, as in the central simulation, it becomes eight per cent in the sensitivity 3. But, of course, you lose some revenue—about \$300 million is lost in revenue by GST freeing the packages—and that has to be made up by offering a lesser income tax cut. So instead of the income tax cuts being about 14 per cent they become 13.7 per cent—\$300 million is not, in this business, a very big number. But the income tax cut has to be little bit less. The long-run welfare effects now switch from being a tiny negative to being about zero. On this terms of trade argument, anything you can do for tourism to reduce the damage to tourism of a package is slightly good. So you move the long-run welfare effect from being a small negative to being about zero.

The fourth and fifth sensitivity simulations are to do with food—GST freeing food. It does not matter precisely for this business how we have defined food. We were not given any instructions on that, but we took it as being meat, vegetables, bread—all the staples. The important thing is that Australians spend about \$27 billion a year on what we classified as food, so GST freeing food cost the revenue about \$2.7 billion. It meant that the income tax cuts that could be offered, instead of being 14 per cent, were 11.4 per cent. So you got lesser income tax cuts offered.

The short-run employment effect actually improves slightly. Instead of a 30,000-job win in the short run, as in the central simulation, that becomes 38,000. The reason that exempting food gives you a short-run employment win goes like this. As you move from the central simulation to sensitivity 4, you can think of it as being a combination of two things. You can think of it as being a reduction in consumption taxes, because in the central simulation you had the consumption tax on food so as you move to sensitivity 4 you are reducing consumption taxes—you are taking the GST off food. So as we move from the central simulation to sensitivity 4, we are reducing consumption taxes and that damps wage demands. Simultaneously, you are increasing income taxes. Instead of 14 per cent reduction, it goes to 11 per cent reduction, so you are increasing income taxes. Those things are balanced. The amount of revenue you lose by cutting consumption taxes is exactly balanced by the amount of revenue that you win by increasing the income tax. But only about two-thirds of the income tax is paid by wage earners, so only about two-thirds of the increase that you are making in income taxes is stimulating wage demands.

Although the revenue is balanced, the effects on wage demands are not balanced. All of the cuts in consumption taxes are reducing wage demands, but only about two-thirds of the increase in income taxes is stimulating wage demands. That leaves you with a small employment gain—a small reduction in pressure on wages. Instead of getting this 30,000 job gain, which you remember was entirely a reflection of the unbalanced nature of the package, now you make a balanced reduction in consumption taxes, an increase in income taxes and you generate a small win. You go to 38,000 jobs instead of 30,000 jobs.

Senator GIBSON—In relation to the level of precision of your modelling, could you give us a bit of an idea about what is just rubbish, perturbation that we should not take any notice of, and what is something real? If I use your numbers, a change of 8,000 in employment in the Australian economy is 8,000 in eight million. Is your model that good?

Prof. Dixon—I have given you an explanation. I have given you an argument that suggests why the model says that this will be slightly good for employment. The model says that this is a small effect. If the right number is 15,000 or if it is 3,000 it is a small effect, but you would expect the sign to be right. I have produced a qualitative argument which suggests why this thing happens. So, qualitatively a plus; quantitatively small.

Senator O'CHEE—It is 0.1 of a per cent.

Prof. Dixon—Yes. The 30,000 is 0.4 per cent employment gain and, when you exempt food, in the short run, you have 0.5 of a per cent.

Senator O'CHEE—What is the margin of error?

Prof. Dixon—I can only give the same answer. You have to believe the argument. I have told you why the model says this. I have told you the mechanism. If it was 50 per cent off I would not be surprised. Instead of 0.1 being the difference, as you pointed out with the 8,000, if the right answer was 0.05 or 0.15, I do not think that has any policy significance. There is nothing that you would want to do differently if you knew that the right answer was 0.05 or the right answer was 0.15. I would be confident that the right answer is small and positive.

Senator GIBSON—In December we had a UK expert on modelling, Professor Wallis, and one his messages to us amateurs, if you like, in this business was to ask people like yourself about the level of precision. I guess my fundamental query to you is this: is your advice to us that we should take notice of anything that is sort of larger than a one per cent gain or a half a per cent change? What is the nonsense and what is real?

Prof. Dixon—It is a very difficult question. I think you have to look at the argument all of the time. You should not believe any of the numbers at all. Just because someone comes before you and says that GDP will increase by four per cent, that is a big number, but that does not mean that you should think to yourself that this model has a 50 per cent margin of error. Maybe this guy means two per cent or maybe he means six per cent. But he still means something big. The four per cent may be totally wrong. It has got nothing to do with it. It could be based on a mistake. That is why you have to tease out the argument. Why does this person think large? What is it about the model? To follow that example, I know there are estimates around like that, and they are based on capital being stimulated very strongly by the package.

Then you have to ask if you would really expect capital to be stimulated as strongly as that. Even if it were, does that make the country better off if, basically, the capital is all owned by foreigners and so on? I think it is a matter of not worrying about confidence intervals and statistical things; it is a matter of trying to tease out the economics of the argument, which is what I have been trying to do here, and, to the extent that we do not

know the values of critical parameters, doing a sensitivity analysis of precisely the type that we have been commissioned to do today.

Senator GIBSON—I understand that, and I think you make the point very well that indicating general directions of trends is basically what your model is telling us. It is important for us in communicating with our people that we do not get too hung up on the absolute numbers. We need advice from you about whether a one per cent change—or two per cent or six per cent—in, for instance, the GDP is a positive trend in whatever dimension we are talking about which indicates four per cent, but do not take the four per cent as absolute. Is that the sort of thing?

Prof. Dixon—No, I am saying more than that. If someone tells you four, find out why. It is not really so important whether they meant three or whether they meant five. You can put statistical confidence intervals around rubbish, and it is still rubbish—it does not make any difference.

Senator GIBSON—Yes, absolutely. I understand that.

Prof. Dixon—The real question is: why do they think large? You might remember that last time I was here I argued that, from back of the envelope calculations, you would expect the welfare impact of this package to be rather small, and we went through the reasons. The idea was to level the taxes and to make the same rate of taxes across all consumption goods so that consumer decisions would not be distorted, so you would not be making up your mind what to consume on the basis of taxes. But when we went through it, using back of the envelope calculations—nothing very sophisticated at all—we found out that there was not very much evening going on. There were plenty of high taxed things that were going to be taxed even higher; there were plenty of low taxed things that were going to be taxed, in relative terms, even lower and so on. There was not much evening going on.

On that basis you would expect this package to produce rather small effects. What do we mean by ‘rather small’? There is a long experience of economic welfare calculations from tax reforms. Big in this business is one per cent, and rather small is 0.1 per cent. This package is at the rather small end of things. Whether it is plus 0.1 or whether it is minus 0.1 depends on a lot of assumptions, mainly to do with the terms of trade.

Senator FERGUSON—When these lights come up, sometimes it is easier to ask questions as they come, but I do not know if Professor Dixon prefers to complete his presentation and then have questions—

Prof. Dixon—No, not at all.

CHAIR—I think we all have an interest in getting the presentation comprehensively before us. I also think we have a reasonable interest in members of the committee who find some point a bit hard to grasp, or are in need of greater explanation, being able to ask a question, but I do not think it is appropriate to engage in a long dialogue.

Senator FERGUSON—I have one brief question. Talking about making food GST free, you used a figure of an effect of \$2.3 billion on revenue. Other figures that have been used

are \$5 billion, and I think Professor Warren used \$4.4 billion. I am just wondering how on earth you arrived at \$2.3 billion for the exemption of food. Doesn't it signify that it is difficult to determine what food is, how it should be exempted and what areas of food should be exempted? Did you only use foods that are currently not subject to a wholesale sales tax? I am wondering how you got \$2.3 billion when other people have a much higher figure.

Prof. Dixon—As I said, I was not given any instruction on the definition of food. In the paper I defined precisely the ABS input-output categories, which I included as food. I think there is a real point as to exactly how food is to be defined, if it were to be exempt. That would be a difficulty. As far as working out the economic effects of GST-free food, if you take a broader basis for food I think these numbers would be magnified a bit. So, instead of 8,000 jobs, you might get 12,000 jobs extra or whatever. If you are getting at the point of compliance costs and rent-seeking and arguing about exemptions and so on, those things are not taken into account in any of these calculations and so, in making a decision as to whether you want to exempt food, they would have to be set against any benefits that you could see from the exemption.

Senator FERGUSON—I just wondered how you got the figure, that was all.

CHAIR—I ask one simple question on a point of clarification so I understand this slide properly. On this slide, you say that short-run employment goes up 30,000—that is, extra jobs. That is due to a cut in income tax rates of 14 per cent?

Prof. Dixon—Yes.

CHAIR—In effect, the cut in tax rates stimulates the economy and creates the jobs. That is entirely independent of a GST. It is open for the government to cut taxes now, using its surplus to fund it, and create that figure.

Prof. Dixon—Exactly, that is the point I made at the beginning: the 30,000 jobs arise simply from the movement in the budget towards deficit.

CHAIR—And it does not arise because you are introducing a consumption tax; it arises because—

Senator CONROY—You are spending the surplus.

Prof. Dixon—Yes. In fact, the introduction of the consumption tax in a balanced situation is job-destroying.

CHAIR—Job-destroying?

Prof. Dixon—Yes. This is a bit complicated, but look at the flip side of it. Let us go through the argument again as to where the 8,000 came from. The 8,000 jobs—that is, the 30,000 of the 38,000—can be thought of as being caused by the following two moves: the first move is that you cut consumption taxes. So you take the GST off food. The second move is that you make a balanced increase in income taxes. Instead of it being negative 14,

it becomes negative 11.4. So there are a couple of moves in which you would have a cut in consumption taxes balanced with an increase in income taxes, and that would create jobs. If you did it the other way around, if you increased consumption taxes with a balanced cut in income taxes, you would lose jobs.

Senator O'CHEE—In the central simulation you have done, the reason you get a short-term employment gain is that, when you look at the package as a whole, people's real spending power is improved.

Prof. Dixon—Yes.

Senator CONROY—You have spent the surplus.

Senator O'CHEE—It is an axiomatic assumption in the central thing and it is borne out by your simulation.

Senator CONROY—It is called 'old-fashioned pump priming'.

Senator O'CHEE—Will you—

Senator FERGUSON—Senator Conroy's government never had a surplus. It is pretty clear.

CHAIR—That is not true.

Senator CONROY—It is a difficult concept.

CHAIR—That is actually not true, but we will have some order at the table. Senator O'Chee, ask your questions.

Senator O'CHEE—I am trying to, Mr Chairman, with considerable patience. What you are saying in the central assumption is that, when you run the figures through, the reason you have a short-run gain in employment is that this package improves people's real spending power.

Senator CONROY—By giving them tax cuts.

Prof. Dixon—The central reason for the increase in employment is that you have unbalanced cuts in income taxes.

Senator O'CHEE—That real spending power is increased?

Prof. Dixon—Yes.

Senator CONROY—If you give \$12 billion to people, I am sure their spending powers increase.

Prof. Dixon—But, if you make a balanced increase in consumption taxes by increasing consumption taxes and reducing income taxes—so that is the move you make, in a balanced way—that is slightly job destroying.

Senator O'CHEE—That is not what the government is proposing. It is proposing a tax mix shift.

Prof. Dixon—The key argument is whether you need the changes in indirect taxes. If the aim of the exercise is to increase jobs, you can do that simply with the cut in income taxes.

CHAIR—That is right. That is the critical point, as I understand this slide. It is not the tax mix switch that creates jobs, it is the stimulus given by cutting taxes overall.

Prof. Dixon—Yes, it is the \$6 billion or \$7 billion net cut in taxes that does the job for employment.

CHAIR—The government can do that irrespective of whether it changes the tax mix. It can just cut taxes.

Senator MURRAY—I was following your point on the sensitivity analysis. If you put food GST free, you also accelerate disposable income and you create jobs, even if it is at the marginal end of it.

CHAIR—That is true too.

Senator MURRAY—Just for clarification, I thought I heard you say on your narrow definition of food that the cost you were using was \$2.7 billion. I heard Senator Ferguson use the figure \$2.3 billion. In your section 7, it is \$2.5 billion. Let us get the figure right. What is the figure we are dealing with. Is it \$2.5, \$2.7 or \$2.3 billion?

Prof. Dixon—I think it is \$2.5 billion.

Senator MURRAY—Thank you.

CHAIR—Please proceed, Professor. We have diverted you from your presentation long enough, I think.

Prof. Dixon—Now we move to the fifth sensitivity simulation. This is again to do with GST freeing food, but in this simulation, we have the different sort of wage bargaining. In the central simulation and in the sensitivity 4, it was after tax real wages that were geared to the CPI. In other words, in the central simulation and in sensitivity 4, workers were prepared to accept the cut in income taxes as compensation for a jump in the CPI. Here, they are not. Here, we have gone back to—it looks like 1 has fallen off—see where it says 'sensitivity', that should be sensitivity 1. This is sensitivity 1 being compared with sensitivity 5.

In sensitivity 1, you will remember there was a considerable loss of jobs, because the cuts in income taxes did not damp wage demands. Here we are going on with that. The cuts in income taxes are not damping wage demands. So in sensitivity 1, we lost 100,000 jobs.

In that unfortunate circumstance, exempting food is really quite beneficial. The loss in jobs goes from being 100,000 to being 68,000. The reason for that is that the exemption of food reduces wage demands, but the corresponding increase in taxes does not stimulate wage demands. If the wage-earners are not accepting income taxes as a reason for modifying wage demands, then exempting food makes a lot of sense.

That is not a really powerful argument for exempting food. After all, if you really thought you were in sensitivity 1 territory, you should not be doing the package at all. But if you are in sensitivity 1 territory, then you could scramble out of it as best you could by exempting food and, at least, you would save quite a lot of jobs, because you would be reducing wage pressures by getting rid of the GST on food. The income tax increases that you would have to give—in other words, instead of having 14 per cent reduction in tax, you would have 11 per cent reduction in tax—the income tax increase that you get as you go from sensitivity 1 to sensitivity 5, the increase in income taxes is not stimulating wage demands.

You save 32,000 jobs by exempting food, but I should repeat that that is not a really powerful argument for exempting food. In the situation you find yourself in in sensitivity 1, you should not be doing the package at all.

Senator O'CHEE—On the sensitivity of analysis 1, given that the change in the tax regime increases real spending power, it is an economically irrational move to ask for a wages increase when your real spending power has already increased, is it not?

Prof. Dixon—Yes, but that does not rule it out from happening.

Senator O'CHEE—No. I am just asking if it is an economically irrational move.

Prof. Dixon—Yes, sure. The last sensitivity run was to do with lagged pass through. This is seen by some people as a downside risk of the package in that the increases in indirect taxes in the GST will be passed on immediately into higher prices, but some of the reductions in indirect taxes will be passed on only with a lag. The reductions in wholesale sales taxes and taxes on intermediate inputs, when they are reduced, will not show up immediately in reduced prices to producers of their intermediate inputs.

I am not sure of the mechanisms by which that would happen but if something like that did happen it would not be difficult to convert that 30,000 job gain, in the short run, into a significant job loss. In the short run it would act as though there were bigger increases in indirect taxes. Prices would be higher and wage demands would be stimulated, as if there were bigger increases in indirect taxes than were actually taking place.

Instead of there being a 30,000 job gain, the simulation we did was really quite pessimistic. It went like this: all of the GST and all of the new indirect tax increases were passed on immediately, but the cuts in indirect taxes on intermediate inputs took two years to flow through.

Senator FERGUSON—Did you use 70-30 or 50-50? What did you use?

Prof. Dixon—It was flow through completely but it took two years.

Senator FERGUSON—Yes, I understand that. Was it 70-30 or 50-50? Would it make any difference?

Prof. Dixon—Yes, it would make a difference. The slower it happened the worse it would be. It was 50-50.

Senator FERGUSON—Is 50-50 a reasonable assumption? Would you have called it a reasonable assumption?

Prof. Dixon—I think it is a reasonable assumption to get an idea of the magnitudes of the effects, but I do not know whether it is a realistic assumption. I do not know what rate of pass through to expect. It underlies the point that if the package is to be implemented—and I think the government recognises this in the ANTS document—it is very important that tax cuts are passed on as quickly as tax increases.

CHAIR—When you say you do not know what rate of pass through to expect—and I understand that—is it reasonable to expect 100 per cent?

Senator SHERRY—From day one?

Prof. Dixon—You would not expect 100 per cent from day one. There will be contracts in which there are difficulties and there will be prices that have been agreed to beforehand. I really do not know.

Senator FERGUSON—You could say in the first year, rather than day one, if you are asking the question.

CHAIR—To rephrase it in a slightly different way, is it reasonable to expect some lag or to think that people will behave themselves perfectly and pass it on?

Prof. Dixon—I really do not know.

Senator CONROY—We have had a range of witnesses come before us and say that they would have concerns about a 100 per cent pass-on—from St Vincent de Paul through to the National Farmers Federation through to VECCI yesterday.

Prof. Dixon—If they have a good argument for thinking that the pass through is going to be asymmetric—in other words, the tax increases are passed on quicker than the tax reductions—then this sort of analysis shows that that could produce some short-run problems.

Senator CONROY—A comparable situation may be interest rates. Most people who have a home loan would see that when a bank has to increase its rates it does it the day after the Reserve Bank, and it usually takes a few months if it is a downward movement.

Senator FERGUSON—That is not a very good analysis.

Senator CONROY—That is a common thing and an excellent analogy.

Senator O'CHEE—A few months? You are really stretching it, Stephen.

CHAIR—We are debating at the table; we should be talking to the witness.

Senator MURRAY—On the same point, a major portion of the indirect tax cut is in fact what is known as a lumpy expenditure, and that is in the area of stamp duties. In other words, the reduction in those prices does not occur immediately because the equipment has to be utilised before new equipment comes in. Is there any estimation in your modelling experience as to when the several billions of stamp duty cuts would be likely to flow through as an effect? I would assume they are automatically lagged, that it is very difficult for it to be in year one, for instance.

Prof. Dixon—No, there is nothing in this modelling that tells you anything about what is likely to happen. All it has done is said, 'If there are delays and they are spread over two years, that costs you 45,000 jobs in the short run.'

Senator MURRAY—My second point of clarification is on your sensitivity analysis. The wage demand stimulation is very important. As you know, much of the analysis in the ANTS package and in the commentary is about the quintiles and where the pressure is there. Does wage demand pressure emerge more in particular quintiles? In other words, would we need to pay attention to the lowest quintiles or to the middle quintiles? Where does that wage pressure come from? Is it from organised, better paid labour or is it from disorganised, poor and unemployed?

Prof. Dixon—There is no analysis of wage demands by different sectors of the economy in these simulations.

Senator MURRAY—Do you have any experience as both an economist and an modeller as to where the pressure comes from, because that too is relevant to the amount of compensation or to the amount of income tax cuts in those particular quintiles?

Prof. Dixon—I think one thing we can do—we have not done it here—is analyse which parts of the labour market are most damaged by across-the-board increases in wages, which parts of the economy are damaged the most and which income classes are most adversely affected. For instance, there are claims for living wages and whatever. There is a bit of a cleft stick here: on the one hand you want to low wage earners more and on the other hand it plays havoc with their chances of getting a job. With our sort of model, we can analyse—we have not done it here—which groups in the society are worst affected by general increases in wages which produce higher levels of unemployment.

Senator MURRAY—Senator Campbell makes the point that he would expect—and I think that is my instinct, but I have no empirical basis for saying so—that the pressure is likely to be in the 30,000 to 50,000 range more than in the below 30,000 range and in the above 50,000 range. Would that be a reasonable remark in your estimation?

Prof. Dixon—I would have to take it on notice, I would have to think it through.

Senator MURRAY—I would appreciate a response in that area because it could be quite helpful.

Prof. Dixon—If I could have that question written down, it would be helpful.

Senator O'CHEE—Could I clarify an answer that you gave to Senator Murray in relation to capital investment and the economic benefit of tax changes on capital investment. By its nature it is not recurrent. In other words, you will not necessarily buy a new piece of machinery every year but you do know the economic benefit of removing the tax because the economic benefit to business in the first year is the amount of tax which is forgone, is it not?

Prof. Dixon—I do not know what that means, particularly. Economic benefits just means that there will be an increase in profits.

Senator O'CHEE—The saving to business is the amount of tax—

Prof. Dixon—There are competitive forces. It is not clear what happens to profit rates until you think of what happens to selling prices. If you remove various taxes on investment or tax on intermediate inputs you hope that competitive forces will drive prices down. The idea of economic benefits to business is not a very clear concept to me.

Senator O'CHEE—The cost saving to business is clear because the saving is the amount of tax that they will not be paying that year. It is quantifiable.

Prof. Dixon—I want to see where you are going first before I commit myself.

Senator O'CHEE—I am asking a very simple question. You can quantify the saving to business because you know the amount of tax which is going to be forgone

Prof. Dixon—Yes. So what?

Senator O'CHEE—I understood you to say that you would not know the saving to business in the first year. I am saying you do know the saving to business in the first year because it is the amount of tax which is forgone.

Prof. Dixon—No, I do not think I said anything about not knowing the amount of savings—

Senator O'CHEE—That is what I am trying to clarify.

Senator CONROY—Do not let him put words in your mouth.

Prof. Dixon—I have not understood this line at all so far.

Senator O'CHEE—This is what I am trying to understand from you. I understood you to say—

Prof. Dixon—What I said was I did not know the rate at which cuts in indirect taxes would be passed on. In a highly competitive marketplace you would expect cuts in indirect taxes to be passed into lower prices very quickly because when you had a reduction in your costs you would get the idea that you could sell your product at slightly less than the guy next door and you would go ahead and do it.

He would then get the idea that he could sell it at slightly less and so on and soon you would be back to a situation in which you all made just normal profits. That is a situation in which it was just worthwhile for you to stay in business and you would be back in that situation with all the benefits of the cut in taxes passed on to the public. There would be no increase in profit to business at all.

Senator O'CHEE—I am referring to your answer to Senator Murray's question about stamp duties rather than indirect taxes.

Prof. Dixon—I ducked his question on stamp duties.

Senator O'CHEE—That is why I did not understand you.

Prof. Dixon—On that question I did not know the answer. I took it on notice.

CHAIR—I think there is a bit of eagerness from the committee for you to continue with your presentation.

Prof. Dixon—I have got only one more slide. The last point that we investigated was to do with the argument that runs through the ANTS document that somehow we have got to change the present indirect tax system because it will not in the future raise enough revenue for Australia's requirements. In our modelling work we make economic forecasts. In other words, we have a picture of how the economy will evolve over the next eight years or so. All of the simulations to do with change in the tax package in fact have been made as deviations away from our forecast.

One example of how the forecast matters was this argument that I have made several times about the terms of trade. Part of our base case forecast is in fact that the prices of tourism and education exports will be increasing relative to the prices of mineral products, agriculture and manufactured goods. So the background forecast matters a bit.

In the background forecasts there are forecasts of tax revenue and these forecasts are made on the basis of no increase in ad valorem tax rates. It turns out that indirect tax collections in our forecasts move at roughly the same rate as GDP. The reason is that some of the present indirect taxes fall on quite fast growing items and some of them fall on quite slow growing items. On average it works out that the indirect tax collections move at roughly the rate of GDP. There are some examples of some reasonably fast growing items and examples of some quite slow growing items, with it averaging out that the collections grow roughly at the rate of GDP.

This is an area which I would have expected the Treasuries to be rather expert in. That, I do not think, is a very deep piece of research. I do not think what I have got on that slide is

silly, but it just seems to me that the Commonwealth Treasury, in particular, could have done a lot better job on this argument than we could. They have much better access to the historical records than us. It seems to me that the committee could ask for a lot more information and guidance from the people who have got the data. From what we can see from outside, the present indirect tax system would raise revenue at about the same rate as the growth of GDP.

CHAIR—Could I ask you a question about that because that is quite an important point. A hell of a lot has been made of the argument that the taxation system in Australia is broken, it is collapsing, and it will not generate the revenue necessary for good government in the future so that we must change to a GST. What this slide says, in effect, is that that is not true because the existing tax system will generate the revenues at the same rate as the GDP increases. Is that correct?

Prof. Dixon—That is precisely what that slide says.

Senator MURRAY—I note that in your paper you made that exact point. At the end of your summary you said:

In motivating the tax package, particularly the introduction of the GST, The Treasury has asserted that a major change in the tax mix is necessary because the present array of indirect taxes will raise insufficient revenue to meet Australia's future needs. Using a MONASH forecast simulation, we find no support for this proposition.

To an extent the committee has explored this with Treasury, although not sufficiently. On the wholesale sales tax area, for instance, Treasury answered roughly in agreement with you, that the wholesale sales tax had held its growth. However, they explained it as a result of increases in rates and of widening the scope of it. Their answer was that without those it would have deteriorated. Well, that might be said for any area.

I would like to pick on a couple of points there so that I can identify what you are saying. I assume, when you are talking indirect taxes, you are talking both state and federal.

Prof. Dixon—Yes.

Senator MURRAY—In relation to petrol, I had understood that because of the falling base price of petrol, which has essentially halved—petrol, oil and gas—and because of greater fuel efficiency in modern technology, that the excise rate for that category was slowing quite considerably. Is that not true?

Prof. Dixon—Yes, and so the assumption underlying the petrol simulation there is that there will not be further halving of the price. One has to make a guess about what is going to happen with the world price of oil. There is no reduction in the real price of oil in the simulations. The fact that petrol revenue may have slowed in recent years is not reflected in the future.

Senator MURRAY—The second thing I had understood with regard to state indirect taxes is that—principally because of Queensland's pressure to hold indirect taxes down, in

fact reduce them in such areas as stamp duties and so on—the state indirect tax growth had slowed, largely because of competitive pressure between the states. Is that true?

Prof. Dixon—I do not know.

Senator MURRAY—The third thing I have understood is that, in order to maintain a revenue base at the indirect tax level, it has been necessary for both the states and the federal government to keep increasing or adjusting rates. The inference is that, if that is the trend, there is no protection against the same happening with the GST. In yesterday's submissions, I think it was VECCI who indicated that internationally the impetus had been almost automatic towards an increase in GST. What I read from this, given the scenario you have put, whether we stay with the existing system or move to a GST, the precedent is always for rate increases and adjustments to in fact maintain indirect tax growth at the same rate or ahead of GDP. Is that correct?

Prof. Dixon—The argument in favour of the GST—I do not know whether it is right or not—is that it would be more broadly based than the present bunch of indirect taxes and therefore you would be less likely to have to increase the rates. For instance, if you were collecting most of your taxes on a very narrow base—on petrol, and the price of petrol went down—you would have to increase the rate. But I do not think that is the case.

This is what I was saying earlier. I would like to see the Treasury's analysis of why they think that the present bunch of indirect taxes would not raise revenue roughly in line with GDP. I want to see what assumptions they make in there. Our revenue projection showed the revenue going roughly with GDP with no increases in the rates of all of these taxes. If Treasury is building in a massive reduction in the prices of cars, electronic equipment, petrol and whatever, I would like to see why they are doing that and what the basic assumption is there. I would not claim to have the resources to have done this sort of analysis in great detail, but it is exactly the sort of thing that a treasury could do.

Senator CONROY—Would you be surprised if they had not done that modelling, given their claims?

Prof. Dixon—I would be very surprised. Surely they make revenue projections. They have made these claims that the revenue from existing indirect taxes will not be sufficient for Australia's needs. But that is all they have done: they have made those claims. And I read the document.

Senator CONROY—They have not submitted to us, either. It is all right; you are not alone.

Prof. Dixon—They have always been loath to make forecasts. For this sort of question you cannot avoid making a forecast. You have to have a view of what is going to happen to the structure of consumption, what is going to happen to prices in the future. They would have to commit themselves to some sort of explicit forecast.

CHAIR—I think this is quite an important point because, to the extent that welfare organisations or those representing welfare groups provide support for a GST in concept, it is

on the grounds, almost exclusively, that the current taxation system will not meet welfare needs in the future. If those projections are right, that assumption that those welfare groups make is not true.

I would be very interested in trying to get to the bottom of this precise point. Given the remarks you have made about Treasury and what information they may have—it is a question I will talk to the committee about—I would be interested in perhaps a series of questions from you that we might ask Treasury so that, through us, we can engage in a dialogue between you and Treasury to tie this fact down.

Prof. Dixon—I think it has become a very critical part of the analysis because we are unable to find significant welfare gains from reallocation of resources. The flattening of the tax system does not seem to produce anything that would make you want to make this major change in the system to generate resource allocation gains. There does not seem to be enough in that. So then it comes back to this other argument that perhaps we have to change the tax system because the present system is falling apart. But at the moment I have not seen the evidence for why you would want to believe that assertion. I would be very interested in participating in such a dialogue.

Senator GIBSON—Going back 50 years, from my rough memory, goods represented something like 50 per cent of consumption 50 or 60 years ago, but today goods are something like 25 per cent of consumption. Services have crept up and up and up.

Senator CONROY—Encourage them to propose a services tax.

Senator GIBSON—They have risen to 75 per cent, or something of that order, of what people consume today. Because the indirect tax system—certainly the wholesale sales tax system—is largely based on goods, wouldn't one expect, therefore, that there would be a diminution in the recovery of tax from that wholesale sales tax in that a tax on services is required in the long run to correct that imbalance?

Prof. Dixon—There already are considerable taxes on services. We have banking and insurance. They are major taxpayers.

Senator CONROY—Gambling.

Prof. Dixon—We have entertainment. It is not really true that the indirect taxes are confined to goods which are a declining share of consumption. That is because banking, insurance and entertainment and all those are rapidly growing areas of consumer spending and they all carry quite high taxes. That is one of the reasons we get the answer we get, which is that the indirect taxes grow at roughly the rate of GDP.

Senator GIBSON—Sure. Just taking the banking one, with FIDS and BADS—which I know at present collect about \$2 billion a year—every state government has recommended to the federal government, over a year ago, that getting rid of them was their highest priority. Why? Because it is driving jobs offshore.

Senator CONROY—Payroll tax is their biggest gripe.

Senator GIBSON—Mr Chairman, could we get Senator Conroy to sit at the table and answer all these questions instead of interrupting Professor Dixon?

CHAIR—Order!

Senator GIBSON—Each of the state premiers recommended to the Prime Minister 15 months ago that getting rid of FIDS and BADS was their highest priority because they are driving financial services jobs away from the Australian capital cities to Singapore, Hong Kong and elsewhere. I think it is a reasonable case that they have to go. The proportion of goods in consumption is going down, so one would expect we need further taxes on services.

Prof. Dixon—The problem with that sort of argument is that everybody who is taxed will claim that the tax that is on them drives jobs offshore, as we have seen in this analysis taxing tourism. That is taxing a service. Taxing experts in tourism will drive jobs offshore. It will drive jobs to New Zealand. The FIDS and BADS might be bad taxes, but that is a separate issue which should be analysed on its own.

Senator SHERRY—That was the point I was going to raise with you. From your analysis, if you expand the indirect tax system—that is, a GST—to cover that sector of services that is relatively low taxed, for example, hospitality, it will cost you jobs: it is a job destroyer in one of the few sectors where jobs are growing.

In reading your paper, you do not appear to have modelled the total revenue raising, over time, of the package itself—the GST replacing the other taxes. You have not done that, as I understand it, have you?

Prof. Dixon—We have not reported the results, but we could give you the result. It is just a by-product, if you like, of the central simulation. The central simulation shows the path of indirect taxes. I think it will move, roughly, like GDP.

Senator SHERRY—I would like those. Did you say that the introduction of a GST replacing the various indirect taxes actually moves taxes up as a percentage of GDP?

Prof. Dixon—It will move indirect taxes up as a percentage of GDP, and income taxes down as a percentage of GDP. Overall taxes will be reduced a little because the package is not quite balanced.

Senator SHERRY—Okay. I would certainly appreciate that analysis.

Senator MURRAY—Staying with indirect tax: it is true, isn't it, that the greatest reduction in indirect taxes over the last decade has been a result of deliberate policy of governments, both Labor and the coalition, in the area of tariffs? Customs and indirect taxes are way down. That is correct, isn't it?

Prof. Dixon—Yes.

Senator MURRAY—As a percentage of GDP, the items that fall under wholesale sales tax have actually fallen in the last decade. In other words, goods have declined relative to, say, services. Is that so?

Prof. Dixon—Yes, I think that is right.

Senator MURRAY—Are you arguing that that decline has now stopped?

Prof. Dixon—No. I am arguing that there is enough other indirect taxes of one sort or another to mean that the total indirect taxes will move, roughly, at the rate of GDP. There are enough taxes on entertainment; there are enough taxes on banking and insurance, et cetera. There are enough taxes on that list there to suggest that, best guess, indirect taxes to share of GDP will be about constant.

Senator MURRAY—I have now got the figure on petrol excise. Petrol excise as a percentage of GDP has fallen from 2.8 per cent to two per cent of GDP in 10 years, which is roughly a third. Is that decline expected to continue?

Prof. Dixon—No, not in these projections. With the petrol excise, I think it has been a decision by governments on occasions to reduce the rate. In ad valorem terms—that is, as a share of the basic price of the product—the rates have all been held constant.

Senator MURRAY—When you make up your model as to where tax falls—in other words, the proportion that items are of total consumption—are you holding that constant or are you changing that, because, of course, consumption is changing?

Prof. Dixon—There are quite detailed forecasts on where consumption is going. For example, electronic and scientific equipment and telecommunications are fast growing consumption items.

Senator MURRAY—So you are modelling to the real world?

Prof. Dixon—We do try to, yes.

Senator MURRAY—Thank you.

CHAIR—I will ask my colleagues if they would not mind sitting on their questions. Professor, I think you did say that you were coming towards the end of your presentation?

Prof. Dixon—Yes. I have done all of the slides.

CHAIR—Is there anything further that you wish to put to the committee?

Prof. Dixon—A summary. I think the sensitivity analysis we did basically strengthens the conclusions that we came to before. The conclusion we came to before was that the change in the tax mix would not produce significant long-run benefits. It would damage some parts of the economy and benefit other parts. So there was a change in the mix of

economic activity to be produced but no real overall gain for the economy. That conclusion comes through.

This analysis has produced two downside risk scenarios: one which was, I think, very important in the mid-1980s in the option C debate. One downside risk is that wages will continue to be geared to the CPI. In that case, wages will move ahead of producer prices, because the CPI is to move ahead of producer prices. If wages continue to move with the CPI, then wages will move ahead of producer prices. That reduces profitability of business and will cause short-run unemployment. That unemployment will not last—wages will adjust eventually but that could cause serious difficulties.

The other downside risk that is highlighted in these sensitivity runs is to do with that incomplete pass through, where the tax increases come on quicker on the tax reductions. That could also be job destroying in the short run.

The main conclusion is—if you want to do it—that I do not think there is a big benefit down there in the future. You would have to think about compliance costs and changeover costs and whatever. So if you do want to do it, you would have to avoid those two downside risks. Firstly, you would have to be fairly confident that the labour market will work properly and that people will recognise the tax cuts as a compensation for the increase in the CPI. You would also have to make sure that the tax reductions were passed on as quickly as the tax increases.

CHAIR—That might be a good point for us to have a break. The senators may have some questions for you when they come back.

Proceedings suspended from 10.37 a.m. to 10.57 a.m.

Senator FERGUSON—Professor Dixon, at the top of page 2 of your submission you say that your central simulation finds, as it did in the December paper, a number of outcomes including an employment increase of about 30,000 jobs, which we have gone through this morning. I just want to examine a couple of the similarities between your December outcomes and the outcomes that you put into this latest paper.

My reading of chart 3.2, in particular, seems to indicate that your latest modelling produced some more favourable outcomes for the government's tax package than your December paper. I wonder if you could describe—in reasonably simple terms, because they have to be for us to understand—why in chart 3.2 in your latest work, the one that you have just presented to us, your investment and capital forecasts are more favourable than in chart 3.2 in your December paper. I have not got the December paper with me; I have only got this one. But I understand they are more favourable.

Prof. Dixon—Yes, that is right. I got some feedback on the December paper which suggested that we had not fully taken into account all of the tax reductions on capital goods. In the December paper we had not got a big enough reduction in the costs of creating capital, so we made a revision for this work. It did not have a big effect but it increased the level of capital creation and investment in the central simulation.

There was one other change. In the simulation for the December paper, the foreign demand elasticity for exports was negative four. Here we made it negative three, and in the sensitivity we took it to negative two. Bringing that sensitivity and that elasticity down was also favourable to the government's package.

Senator FERGUSON—In charts 3.7 and 3.8 there are also some changes, where your forecast on GDP and economic welfare outcomes also compares favourably with that in the same charts in the December report.

Prof. Dixon—Yes. Both of those things I just mentioned have a slightly favourable effect: less damage to tourism is good for the terms of trade and that is good for welfare. More capital is good for the country as well, in a fairly indirect way: although I would expect most of the extra capital to be actually owned by foreigners, who would be receiving the dividends and payments on the extra income that their capital produces, they would be paying income taxes, which would stay with the local residents.

Senator FERGUSON—I suppose it really leads to a further question: if we asked you to do another one in April, on another contract, could you perhaps get some more favourable outcomes for the government?

Prof. Dixon—I think it is very important that economic modelling be open. This is one of my objections to Treasury's approach to life. I put that paper out in December, I sought comments, I went to see Chris Murphy, as is acknowledged here, and I got detailed comments from him. I made two minor corrections, both of which kicked the ball somewhat in the direction of the government's package, but that was only small. There was nothing particularly wrong with the 10 December results, but I felt more confident when I got some feedback. I had the thing analysed quite thoroughly by my peers.

Senator FERGUSON—Also, in your December business capital forecast there was 0.4 per cent increase. This has increased to what looks like about 0.9 in your latest work. I understand that the comparable figure in the ORANI-G model, from which your work is derived, is 3.4 per cent and other models have results nearer seven per cent. Can you explain why there is a lower result in yours?

Prof. Dixon—There are various reasons. One is that the measures of capital are given. Here we are talking about all capital, so the K that appears in this paper is all capital. In some of results I have seen quoted around the place, it is just business capital that is being talked about. Housing capital will fall with this package.

Another difference is some of the other modellers have overestimated the capital effect by failing to take the public sector properly into account. I do not expect this package to stimulate public investment, so I have held capital stocks and investment in the public sector fixed. I believe that that has not been done the same way by some of the other model builders.

Another reason is that these simulations go out eight years; the adjustments are not quite finished in these simulations. So rates of return on capital are still slightly higher than they otherwise would have been. In static analysis, where people are just concerned about

movement from one equilibrium to another equilibrium and they do not give you a time path, they assume that rates of return are actually fully adjusted and equilibrium is restored. Equilibrium is not quite restored here.

There is yet another reason. There is some disagreement about the critical parameter to do with the elasticity of substitution between capital and labour. In this modelling I favour a somewhat lower number than some of my modelling colleagues.

Senator FERGUSON—Can you explain the real exchange rate profile in chart 3.6? I would have thought that financial and currency markets are forward looking markets and would already have factored some GST effects into future projections. Is the sharp rise and fall that you come up with consistent with the behaviour in a forward looking market? How significant is your model in result compared to other influences on the exchange rate?

Prof. Dixon—I will just explain the pattern first. If this particular change in tax mix is made, I would expect there to be an increase in investment, as we have just gone through. There will be an increase in the capital stock brought on with a fairly sharp increase in investment in the short run. So, if you are going to increase the capital stock by one per cent over a couple of years, you are going to need a much bigger percentage increase in investment, through a four per cent increase in investment.

When investment increases, that deteriorates Australia's international competitiveness and that is the appreciation of the real exchange rate. As time goes on, the capital stock will get to its new higher level, at which stage investment will fall again. The real exchange rate then comes down in line with the movements in investment.

As far as forward looking expectations go, these simulations are done with what is called static expectations. Our agents are not anticipating the GST. The exchange rate movements are really reflecting current movements in investment and they are reflecting the immediate past.

Senator FERGUSON—I move to a comment that was made on your December report. When your first report came out on 20 December, Senator Lees, the leader of the Democrats, made a comment in a media release. She said that it shows the exclusion of inbound tourism packages and food from the GST would have a positive impact on jobs and economic growth. That is not what you told us this morning, is it? I am not sure whether it is her interpretation of your earlier figures, but it is not exactly what you showed us in your slides this morning.

Prof. Dixon—I do not know where she would have got that idea in December, because I had not actually done it in December. No, I think the exclusion of food would have a short-run positive impact on employment and it had that on both wage assumptions.

In one scenario—I think it was sensitivity 4—employment increased by 30,000 with food GST. As you moved and took the GST off food, the employment gain was 38,000. Under the other wage scenario—the sort of disaster scenario—the figures were 100,000 jobs lost in the central simulation. Take the GST off food and it is 68,000 jobs lost.

I think, in the short run, failing to GST food would have favourable employment effects. It does not mean that that is what you should do. You have got to think about the longer term, the compliance costs and the difficulties of making major exemptions. But I think the interpretation that the short run would be easier if GST were not applied to food is right.

On tourism, I think the simulation that we have got there, in which the GST is not applied to packaged holidays—I forget exactly which one that was—had minor favourable effects. That was the main result there.

Senator FERGUSON—Looking at the figures that you had this morning on the work that you have done, where we are talking about these negative figures, you have already scaled back from minus three and you have used a negative two. That negative two is way above what other tourism economists used. They used negative one and negative 0.2, as I understand it. Access Economics have done a lot of work on tourism for the Tourism Council and they used negative one and negative 0.2. I understand that the Centre for International Economics a number of years ago used exactly the same range. If you were to use the range of negative one and negative 0.2, is it fair to assume that if you used those accepted projections it would change your outcomes?

Prof. Dixon—I am surprised at Access. I actually checked with Access. They were quite happy with the negative two to three range.

Senator FERGUSON—But I understand the work that they have done with the Tourism Council, their accepted range is negative one to negative 0.2.

Prof. Dixon—If you really believed these very low elasticities that you have just quoted—say, the negative 0.2—what that means is that we could increase the costs of a holiday to foreigners by a per cent and only 0.2 per cent of them would stay away. Every time we increased the cost of a holiday to them, we would actually increase our revenue. That would be a remarkable and wonderful thing, I think, which we should probably as a nation exploit.

Senator FERGUSON—The fact is, these are the figures that have been used and once the—

Prof. Dixon—I took this very seriously, Senator. I rang officials in the tourism department and so on and got the studies which produced these very low elasticities. It is written up in this report. They are absolute nonsense—incredible nonsense. Let me try to explain how you get these very low elasticities. What people do is run a regression, a statistical analysis which says that demand for tourism in Australia by Japanese is a function of or depends on the Australia-Japan exchange rate and it depends on the cost of things in Australia and the cost of things in Japan. That totally ignores the costs of things in Hawaii or Bali or the United States.

What we are doing here with this GST is we are running an experiment in which we are going to increase the cost of a holiday in Australia relative to the cost of a holiday in any other destination in the world. That is the elasticity we want, the elasticity which shows how

substitutable a holiday in Australia is for a holiday in Hawaii, for a holiday in New Zealand or for a holiday in other destinations.

It may well be that if we make holidays in Australia more expensive, what happens would be that people who are coming to this part of the world would spend two days in Australia instead of four days in Australia and four days in New Zealand instead of two days in New Zealand and so on. There is plenty of substitution. The international tourism business is a very competitive business.

These low elasticities, as far as I can make out—and it is analysed in this paper—are based on very poor econometrics. It does not make any kind of sense. They are producing results which are totally implausible. If you really believed 0.2, let us forget about GST; let us get very rich by charging massive taxes on tourists when they arrive. They will be only too happy to pay them. It just does not make sense.

Negative two is as low as I can really plausibly go. You are right that if the result was much lower than two—if it is 0.2 or something like that—of course we would get different results.

Senator FERGUSON—Which is what other economists have used.

Senator O'CHEE—Could I raise with you the issue of substitution? The price of a five-day package tour from Japan to Honolulu throughout much of the 1990s was half of the price for a five-day package tour from Japan to Cairns. Yet in that period of time we saw phenomenal growth in the early to mid-1990s in the Cairns tourism market. That is in spite of the fact that they can go to Honolulu for half the price. Surely that shows the resilience of the Australian tourism product because it is unique?

Prof. Dixon—I would need to check out the facts. I am not willing to concede that that is the fact. What we are talking about here is raising the price of holidays in Australia relative to what they otherwise would have been. It may well be that tourism growth will continue. What I am saying is that it will be less than it otherwise would have been. What I am saying here is that the GST, if implemented as the government plans, would reduce tourism to Australia by say, eight per cent, 10 per cent, that kind of number, which would be something like a year's growth.

Senator O'CHEE—So we are not necessarily talking about an absolute loss in tourism, we may just be talking about a change in the growth rate. In other words, tourism arrivals may well continue to grow, but at a changing rate?

Prof. Dixon—Yes, that is right. All the results I have produced are deviations from where we otherwise would have been. In other words, we are saying that tourism would be eight per cent below the path that it would have taken without the GST.

Senator O'CHEE—Good, that is a very important point. I understood you to mean that it would actually drop. But we are talking about a growth industry.

Prof. Dixon—I do not think you have any excuse for understanding that on the basis of this report. I think it is made extremely clear throughout.

Senator O'CHEE—I just wanted it clarified.

Senator GIBSON—Last year in a coalition tax committee we had lots of evidence about the disincentive of the high marginal tax rates to people, particularly for those on low and medium incomes, doing extra work—extra overtime, working weekends, doing extra jobs and all that sort of thing. In addition, there was a lot of evidence about extra high marginal rates—the welfare trap which you would be well aware of—in some cases over 100 per cent. The tax package is basically endeavouring to address that and is lowering the marginal tax rates for most workers in the \$20,000 to \$50,000 range to 30 per cent.

Is your model picking up the nuances of changing the incentives for people to work? A lot of business groups are telling this committee that they believe the economy will improve, because the incentives of people to do extra work will be there. Business groups are also saying that removing the inefficiencies of the nine state taxes, and having a simpler GST rather than the complications of seven rates in WST, will make business more efficient. Does your model pick up that sort of stuff or is this over and above that?

Prof. Dixon—It does not pick up any incentive effects. The basic assumption is that we do not have a problem in the labour market of supply. In other words, there are enough people around who want to work anyway. It may well be that the present tax system discourages some people from wanting to work, but there is enough unemployment and enough disguised unemployment in the economy for us to think that that is not a very important macro-economic problem.

Senator GIBSON—Sure. But the particular evidence we got last year was that, particularly in small business, a lot of people in employment do not want to do the overtime and do not want to work at weekends. In other words, the business misses out and the individual employees miss out because of this disincentive effect of the high marginal tax rates.

Prof. Dixon—Yes. To the extent that the package can address those issues, that is useful, but that has not been analysed here.

Senator GIBSON—If that is positive, would you expect there would be an additional economic growth and an additional employment effect?

Prof. Dixon—Not necessarily. With high unemployment, it is not clear that increasing the supply of labour does much for economic growth. It may help in some areas where there really is a labour market constraint but, overall, still with eight per cent unemployment officially and probably another eight per cent disguised unemployment and so on, it seems to me that there is plenty of labour there to be used. I would be very happy to think that the package will increase incentive effects and will reduce poverty traps and so. I would not expect that to have much impact on economic growth.

Senator MURRAY—I would like to try to summarise my understanding of where we have got to at present. You are saying that, if the tax package is unchanged, and if the consequence of that tax package is to generate wage demands because of an expectation by those people, whether rational or not, that the costs of the package will be greater than the benefits, the package unchanged will generate job losses. In other words, it will be a job-destroyer. Is that a correct summary?

Prof. Dixon—No, I think not, Senator. The central simulation actually showed job gains in the short run. There are two forces on wage demands—

Senator MURRAY—If I may interrupt you, I understood that for what you said; but you said ‘if’ there was excessive wage demand, then that would be reversed. Is that correct?

Prof. Dixon—There were two labour market scenarios. One was when wage earners accepted cuts in income taxes as a reason for damping their demands for wage increases. What they were really concerned with was their purchasing power of their wage after tax. If that is what you are really concerned with, then you will accept a cut in income taxes as a substitute for a wage increase. However, there is a possibility that the labour market will not act that way and in fact will go on demanding wage increases roughly in line with CPI. If that happens, the wage that the employer has to pay will jump with the CPI, but the prices that employers will receive for their products will not jump with the CPI. So wages will jump ahead of prices to be received by producers for their products. That is what will cause unemployment.

Senator MURRAY—Wage growth at present is not tracking GDP growth, is it? It is actually greater than GDP growth. Is that correct?

Prof. Dixon—CPI.

Senator MURRAY—Greater than CPI.

Prof. Dixon—Wages normally grow a little bit ahead of CPI, they grow faster than CPI—and that is fine. That is the pain that we get for productivity increase. The normal way in which wages behave in Australia is that they go with CPI, plus productivity. Now, on this occasion, if you introduce a new indirect tax and make the CPI jump, there has got to be a period in which wages actually grow slower than CPI, wages drop below the CPI for a while. We have to accept that, and we have to accept that the income tax cuts that we are getting are compensation for the jump in the CPI—we do not need a wage increase. It is absolutely critical that we understand that, because if we do not, if the labour market reacts by sending wages up with CPI, then you are into sensitivity 1 scenario, which is quite costly—that would cost you something like 100,000 jobs.

Senator MURRAY—If we stay with the downside and the labour market was likely to react that way, but if, however, the package was adjusted—the range of suggestions so far are exempting food and tourism, raising compensation in certain undercompensated or marginally compensated areas and maintaining the fiscal stimulus—the consequence will be either to ameliorate the downside or to produce a positive result. Is that an appropriate summary of what you have said?

Prof. Dixon—Except for the last sentence, I think. There was no positive result. If you exempted food, for instance, the downside was ameliorated—the downside of the labour market not understanding how the package was supposed to work, of wages moving with CPI and, instead of producing a 100,000 job loss, it produced a 68,000 job loss. But there was no positive effect—the package looked very bad if the favourable wage assumption was not realised.

Senator MURRAY—We have looked at what happens with a downside scenario and then adjusted it with changing the packages. Now let us look at the upside. The upside is that there is not unreasonable wage demand. If the package was still changed on that basis—food and tourism exempted or zero rated, or let us use the words GST free, fiscal stimulus maintained and greater compensation for those who are undercompensated or marginally compensated—would the accelerated beneficial effect be considerable or marginal?

Prof. Dixon—In the favourable situation, where you got the 30,000 job gain in the short run, exempting food took it to 38,000. So that was a very marginal win. Minimising the damage to tourism is probably a good idea under either wage assumption. It does not seem to me that there is a good case for taxing tourism exports. We are not taxing exports of anything else—and the economics of that say that that is right, that you should not be taxing exports with the GST. Singling out tourism for taxing does not seem to be a very good idea and if it is administratively convenient not to tax the package holidays, at least at the level of analysis that we have managed here, it shows a small win. We have not looked at the compensation package at all in this analysis.

Senator CONROY—Isn't it right that effectively there is a double hit on tourism from overseas, because in Treasury's forecast—and I think everybody has agreed—there will be an appreciation in the dollar of three to 3½ per cent?

Prof. Dixon—Yes.

Senator CONROY—So not only do you have the impact of a GST but you actually have a double whammy with the hit of the increased exchange rate. Even if you were to throw away the GST on inbound tourism—if you could administratively do that, and let us assume you could—you still have a detrimental impact on tourism even in that circumstance because of the appreciating dollar.

Prof. Dixon—The way it works here with all your exports is that the foreigners are hit by the exchange rate appreciation but they are compensated by the fact that the \$A prices of things will be lower in Australia. That is why you do not want a GST on exports. The foreigner does not see anything happening here. All that happens is that the \$A prices of wheat, wool and so on are down three per cent but, as you have appreciated by three per cent, the dollar foreign price is unchanged.

With tourism, you have the appreciation but the \$A prices go up, because when the tourist comes here the tourist finds that the hotel price, instead of going down by three per cent in \$A terms, has gone up by seven per cent, which is the three per cent down plus the 10 per cent GST coming up. So this particular type of exporting activity, exports of services, is quite hard hit by the package as it currently stands.

Senator CONROY—Would that be the same for education?

Prof. Dixon—Exactly, yes. In both cases there are major parts of the expenditures by the foreigner that are not going to be GSTed. In the case of tourism, air travel will not be GSTed, and apparently the plan in the case of education is not to GST education fees. But, nevertheless, the student needs accommodation, food, clothing and travel in Australia and all of that will be GSTed.

Senator CONROY—The state of Victoria is one of the largest, if not the largest, exporter of education.

Prof. Dixon—I believe so, yes.

CHAIR—Monash is one of the biggest. You have the call, Senator Murray. Before you commence, can I just say that we were due to complete this segment now, but in order to meet the reasonable needs of questions from the committee we are going to extend. I do apologise to the next group of witnesses who are waiting but, because I have to meet the needs of the inquiry, we will go on for a little longer.

Senator MURRAY—As I see it, changing the tax policy could have four components. The first is a social objective. As you know, governments have sin taxes and attempt to adjust social behaviour through that, and one area in which this government is addressing social policy is in the poverty trap area and all that sort of thing.

The second area is the economic area, where things like depreciation allowances or tax systems can encourage greater investment or jobs or that sort of thing. The third area is tax efficiency and recovering appropriate revenues for governments' needs. The fourth is the issue of equity and fairness, where you attempt to ensure your society is run under fairer principles.

The first area, social policy, we will hear more about from other people later on. I really want to concentrate on the last three. I draw your attention to a statement you made just after a lot of equations—which all the senators understand very much!—in section 2. This is not in algebra. You say:

At some points in ANTS it is argued that cost reductions will give Australian producers a competitive advantage in international markets. This also seems an illusion. We would expect that general changes in the business cost/price level would be offset by exchange rate movements. In fact, in their PRISMOD calculations, Treasury assumes an offsetting loss in competitiveness via a 3.5 per cent appreciation of the Australian dollar.

Some of my colleagues have translated that into plain language to the business people talking to them and said, 'Look, if you're going to pass through all the savings that arise from this package and increase your costs by just the costs that arise from the package, and if there is no employment generation—which is what Treasury said—and if there is no real competitive benefit, what's in it for you? No increased profits, no increased sales, nothing.' Therefore, that assumption that in a perfect equilibrium model idea the exchange rate movement will automatically adjust any supposed export improvement is a fundamental one, because all the business groups are saying that we are going to be better off with this

package. But both Treasury and yourself say pretty well it is an illusion. Could you expand on and explore a little the economic consequences of this package?

Prof. Dixon—At the beginning of the ANTS document there is a lot of talk about how costs to business will be reduced by 3.2 per cent. That is right, probably. I do not object to that estimate. But what I do object to is the idea that a general, across-the-board reduction in the price level will have any effect on Australia's international competitiveness.

Senator MURRAY—Which is the biggest claim made, isn't it—that the biggest advantage of this package is the exports?

Prof. Dixon—Yes. At the beginning of that ANTS document there are claims made that this will be good for exporting. But you will notice that, by the end of the ANTS document, the assumption is made that it will have no effect on exports. It appears as though different people wrote the start and the finish.

The truth is that you would not expect a general reduction in the price level in Australia to stimulate exports or cut back on imports. You would not really expect the balance of trade to suddenly improve because of a general reduction in our cost level. What you would expect is that the exchange rate would strengthen. What determines the balance of trade—what really determines whether we export more or export less, or import more or import less? What really determines that is to do with how much investment is going on in Australia and how much saving we want to do.

One of the things that may well happen with this package is that investment will become profitable for a little while in Australia. There are going to be reductions in the cost of capital goods, so that may well lead to an investment surge, which you can see in these simulations. In fact, an investment surge is likely to deteriorate our trade accounts, which is fine—no great problem. When people want to invest in our country, if we do not want to do all the saving that is necessary to finance the investment, then people lend us money.

If people lend us money, then the way they lend us money, fundamentally, is they tell us, 'Look, you need not pay for all your imports.' When they tell you that you need not pay for all your imports, what they are telling you is that you can run a balance of trade deficit. And the way they tell you that is they strengthen your exchange rate. You see, when they want to invest in your country they have got to buy your dollars. So they push up the exchange rate and they make us uncompetitive. We will find that we do not want to export as much as we used to—deviation from control, Senator O'Chee. The growth of exports will be less than it otherwise would have been and the growth of imports will be more than it otherwise would have been.

Fundamentally, what determines our competitiveness, the amount that we want to export relative to the amount we want to import, are investment opportunities in Australia. If we do something good for ourselves and strengthen the investment opportunities in Australia, bizarrely, we actually deteriorate our competitiveness. The other fundamental factor is our willingness to save. If we want to save more, then foreigners lend us less, and that strengthens our trade accounts. How can we save more? In this country, the main way to save more is for the government to move its budget towards surplus. So if the government

really wanted us to save more, it would not be offering us this tax cut. I am not saying the tax cut is a bad idea; it may well be a very good idea. But if you were really worried about the trade accounts, you would not offer a reduction in overall taxation.

Senator MURRAY—All right. Go back to my four areas. Both you and Treasury put a question mark over the economic area. On the revenue raising and the integrity of the revenue system, we have already had a discussion about that where you have drawn attention to the lack of explanation for Treasury's view that, without this adjustment, our revenue base will deteriorate. So we have had that discussion and there is a question mark over that.

That leaves us with the first one, which is social policy, and the last one, which is equity and fairness. You have, somewhere in your paper, made the comment that the effectiveness of this ANTS thing—and I am paraphrasing your words—is that the winners are highly taxed individuals, industries and organisations, and the losers are lowly taxed individuals, industries and organisations. In other words, there will be an equity adjustment from one to the other, a fairness package.

If the consequence of this inquiry was to establish that, by and large, the economic effects were marginal or an illusion and that, by and large, we have a workable system and we will get a new workable system, so it is not that material, then the entire policy weight of the ANTS document surely has to fall on the fairness and equity levels. That would then bring specific pressure to bear on the area which you have not modelled and for which the committee has commissioned some modelling, which is the distributional effects, the compensation effects, and what it does to particular industries, organisations and individuals. Is that a reasonable proposition I have put to you?

Prof. Dixon—Yes, I think that is a pretty good summary. Once you have stripped away the idea that you are going to get a massive tax efficiency gain, or once you have stripped away the idea that the present system is falling apart and therefore you need a new system of taxes to raise enough revenue—once you have stripped away those things—then I think you are down to social policy, to poverty traps, you are down to equity issues. And then I think you have got to start asking yourself: well, is the GST the right way to be addressing those issues?

This is going beyond this report. But GST does not come to mind as the very first thing you would think of when you are thinking about equity or when you are thinking about poverty traps. If you stripped away your ideas in your catalogue, Nos 2 and 3, and you are left with Nos 1 and 4, then I think the debate should be open again.

Senator CONROY—Professor Dixon, we had evidence given to the committee by British econometrics professor, Ken Wallis, in December. He was very complimentary. If I can perhaps embarrass you fractionally, he suggested there are people who work on these things. He said there is a world famous group in Australia at Monash and that the intellectual leader is Alan Powell, and Peter Dixon does it. He said that Alan's reputation is truly international. He added also that their project initially started with support from the IC, that is, the Industries Commission.

And last week, again before the committee, Professor Ann Harding was very complimentary of you and your group's work. I just wanted to make sure that was on the record.

CHAIR—It is now.

Senator FERGUSON—It was before.

Senator CONROY—Does your model forecast any significant job gains from the government's tax package in the long term?

Prof. Dixon—No.

Senator CONROY—This seems fairly extraordinary, that the GST is not going to create any jobs in the short term, despite the repeated claims by the government to the contrary. Are you saying that any short-term job creation in the optimistic scenario will be due entirely to the income tax cuts?

Prof. Dixon—Yes. The result is that if you had a balanced package, if you do not offer an overall reduction in income taxes, if you just balanced a cut in income tax on the one hand with an increase in indirect taxes on the other hand, it would be slightly job destroying.

Senator CONROY—Job destroying?

Prof. Dixon—You get a negative. That is revealed by that analysis of why you go from the 30,000 to the 38,000 when you exempt food. Reverse the arguments that I made there and then you can understand that replacing income tax with a consumption tax, under the wage assumptions that we have made, would be slightly job destroying.

Senator CONROY—I want to go over again one of your earlier points. If half the savings from the indirect tax reductions are held back by business for one year, you are predicting short-term job losses of 15,000. Is that right?

Prof. Dixon—Yes, that was the final sensitivity analysis. So that means that we came up with a scenario in which holding back the price reducing effects of the tax cuts would actually destroy about 45,000 jobs. Instead of getting a 30,000 job gain, it would switch to a 15,000 job loss.

Senator CONROY—Are you able to tell us what would happen to jobs each year that the full savings of indirect tax reductions were withheld by business? Is there a rule of thumb that we could use from your modelling?

Prof. Dixon—Business could not withhold the tax cuts indefinitely. Competitive forces would eventually bring the tax cuts to bear on prices. So, in the long run, you would eventually wind up roughly where you would have been even if the tax cuts had been passed through immediately. There is no real long-run problem; it is a short-run problem if the tax cuts are not passed through.

Senator CONROY—The government and Treasury have claimed the tax package will strengthen the economy, make it more efficient and boost economic growth, yet your results suggest negligible change in economic growth in the long run and no real improvements in efficiency. You say that the long-run resource allocation gains flowing from the proposed tax changes will be negligible. If, as the Treasurer keeps saying, the government is replacing a ramshackle wholesale sales tax of the 1930s with a modern, efficient GST of the 1990s, why won't there be an increase in efficiency and economic growth?

Prof. Dixon—I just hated all those adjectives, to tell you the truth. I looked at that ANTS document, looking for a substantive argument. 'Ramshackle', '1930s', 'Botswana'—this is not economic argument. This is just some sort of lightweight rhetorics. I was just very irritated by that document.

There are arguments that you could make but they are not made in that document. I listened carefully to the Prime Minister and other senior members of the government and I am still listening, still waiting for them to make their substantial arguments, to explain to me why the present system is going to fall apart, why they expect such revolutionary gains from substituting one indirect tax for another indirect tax, why they cannot achieve the small employment increases that we are talking simply by cutting income taxes—why you need to reform the indirect tax system to do it. I just want answers. I may well be wrong in this analysis, but I have not seen anything from the government or the Treasury to explain to me why this analysis is wrong.

Senator MURRAY—On the record, if I may, Senator Conroy: I asked a question on notice of government to verify and validate those statements they made that investment would increase jobs and so on. The reply that came back was that they were qualitative statements, but there was no explanation as to how they were derived. So we too, as a committee, are in the air on that.

Senator CONROY—You say that the change in GDP does not measure the benefits or costs to Australia, since some of this change will accrue to foreign investors. So you say that the correct measure of the national benefits of the tax package is the change in welfare accruing to Australians. Can you explain this? How is the welfare measured, and can we consider it to be some measure of average Australian living standards?

Prof. Dixon—We will start with GDP, which is a measure of output. If we stimulate output by having more capital in the country, but the capital is substantially owned by foreigners, any extra income—the extra GDP—belongs to foreigners and that is not a welfare gain for us.

Another problem with GDP, which as I say is a measure of output, is that if we take actions which reduce the prices of the products that we sell on international markets by trying to sell more of them or by changing the mix of things that we sell towards lower priced products, then we may enjoy an increase in GDP but we can simultaneously have a reduction in our living standards because, although we may be producing more of the things that we produce, they are simply not worth any more. With this package both of those things are likely to happen: we will get an increase in the capital stock, which will increase our

GDP but not the value of goods and services available to us, and we are likely to deteriorate our terms of trade.

Economists usually measure standards of living from changes in a tax mix by looking at the quantity of things that we can consume—the quantity of housing, clothing, education and all the other good things of life that we can consume—compatible with no change in our trade accounts, no increase in our debt and no change in the amount of capital that we actually own. From making those calculations, this package, in the central simulation, shows a tiny reduction in our standards of living in the long run. Some sensitivity analyses we managed to get into a tiny plus, but the numbers are small and certainly I could not tell you whether it is a tiny plus or a tiny minus. I am pretty confident that it is small.

Senator CONROY—As you have just stated again, you predict a small reduction in the welfare from the government's tax package and the reasoning for this is that Australia is not benefiting because it imposes a cost on our labour-intensive, export orientated service industries, whose long-term international prices are rising.

Prof. Dixon—Yes.

Senator CONROY—And also home building?

Prof. Dixon—I do not think that was an important part of the story. It is true that costs of home building will rise and we will have a slightly smaller housing stock than we otherwise would have had. But it may well be true that ownership of dwellings is undertaxed at the moment, so I would not have thought that getting some taxes on to the ownership of dwellings is necessarily a bad thing.

Senator SHERRY—Tourism is more important to some regions of Australia—Queensland, Tasmania and the Northern Territory—than to others. Is it reasonable to assume an interregional shift in our economy, favouring some areas over another and some areas losing over another, because of that?

Prof. Dixon—Yes, that is reasonable. I think in the December paper there are some regional results. From what I can remember about them, Western Australia was the key winner from the package. Winning industries are the traditional exporting industries, especially mining, so Western Australia looked good. I think Tasmania looked a bit below average.

Senator SHERRY—I won't thank you for that answer!

Prof. Dixon—It was not disastrous, though, Senator.

Senator CONROY—In your paper you conclude in the following terms, firstly at page v:

Overall, the six sensitivity simulations strengthen the finding in our December paper that the Government's proposed tax changes will have little effect on Australia's long-run macro-economic performance. They add a new dimension by illustrating two short-run down-side risks: the package will cause job losses in the short run if wage

earners refuse to allow before-tax wage rates to fall relative to the CPI or if increases in indirect taxes are passed on more quickly than reductions.

Then on page 24 you say:

Finally we should emphasise that no consideration has been given in this report to the costs of implementation, compliance, administration and rent-seeking. These should be set against any benefits claimed for the package.

Yet the government has consistently claimed that Australians should support its GST package because it is good for economy. You seem to find that the government's tax package will not improve the efficiency of the economy, increase economic growth or raise average Australian living standards. You find also that the implementation of the package runs the risk of major job losses in the short run and that any possible short-term job gains will be due to spending the budget surplus on income tax cuts, not to the GST. Is that a fair summary?

Prof. Dixon—Yes, that is the summary I made.

Senator CONROY—Finally, you point out that your modelling does not take into account the compliance costs faced by the more than 1.5 million businesses that will have to file GST returns. After taking these costs into account, can you summarise what you think the tax package would do to jobs, economic growth and welfare?

Prof. Dixon—I think the economic modelling has shown that there is nothing much in it from the point of view of macro-economic performance. There is nothing much in it from the point of view of overall economic welfare, as economists think about it. So then it really comes down to an issue of what you think about compliance. To have a convincing argument for the change you would have to think that the compliance costs involved in the present system were high relative to the compliance costs in the new system and, of course, the changeover costs. I haven't got anything to say about that issue, but that seems to me to be critical.

If you wanted to make this change, really what the economic analysis that has been produced by the Centre of Policy Studies—and I think I can even include Murphy in this, too; his number is just a small plus—is telling you is to forget about economic modelling now. Economic modelling has done its thing. It has come out with nil—draw. It tells you that there is not a big bonanza in making this change. So now, if you want to make it, you have to think of some other criteria.

I think Senator Murray was getting to the right ideas: are we making this change because we think we can relieve poverty traps? Do we need a GST to do that? Perhaps we should think in some other terms. If we have got these income tax cuts to give, perhaps we should just be concentrating on the income tax cuts. Or equity issues: again income tax cuts or a change in the income tax mix or negative income taxes and so on, all of those things, would seem to be much more direct ways of getting at equity issues.

But if you did want to make the change, then you have really got to substantiate this argument that the present system is falling apart and you would have to argue that compliance costs in the present system are high relative to compliance costs and changeover

costs. I have not seen any of those arguments being made by the supporters—not beyond just asserting that they are truths.

Senator SHERRY—These are the lightweight arguments you referred to earlier?

Prof. Dixon—I am talking about the Botswana argument and so on, which I found—

Senator SHERRY—Lightweight arguments.

Prof. Dixon—Yes. That is just plain offensive and silly, I think.

Senator CONROY—The government has cited the results of other modelling based studies to justify its claim that its tax package is good for the economy. It says six such studies support the government's package in a letter from the Acting Treasurer to the *Australian Financial Review* early January this year. But four of the six studies were released before the tax package on hypothetical packages and one of the modelling groups, the Melbourne Institute, more than halved its forecast of the impact of the package on economic growth from an extra 3.75 per cent to 1.7 per cent after the actual package was released. So that leaves Econtech at two per cent of GDP, the Melbourne Institute at 1.7 per cent of GDP and you at about zero. Can you comment on these other studies and their impact on living standards instead of GDP?

Prof. Dixon—I think we are not exactly at zero on GDP. I forget exactly where we are on GDP—

Senator MURRAY—You were marginally negative.

Senator CONROY—On your central one, I thought it was marginally negative and then, depending on which assumption, you are marginally positive. So I am sort of drawing a line in between.

Prof. Dixon—The GDP results from Econtech and the Melbourne Institute are almost entirely explained by the increase in the capital stock that they get. Econtech, as I remember it, got something like an eight per cent increase in the nation's capital stock. When you get an eight per cent increase in the capital stock with no change in employment—capital is worth about 25 per cent of GDP—you would expect an increase in GDP of about two per cent. So that is where their number comes from. It comes from the idea that they think that the package will stimulate capital stock in the long run. Remember, these other people are all doing comparative statics. That means that they look at the present situation and a situation way down there somewhere—it is unspecified how many years out—

Senator CONROY—Eight to 10 years—is that a reasonable—

Prof. Dixon—That was the only sort of modelling I knew how to do once. I claimed it was eight to 10 years. That seems to have stuck. There is no evidence for it being eight to 10 years.

Senator CONROY—It could be longer.

Prof. Dixon—Yes, it could be longer. In fact, I believe it is a good deal longer now. But, whatever it is, it is not a picture of how you get from A to B; it is a picture of A and a picture of some hypothetical B a long way out. In this hypothetical B a long way out, you have eight per cent more capital than you otherwise would have had, and that produces a two per cent increase in the GDP.

The important thing is that the eight per cent increase in capital is not a welfare gain. It is either owned by foreigners, in which case the two per cent increase in GDP belongs to them as well, or we have had to save extra. We have had to forgo consumption on the way there in this sort of uncharted territory of A to B. We have had to forgo consumption while that has been going on to do the extra saving to own the extra capital. So the extra capital—this increase in GDP—should not be portrayed as an advantage of the package in either the Melbourne Institute or the Econtech calculations.

We think there is a good deal less stimulation likely in the capital stock. I touched on the reasons for that earlier. We think that the other modellers have overestimated the responsiveness of public sector investment to the change in the tax package. The number that has been thrown around, the seven or eight per cent, excludes housing. We have put housing in. Housing will actually decline with the package, not increase, so we get a much smaller increase in the capital stock; therefore we get a much smaller change in GDP.

Senator SHERRY—Why do they exclude housing?

Prof. Dixon—I do not know why they exclude housing, but the measure that is often quoted is ‘business capital’.

Senator CONROY—You mentioned Econtech. Are those comments you made equally applicable to Melbourne? Did they make the same assumption on capital stock or is there a different set of—

Prof. Dixon—In both cases, it is not exactly a criticism, it is a misinterpretation of their results by others. What I am saying here is that you might believe—I do not believe it—that you could get a substantial stimulation of GDP through an increase in the capital stock. I think they have exaggerated that effect. But the misinterpretation is leaping from there to the idea that the change in the tax mix is a good idea. Just because you get an increase in GDP does not justify a change in the tax mix because GDP is the wrong measure.

CHAIR—We have been around the table, but there are a few comebacks.

Senator FERGUSON—There are a couple of other questions which I might put on notice because I am aware that the next witnesses have been here for a while now and would like to be heard before lunch. I think that perhaps any further questions we could get to Professor Dixon by way of notice.

Senator MURRAY—I will put mine on notice.

Senator SHERRY—I have a couple that I will put on notice too.

CHAIR—From the chair, I have not asked you any questions in this session yet, Professor, but I will put them on notice, too, although I was interested in exploring at some point the possibility—in whatever format—of bringing you and Treasury together to look at this question of what revenues are generated from the existing system and to tie that issue down. I think that is quite an important one.

Therefore, it means at this stage we have no further questions for you. I thank you for making your time available this morning and running over and for being so frank and direct in your answers.

Prof. Dixon—It is a pleasure, Senator Cook.

[12.04 p.m.]

CLAUGHTON, Mr Kenneth Lindsay, Member, Melbourne Indirect Tax Cell of the Taxation Centre of Excellence, Australian Society of Certified Practising Accountants

DRUM, Mr Paul Joseph, Senior Tax Counsel, Australian Society of Certified Practising Accountants

MORTON, Ms Joycelyn Cheryl, National Vice President Intellectual Capital, Australian Society of Certified Practising Accountants

RYAN, Ms Angela Mary, Director, Taxation, Australian Society of Certified Practising Accountants

Ms Morton—Most of you would know that, prior to joining the Australian Society of CPAs, Angela Ryan had extensive experience in Australia and New Zealand working in Treasury and in the Department of the Prime Minister and Cabinet. Ken Claughton is one of Melbourne's leading indirect tax specialists and is the indirect taxation manager with Pitcher Partners. Paul Drum previously had experience in private practice and was with the taxation office in the position of senior audit manager prior to joining us.

CHAIR—On behalf of the committee, I apologise for calling you later than your appointed time. Should we need the extra time, we will take it out of our lunch period and not reduce the amount of time that you have to present your point of view to our committee.

Ms Morton—The Australian Society of Certified Practising Accountants is Australia's largest professional body with more than 87,000 members. Our members are an influential force in Australia simply because they operate at the coalface of the community and, as such, we have a stake in the wellbeing of the entire community. Over half of our membership work in commerce and industry providing advice to every sector from microbusinesses through to the largest corporations. Our public practitioners, who represent 25 per cent of the membership, are the chief advisers to small business in this country.

In addition, 20 per cent of our members work in the public sector—and will be responsible for implementing the sweeping reforms necessary to administer this new tax regime. We would estimate that around 80 per cent of our members would be involved or responsible for taxation matters.

We come here today to present what we believe will produce the best results for the community as a group, with a wealth of experience and knowledge in this area. We are not here to ask for special initiatives for one sector at the cost of other sectors of the community. Our sole aim is to create a tax system that will serve Australian's needs now and in the future.

The Australia Society of CPAs supports a comprehensive tax reform aimed at broadening the direct and indirect tax bases, while lowering tax rates and, at the same time ensuring that low income earners are adequately compensated for the net impact of those tax reforms made. Reform must be comprehensive, encompassing much more than just a broadening of

the indirect tax base. Wholesale reform requires the overhaul of the Commonwealth-state financial relations, the urgent need to simplify and rationalise the personal and business income taxes, and the removal of a range of inefficient indirect taxes, many of which are imposed by state and territory governments.

Today, we would like to focus on just some key issues of importance that will inevitably determine the final shape of our tax system. Much of the current debate is centred around the GST and, accordingly, we will mainly concentrate on that unless any of the senators wish to inquire of any other form of tax reform.

Our major focus points are: the GST should be broadly based and applied as single rate to make it administratively simple—particularly for small businesses—as well as efficient and equitable. It is essential that the position of low-income earners be protected from the impact of tax reforms. This should be addressed by close considering of the compensation package—not through GST concessions. A lead time of at least 12 months will be required between the passing of the legislation and the implementation of the GST to provide adequate time for the administration arrangements to be put in place. To provide for certainty to business, the nominated start date of 1 July 2000 should be met to ensure the minimised disruption in the transition.

We welcome the opportunity to appear here today before the Senate inquiry. We have already forwarded a submission to this inquiry and I have now also tabled our framework paper which is entitled *Building a tax system—the essentials*, which covers our broader tax position on tax reform.

CHAIR—Thank you very much. Do any of your colleagues wish to add to your statement or supplement any point?

Ms Morton—No, we are happy.

CHAIR—That is fine. I assume everyone is available to help answer questions.

Ms Morton—Yes, they are.

Senator GIBSON—The last witness made comment about the current indirect system and said the economic modelling he had done showed that the indirect tax system could still raise the same amount of revenue into the future as a proportion of GDP as it does at present and, by implication, that there is not much wrong with the present indirect tax system. You are the practitioners at the coalface; I would like to hear your comments on the indirect tax system.

Ms Morton—Thank you very much. As I was sitting at the back of the room, some of the comments were of concern to me in that I have actually had to apply the current indirect tax system on a daily basis. The current indirect tax system is ad hoc; it is ramshackle; it is difficult to administer. It is riddled with anomalies and it is also very discriminatory against people who actually produce things in this country versus services. How you can have a system that discriminates against people who are producing goods for the country is hard to imagine.

Furthermore, the system is constantly having to be propped up by rulings and other administrative assistance. Constantly, people are trying to find out, because of new products, what sort of sales tax rate should actually apply. I will actually ask Ken Claughton, who is also involved in advising on that, to comment briefly on the current wholesale sales tax system.

Mr Claughton—I would be one of maybe 100 to 200 persons in the accounting profession throughout Australia who practices virtually full time until now in sales tax. The problems that Joycelyn spoke about are always an issue, for example, whether particular products are building materials within the exemptions that have been provided, or whether printed matter is within an exemption or whether it is excluded from exemption.

The system is established, so far as rates are concerned, by a classifications act that specifies what is exempt or what is taxable at different rates. Anything that falls outside those specifics is taxable at 22 per cent. Its statutory interpretation is twofold. Firstly, it is understanding what the Australian Taxation Office itself is saying about the legislation. Secondly, it is interpretation of whether or not that is the correct way to read the law. That is one side.

The second side deals with the value on which sales tax is payable. It is payable on a wholesale value. There are problems in determining whether particular sales are wholesale sales or retail sales. There are problems if they are retail sales in determining what is a notional wholesale selling price of the goods. These are two areas where there are currently problems.

Sales tax also tends to cascade through the pricing of goods. Because the exemptions are limited to what is specified in the law, there are a number of goods used by businesses and the use of those goods is ultimately reflected in selling prices that sales exemption does not apply to.

If we take just a food chain production, for example, a farmer will get sales tax exemption on the equipment used to produce his food, but not the truck to take that food to the market. The market wholesaler will not get sales tax exemption on the computer equipment that it uses in processing its business. The retailer will not get sales tax exemption on the racking and shelving and the cash register. Yet all of those items plus their sales tax plus probably mark-ups are reflected in the selling price.

To a very large extent, the system of GST as proposed by the government takes away a lot of that cascading. It takes away a lot of the classification issues and most of the taxable value issues.

Mr Drum—There have been a number of studies done in Australia on cost to compliance to small business and I acknowledge that your question was originally about impact on GDP. However, I think that it is important to note that part of our representations here today are on costs of compliance to small business and not contributions to the economy in general. Some of those studies have indicated that the tax which has given small business the greatest problem in the past and up until today has been sales tax. We are very

keen, as a society, to see that as one of the indirect taxes that would be abolished under tax reform.

Senator GIBSON—If we move to a GST there have been proposals to give concessions for further exclusions from the program put forward by the government—food, in particular, and also some suggestions of further exclusions of necessities of life. Would you care to comment on moving from the system that is proposed to one adding, if you like, to the complexity with exclusions?

Ms Morton—I will start off and then ask Angela to back up on some of my comments. First of all, it is absolutely imperative that this system be kept as pure as possible and as simple as possible to ensure that the administrative burden on business, especially small business, is kept to a minimal impact. The more exemptions you have the harder it becomes. At the moment you will have a situation where people can just do a fraction of all of their sales or a fraction of all of their purchases to determine their GST liability. Once you start getting exemptions into the system, it then becomes an administrative nightmare. And you go into situations like Canada where in a small business, in one case a bakery, for six doughnuts there is no GST, but for one doughnut you pay GST. So instead of being able to say, ‘What were my sales for the month? Hence 10 per cent of that must be the GST component,’ they would have to separate those with from those without and it would become quite complicated. We are very conscious of the impact to the lower income earners and hence we stress the compensation package. I would strongly recommend that the exemptions in the GST system be kept to an absolute minimum.

Ms Ryan—Some of the other points about creating exemptions for items like food that are so broadly spread through the business community are that it does become an avenue for avoidance and evasion. I think it was quite justified that we saw comments from the Labor Party leader during the campaign that the UK had a real problem with avoidance and evasion. I would contend that the main reason for that is that the UK has a number of very wide ranging exemptions in their VAT, including food and children’s clothing. Under a system like that, it is a relatively easy step for people to be able to falsify invoices. Instead of showing it up on your till as adult clothing you could show it as children’s clothing and things like that. This means that the system is not comprehensive. What you are trying to do is actually lessen the black economy with a VAT type arrangement. Where you have a huge range of concessions, you could actually be increasing the size of it. To take the counter example, New Zealand, which I have had the most personal experience of, has a very broad ranging GST including items like food—including just about everything, in fact. There they found that when they called for registrations for GST the number of businesses that actually applied was half as many again as they were expecting initially. They thought 200,000 businesses would register; they got 300,000 and they found in the two years following the introduction of the GST there that their company tax collections went up dramatically and the number of company returns also increased dramatically. It really is an indicator that, if you tackle the GST the right way, you can actually help with the avoidance, evasion and black economy problems. If you handle it the wrong way, you could actually make that problem worse.

I think there are other problems in broadening out exemptions. If you are to exempt something like food, where do you draw the line? Why is food more or less essential than

clothing? Why is clothing more or less essential than a telephone or a whole lot of other services that people now say are essential to living in a modern economy? The easiest approach, I think, to all of that is to just apply the tax very broadly.

One of the major reasons for tax reform is to have a broadly based revenue generator. That is really what you want with a GST. If you are concerned about equity and where it puts people in terms of the tax they pay, we have got the income tax and the rate scales there. I think you would all agree that income is a much better indicator of people's capacity to pay than what you buy at the supermarket. We also have our social welfare system and the grants system.

Ann Harding's name was mentioned this morning. She has done some work with Brian Andrew, who is one of our members, on looking at the effectiveness of social security payments in terms of providing assistance to lower income groups. It tends to be much more effective than trying to apply assistance through the tax system.

For all those reasons, we would be very much opposed to seeing the exemptions increased from those that have already been announced as part of the government's package.

Mr Cloughton—The only thing I would like to mention in addition to that is the education that is going to be required of taxpayers if the exemptions are broadened beyond what they are at the moment. The education of taxpayers now is going to be quite substantial. There is going to be quite a substantial effort needed to educate taxpayers. That will just multiply two or three-fold once you start to get some exemptions in.

Part of the submission that the society has made includes a paper that is a VAT instruction guide dealing with the exemption that applies in the UK to food. You can see the size of that. Some of the people most affected by this are going to be in corner milk bars and take-away food shops. It will be difficult for them to be able to understand a document of that size and to self assess their liability based upon their understanding of that document. This system will obviously be much easier to comply with if that exemption does not apply.

Senator GIBSON—We are talking about 30-odd pages or more, aren't we, of the definition of food in the UK VAT system?

Mr Cloughton—Yes, it is a huge one.

Ms Ryan—Having recently visited a lot of small businesses in New Zealand and talked to the operators of those businesses, the uniform finding from those businesses was that the GST over there was the easiest tax for them to comply with. In terms of the sort of burden of paperwork that it imposed, it was minimal. Universally, the assessment from those small business operators was that if the government over there was to change any tax or remove any tax, the GST would be the last one they would want to see removed because, for them, a lot of the record keeping was what they had to do for their business anyway.

That is the other advantage of having a broadly based GST. If it is broadly based, you are really only asking the small business person at the end of a quarter to apply a couple of

fractions. Really, it is just another column in their cash book to comply with the GST. It does not take them very long and it is not a huge imposition.

As Ken was saying, the problem as soon as you have exemptions is that you will then be asking them to basically collect a separate set of accounts or a separate set of books just for the tax man. That is why it is so much more expensive in terms of compliance if you are having items excluded from the GST base. It will not just be the 70,000 people with wholesale sales tax; it will be 1.4 million taxpayers. I think a lot of people forget how broad this is going to be and that even if we are only adding another hour of compliance time—and I would suggest that something like food would add substantially more than that—that is 1,400,000 hours that could have been going to something productive.

It is not a small issue by any means. I think a lot of what the committee has been hearing is about the big macro effects, but I think you need to remember that it is going to impact at the micro level as well. For a lot of these small business people, they will be paying sales tax for the first time. It is a brand new system for them. The easier we can make it, the more likely we are to get voluntary compliance and the better it will be for the economy all round.

Senator O'CHEE—Can I ask you some questions about the whole issue of food? You say that while concessions are often sold as being more equitable, it is a fact that higher income people spend more money on everything. They will always do better out of the concessions than lower income people. Do you think that applies to food?

Ms Ryan—If you look at the data—and I think it has been used by many people now—from Dr Neil Warren who looked at the data that the ABS collected initially and carried out some estimates on it, the top percentage of income earners actually do spend the highest amount on food. If you are looking at the dollar amounts of GST that you are going to lose if you take out something like food, it is the high income earners that will do best out of that system by a proportion of about two to one if you compare the top 20 per cent of households with the bottom 20 per cent.

Senator O'CHEE—So the top 20 per cent of households get double the benefit by exempting food than the bottom 20 per cent get?

Ms Ryan—That is right. What that means is that, if you include food in the base, you have got more than enough revenue collected from the higher income earners to compensate the lower income earners and have money left over that you can spend on other welfare programs if that is what you want to do.

Senator O'CHEE—By bringing food in and putting compensation measures in, you target it better. Is that what you are saying—you target your assistance to low income earners better?

Ms Ryan—Exactly, yes. It means that you are getting the revenue in to provide for that compensation and then you are having some other money left over that you can also spend in those ways if you choose to.

Senator O'CHEE—Is it a characteristic of high income earners that they are more able to shift their pattern of consumption than low income earners? In other words, they have got more discretionary income. Is that the case?

Ms Ryan—They would have more discretionary income; that is true.

Ms Morton—But in relation to food, if we are talking about exempting things like fruit, vegetables and milk et cetera, you do not shift your consumption pattern there. I do not think that that would flow through to those—your argument there I do not think would apply.

Senator O'CHEE—But if you are a high income earner and you have a certain amount of money that you allocate to recreation and entertainment, you might well make the decision that you are going to spend more money on going to restaurants and less on going on holidays, going to the opera or whatever because you know that you are not going to be taxed if you go to the restaurant but you are going to be taxed if you go to the opera.

Ms Morton—If food was actually exempted, more than likely takeaway food would be taxed. If the wealthy did go to a restaurant to have a meal, they would be still subject to GST.

Senator O'CHEE—But if you do not tax any food at all?

Ms Morton—If you do not tax any food at all, not even from restaurants?

Senator O'CHEE—Yes.

Ms Morton—I think that you would then be narrowing the base very severely. Very few countries have exempted even takeaway food or restaurant food. Virtually all of them have taxed that portion of food. Then you would be really severely inhibiting the other tax cuts and the other range of tax cleaning up, basically, that we could do as a nation.

Senator O'CHEE—You cannot take all food out. You have to tax some food and not other food?

Ms Morton—That is right.

Senator O'CHEE—Then, as soon as you do that, you get into the problem that Mr Cloughton said as to what constitutes food.

Ms Morton—Exactly.

Senator O'CHEE—Suppose, for example, you had a typical corner store like the one that I use and they have tinned food, frozen food and so on. That, theoretically, would not be taxed because I am taking it home and I am going to prepare it. But if they have a little Slush Puppy machine that sells frozen drink, I assume that I am going to consume it somewhere between the takeaway store and my place. That would be taxed?

Ms Morton—More than likely.

Ms Ryan—I think the point you are making is a very valid one. Even under the wholesale sales tax we do have some items of food that are taxed and some that are not. The classic most recent example has been the case of yoghurt where it took two to three years to get a decision. In the meantime, the poor operators that are facing this position of knowing whether or not they should be paying sales tax are really given an impossible situation to deal with. This is in the relatively narrow range of items where the wholesale sales tax boundaries apply at the moment, compared to the sort of boundaries we would be dealing with if we were looking at all food. That problem will be multiplied literally thousands of times and people are going to be left in a situation of sometimes waiting for years trying to work out what their liability is, and that is just an impossible situation that you are asking businesses to deal with.

Senator O'CHEE—So that was simply a classification issue of whether it was yoghurt or whether it was ice-cream?

Ms Ryan—Yes.

Senator O'CHEE—If you had the other situation, of not taxing grocery items that people are assumed to consume at home but taxing takeaway food and restaurant food, then if you have a corner store that sells cans of coke in the refrigerator, the question is: is it takeaway coke or is it groceries?

Ms Morton—That is exactly right. Bearing in mind that the tax office's aim in this will be to get as much revenue as possible when they administer it, you might have a situation where you have bottles of coke on the shelf which are warm, and there would be no GST on them, but if they were in the fridge and they were cold, they might be deemed to be takeaway and therefore subject to GST. Similarly, in a large supermarket, if they have the large chicken rotisserie, is that takeaway chicken or is that to consume at home? If they have the small pieces of chicken, is that takeaway or is that to consume at home? So you would get all these definitional problems. Every time you try to make that distinction you will be causing people an enormous amount of distress from an administrative point of view.

Senator O'CHEE—That is just looking at the issue of collection at the point of final retail. But if you say that food is not subject to GST, does that mean we exempt the food all the way down the chain, or is it rebated back all the way down the chain and then you put the administrative burden on the point of final retail? How do you do it?

Mr Cloughton—That is in fact an issue we were speaking about this morning. I think it depends on the system that would be put into place to provide exemption for food. If it was one down the chain—that a particular item, a tomato, was exempt all the way down the chain unless it was used in a sandwich or in a meal in a restaurant—you in fact multiply by two the complexity for business operators. They not only have to look at their sales and determine whether or not a GST is liable on their sale of this tomato, they have to isolate the purchase of tomatoes to ensure that they do not incorrectly claim an input tax credit for what they have paid when they purchased those tomatoes. If that was the way the system went, that would be the complexity that would arise.

If it went another way, if it did get to the stage where you had to look at a particular sale transaction to generate a GST exemption on food—for example, it was taxable all the time into the supermarket but not taxed on the sale by the supermarket to the householder—you might almost need declarations from purchasers that they were going to use this food at home, rather than consume it somewhere else or resell it themselves.

Senator O'CHEE—Because of the liability attaching to collection?

Mr Cloughton—Yes.

Senator O'CHEE—I had not thought of that. So we have got two issues. There is the classification issue, which affects whether you charge GST or not at the final point of consumption. That is the issue of the cans of coke in the fridge or on the shelf which, theoretically, you might be able to deal with it in accounting terms by having two keys on the cash register.

Mr Cloughton—Yes.

Senator O'CHEE—But you would still have real problems with audit and compliance in proving what you did.

Mr Cloughton—Yes.

Senator O'CHEE—But the bigger burden is actually on accounting on your purchases, isn't it? Because you just cannot total up two keys on the cash register; you would then have to go through all of your purchase invoices.

Mr Cloughton—Yes, you would. You would need to separately identify each and every thing that you have purchased, and make a decision as to whether or not the price you had paid for that good included any GST.

Ms Morton—If the exemption actually went right down the line in the production chain, you would cause extraordinary amounts of problems. Take the product bicarbonate of soda as an example. It has two purposes when it is sold in a supermarket—in fact, whether it is in a corner store or a supermarket. It is in the cleaning aisle. It is also in the food aisle.

Senator O'CHEE—As a baking product.

Ms Morton—So when the manufacturer is manufacturing it, are they to claim zero rating or exemption on all of their inputs because they say it is going to be food, when they do not know where it is going to end up on the shelf? You just could not do it. If there was going to be any form of zero rating, it would have to be at the final consumption level. But then what do you do if somebody picks up a can of bicarb out of the cleaning aisle? How do you distinguish between whether it has come out of the cleaning aisle or the food aisle in order to determine whether it is food or whether it is a cleaning product? Clearly, in this system, we want the bicarb that is going to be used for cleaning to be taxed, but you just could not do it. There are a number of items like that that can fit between a number of different categories. That would cause quite an administrative problem.

Ms Ryan—One of the examples that I have heard from the UK is where meat generally taken away from a corner store or a grocer is zero rated if it is bought for human consumption. If I turn up to the till with my trolley of goods, the operator at the till and every operator in that store—even at a corner store that might employ three or four schoolchildren to come in after school to do a few hours—have to be aware of which items are GST inclusive and which are exclusive.

If I buy some meat at that store for my own consumption, as I might do in the UK, but keep it in the fridge for a couple of days, then decide that I really do not want to eat it any more because it has gone off a bit and so I give it to the dog, that is meat that has now turned into dog food and should have been subject to GST when I was at the till. If, in that situation, the tax office were to turn up and say, ‘We have found out that this was used for a different purpose than what the till operator was told,’ where does the liability lie? There was tax that should have been paid that was not paid. Who is responsible?

In that instance, you can say it was nobody’s fault; it was a change of use after the purchase was made. It does sound mind-numbingly dull. But for the businesses that are dealing with this sort of detail, those really are the real-world issues that you have to think about when you think about exemptions. What we are raising today is a little tiny tip of a huge iceberg if you go down the route of major exemptions from the GST.

Senator O’CHEE—The Business Council for Tax Reform, in their document ‘Food facts and arguments’, says in relation to compliance and excluding food:

If food was zero-rated all retailers selling food would have to differentiate between taxed and GST free items . . . This differentiation would be ever-present including (but not confined to) activities related to:

- . marking prices
- . making sales
- . preparing GST returns.

We have already spoken about the other two, but would you also endorse the argument that you have to mark the prices so the consumer knows them, so that it is not just at the cash register that the process of differentiation is done, it is done twice, because it is done when you put it on the shelf and when you price it as well?

Ms Ryan—I think that would have to be the case if you went for an exemption on something like food. You would need to show the consumer the price that they would be paying and how much of that was tax. It is another reason why you would want to keep the base broad. To use New Zealand as an example again, at the retail level all their prices are GST inclusive and everybody knows that everything has 12½ per cent tax on it. There is no problem about having to distinguish items because everybody knows that there is tax on everything. But as soon as you have those differentiations, you are right, you have to have separate markings on your shelves, you have to show GST inclusive and exclusive prices. That brings with it another whole layer of complexity and compliance cost for business.

Senator O'CHEE—So, basically, you would say that excluding GST would be an administrative nightmare.

Ms Ryan—Excluding food from GST would be an administrative nightmare. I might also say that it would be a bonanza for the lawyers and, I can say, for accountants. In lots of ways we are not talking our own book here. If we want to have huge accounting GST practices all around Australia, please exempt food. So we are not talking our own book.

If you look at the accounting practices in the UK that deal with their VAT, I understand KPMG, for example, has a bigger VAT practice than their personal tax practice. There is nothing like that in New Zealand, and the reason is that there is not a whole army of accountants out there having to go into every business and help them with all the definitional problems. If accountants and lawyers are to become rich, we should make the GST as complicated as possible.

We are all for simplicity. That will not line our own pockets, but we are very happy with the alternative, which is to have happy customers that we can be informing and giving small business advice to about how to generate the best out of their resources, not how they can minimise or the difficulties of complying with tax.

CHAIR—Do you have any more questions, Senator O'Chee?

Senator O'CHEE—Yes, Mr Chairman.

CHAIR—I would like to move the call around, if I could, so can we come back to some of those.

Senator O'CHEE—If you wish, Mr Chairman, yes.

CHAIR—Do you have a question or two to follow-up?

Senator O'CHEE—Yes, they follow on.

CHAIR—Go ahead.

Senator O'CHEE—Mr Cloughton spoke about the complications of the existing system. We just heard Professor Dixon say the real issue with tax reform, as far as he is concerned, is the comparison of compliance costs under the existing system compared with simplicity and compliance under the new system. Do you believe, Mr Cloughton—or anyone else at the table—that the overall costs of compliance, in terms of efficiency as well, under the existing system to business generally are much higher than under the system as proposed by the government—the broad based system?

Mr Cloughton—As I mentioned to start with, I have a full-time practice at the moment, giving advice, advising clients how to comply with their sales tax obligations. That practice will almost disappear under a GST.

The issues of classification, the rate of tax that applies, the issue of the taxable value that applies to transactions, will disappear under the GST system as it is proposed. That compliance cost will disappear. Clients will save that compliance costing complying with their obligations under the two taxes.

Senator O'CHEE—Can we quantify the cost savings in not having to comply with wholesale sales tax and the other taxes being abolished, just in compliance terms? Can we quantify that?

Ms Morton—I can make a comment. There was a report of the small business deregulation task force. This was the Bell report. In the key findings and recommendations, they said that, on average, small business spent 16 hours a week on administration and compliance activities, of which three hours was directly associated with tax matters and other compliance matters totalled about \$7,000 a year.

When I visited New Zealand, the retailers there—and it did not matter how big or small they were—said, on average, it took them 15 minutes a month to do their GST return—15 minutes. They said it was so simple because it was kept pure. Because it did not have all these other exemptions, it was a very, very easy return to do. That nowhere compares with the hours that are referred to in this Bell report.

Senator O'CHEE—Thank you.

CHAIR—Just before I call Senator Murray, aren't you making a very powerful case for no exemptions at all?

Ms Morton—Clearly, we would like there to be very few exemptions. Obviously, the government has chosen, for community reasons and for public benefit reasons, that there should be certain exemptions. We understand that, and we think that those at least can be confined within the parameters that they have been set. But, to extend it across to food, we feel very strongly about that because of the definitional issues, the marketing issues and all the other administrative issues, because that then impacts on a whole range of businesses, rather than confining it to just a smaller group.

CHAIR—But my understanding of the central tenet of what you are putting is that the more exemptions, the more complex are the compliance costs—and obviously it depends on which sector the compliance cost weight falls—the more difficult it is. Doesn't it follow from that that a GST with no exemptions is a better system?

Ms Ryan—To be perfectly clear, the society's policy position is that we would have preferred to see things like health and education included. There is no question about that. Our policy paper that we have distributed today makes that clear.

From the society's point of view, we feel from the position we were starting from that there have already been substantial concessions to the way the GST is framed. What the government has proposed from our point of view already makes some changes that will add to compliance costs that we would have preferred not to have seen. But we can recognise those things.

I think the other key point is that we do recognise that health and education are two of the most difficult areas to deal with. Primarily that is because you have got both the private sector and the public sector operating in those markets. Where the public sector is effectively charging a zero price, you can argue—and there is a good theoretical case to say so—that you create a distortion between the private and public markets in those sectors if you have one that is effectively subject to GST and one not because of that zero pricing.

I think there is a legitimate debate that has been had around the world about whether or not things like health and education should be in for that reason. So, if you like, those were the two most likely cabs off the rank in terms of zero rating.

One thing I will say is that we are absolutely delighted that they are zero rated or GST free and that they are not going to be input taxed because we have not really gone into that today. Input taxing is a complete nightmare. The government has announced that that will apply to financial services. Again, we acknowledge that that is necessary and we have said so in our own policy paper, that nowhere in the world have they found a system that works for financial services, so unfortunately that is the best you can do with the GST.

CHAIR—So your position is not to in fact endorse the government's arbitrary selection of health and education being excluded; your ideal position is for them not to be excluded.

Ms Ryan—We have a number of areas where we have a different view from what the government has. We had our policy paper out and presented before any political party made any of their platforms known. For example, I think it is very well known that the society was a strong advocate for the abolition of payroll tax as well. Having said that, the government's reform package certainly goes a very long way to addressing many of the concerns we had and we certainly endorse it in that it is a very strong move in the right direction. Obviously, there are some things around the edges that do not concur or exactly line up with our own policy preference. I would be amazed if you found anyone coming to this table and saying that. Probably, if we did, we would be accused of coming up with that anyway. I think it is quite reasonable that you think of reform as an ongoing process and a staged process. We are very supportive of the moves on tax reform that the government has proposed. Certainly we think there are areas that could go further. Tax systems never stand still.

CHAIR—Do you take a staged approach—that is, get this package in and then the CPA will later argue for this package base to be spread more widely and, at some later time, achieve the ideal of perfection in policy terms that you espouse by including health, education and financial services?

Ms Ryan—I think that is such a long way down the track that we are not considering that yet. Food is obviously the major issue that is still being debated at the moment. Obviously, as things evolve, we will have a very different tax system, I would assume, in another couple of years, and obviously we will be assessing and reassessing our policy position as times change.

CHAIR—You have seen the government legislation. Do you have any amendments that you wish to make to that?

Ms Ryan—We have put in our submission to this inquiry. We are still basically making our investigations on the bill. You would be as aware as I am that it is a very sizeable piece of documentation, so we are still looking at those things. I am sure we will be communicating with all political parties, as we do with all of our submissions. We will make them available to everybody. We certainly like to make sure that the information that goes to all parties is identical. Basically, we are still looking through it and we will be coming back with more detailed comments on it later on.

CHAIR—Why can't you respond now, though? The legislation has been out for a month or so.

Ms Ryan—Over Christmas and all of that. As Ms Morton pointed out at the beginning, we have 87,000 members and we do not like to do things without consulting them. It took us four months to get our policy paper together in terms of getting a draft, sending it out to members, getting comments and all of those things. We are quite a consultative body. We do like to represent the membership, so we cannot turn things around in that short a space of time, especially over a period when we know that a lot of people are away.

CHAIR—But the government asked the House of Representatives to vote on this before Christmas. Are you implicitly saying that that was too short a time for the parliament, at least in the lower house chamber, to make a reasonable judgment, and that this inquiry, in the lengthier time that the Senate might ponder this legislation, will enable you to bring forward a more complete representation of your members' point of view about what particular changes you might wish to make?

Ms Ryan—The other issue which we are very mindful of is that the transition to any new system like a GST or a VAT is basically, however you go about it, going to be hugely disruptive for business. They have to get a whole lot of new systems and a whole lot of new things into place. They are doing that, and we are advising our clients at the moment that there is a start date proposed of 1 July 2000 and we have to start preparing on that basis. That is what we are doing now with a lot of the contracts that are being entered into. As you would know, there are clauses in the legislation dealing with those. We need to be advising, and our members need to be advising clients on the basis of a proposed start date of 1 July 2000. If that date changes, that is going to make it very difficult for a lot of business people who are planning now around that date. They have no option but to do that because that is the best estimate, if you like, that we have. We really do have to make sure that that date is adhered to. That does mean that the legislation is going to have to be moved through fairly quickly.

CHAIR—But you cannot tell us, after the legislation has been out as long as it has, what your members think and where the particular areas in the application of compliance and other changes are that you will have to administer at the coalface for small business. You cannot tell us now what those changes ought to be, but we are being asked to vote on this fairly quickly.

Ms Morton—A number of organisations are currently preparing lists of detailed areas where they think the legislation needs finetuning. I think the general consensus would be that

the framework is good, generally speaking, but there are areas where they need to be finetuned.

CHAIR—Could you enumerate those areas?

Ms Morton—I can you give you a very simple example. Imports into the country currently—although there is a possibility in that area for the commissioner to make some other arrangements—are going to be taxed up-front, whereas if you bought that same product locally—and in many instances the product may not be available locally—you would get a longer term to pay your GST because you effectively pay it at the time you pay the invoice. That could be another 30 to 40 days later.

CHAIR—Perhaps I should put this on notice because I am conscious of the time and my colleagues. Could the CPA provide us with an exhaustive and comprehensive list of areas where you believe the current legislation requires amendment in order that it operate with no unintended consequences and as smoothly as it possibly can?

Ms Morton—Yes, we can.

Senator MURRAY—On this side of the table we are often faced with organisations who either think that anything the government does is wrong or who think that anything the government does is right. I do not want to put you in a box, but I want to be sure that I understand and that there is no sycophantism here.

Going back to the start of Senator Cook's questions, would you, as an organisation, prefer that education and health were not exempted?

Ms Morton—Yes. That is quite clear in our policy statement.

Senator MURRAY—My second question relates to the personal experience of the four of you. There are 27 OECD countries. Of those, 23 of them have a GST or VAT system, and, as you know, some of the American states have it as well. There are 18 out of 23 which zero rate, exempt or low rate food. Have any of the four of you operated as a tax consultant or adviser in any of the countries which zero rates, low rates or exempts food?

Ms Morton—I have not personally operated in the areas where they exempt food. I have operated under the current system where food is partially excluded out of the wholesale sales tax system. So I have very hands-on experience with our current wholesale sales system in precisely that area and the problems that it raises, especially the definitional problems. I also have had quite extensive discussions with people in New Zealand and Canada, comparing the two, and some discussion with people in the UK. There is no doubt that, if they had their preferred position, it would be the New Zealand system because of the complexities.

Senator MURRAY—I should forewarn you, as an aside, that I might be the only senator who has operated businesses in four countries of the world. Two of them had retail sales tax systems and one had a VAT system. I just advise you that not everyone is theoretical about these matters. I ask you for a judgment: I would assume, like me, that you do not think Australians less capable than citizens of other OECD countries?

Ms Ryan—Absolutely not.

Senator MURRAY—You would accept that hundreds and hundreds of millions of people living in the 18 countries that zero rate or exempt or low rate food all cope with the system very well, wouldn't you? I understand their definitional problems; I understand their litigation problems. Nevertheless, they live under the GST or VAT systems, which discriminate with food, and seem to be able to manage their businesses and their lives effectively.

Ms Morton—The questions are: would they prefer not to have food treated separately and how much extra cost are they incurring? They might cope with it, but we do not believe that this is about coping with the system. This is about having a system that impacts as little as possible on the day-to-day running and the production of their business.

Senator MURRAY—By 'they' are you meaning businesses or the people of those countries?

Ms Morton—Businesses primarily, because it is the businesses that employ people; it is the businesses that have the food on the shelves. I am talking about the impact on them primarily.

Senator MURRAY—If between 60 and 70 per cent of Australian people and 60 and 70 per cent of Canadians, Welsh people or whoever—the people, not the businesses—wanted food zero rated, exempted or low rated, do you think that business organisations should cop it sweet as an expression of the will of the people in a democracy?

Ms Ryan—I think part of the problem is that, if the ordinary man or woman on the street were asked: would you like to have food zero rated? it is a bit like asking them whether they would like to pay half as much income tax as they paid last year. It looks like it is something for nothing. Yes, of course I would like not to have tax on my food and I would also like not to have it on a whole lot of other things.

Senator MURRAY—So you just ignore that as an uninformed comment?

Ms Ryan—No, but I think there is an education issue there. I have also been at pains to explain to people who do not operate businesses that the compliance cost must be recovered. Although consumers do not see that in the price they are paying for goods, somebody pays for that compliance cost and that will flow through to the price of goods. So there is a cost in zero rating food that most consumers would not be aware of because it is not identified when they buy a good.

Senator MURRAY—Why do you assume they are not aware of it?

Ms Ryan—Because I think most people on—

Senator MURRAY—Have you surveyed the question?

Ms Ryan—My feeling, from having done an awful lot of talkback radio on the GST, is that most people have very little understanding of how the process works in terms of collection. For example, I would not expect most average citizens to be aware of what happens if you take food out. Most consumers would not be aware of all the issues we have talked about this morning—having to separate inputs and outputs; what is taxed and what is not, and the definitional problems; the fact that it takes two or three years to get these things settled with the tax office—and I would not expect them to be.

Senator MURRAY—Let us come to the facts then. You gave us some figures earlier about business people who fill in all these returns—it is about three hours a pop at present. I understand that about 80,000 returns are made for wholesale sales tax. I know they are not every week, but let us assume it was every week. Three hours by 80,000 would be 240,000 hours. The GST is going to be filled in by a million people, a million businesses. But you said the actual time based on the New Zealand experience drops to 20 minutes. Let us assume it was all in a week, which it isn't, as we know. It is the same assumption as for wholesale sales tax. A million times 20 minutes is 330,000 hours, which is more than 240,000 hours. The simple point I am making to you is that the aggregate compliance cost, regardless of the greater efficiency, is in fact more than the present compliance cost. Therefore, in arguments with people you have to elucidate these facts. Unless you want to react, I will not pursue that further. Would you like to react?

Ms Morton—You are right that, in total, it does increase. But the very important feature here is the reason it increases is that it now brings a significant portion of the population that currently does not pay the wholesale sales tax into the system and therefore does not discriminate in favour of services over goods that are produced.

Senator MURRAY—That is the equity argument.

Senator O'CHEE—It does not include the professional people and the costs associated with paying them.

Ms Morton—That is right; the professional costs as well.

Senator MURRAY—That is the equity argument and I accept that. I merely want to make the point to you that the compliance cost thing has to be looked at globally. I assume you have read the Walpole Evans New South Wales study, which is very interesting in that area.

I want to move on quickly if I may because I am conscious of my colleagues and the time. The other big issue in this is intangible. It is psychological. I assume you have never surveyed your 87,000 members as to what they think of politicians and the political process?

Ms Ryan—I do not think we have had any reason to.

Senator MURRAY—I want to point out to you that the Roy Morgan organisation does do that. It surveyed Australians, and has done so since the 1970s. What it has established is that the population's view of how trustworthy politicians are has dropped from 20 per cent to seven per cent, which means 93 per cent do not trust us. The problem for rational

organisations such as yourselves is that the irrational, the psychological, the emotional, loom large in this debate. What I put to you as a question is this: would you accept that zero rating food or other items—you can choose other items—is likely to have greater and more immediate certainty in the minds of distrustful Australians than the idea of compensation which, from the New Zealand experience, can be taken away from them? Can you see that that is an attractive option in terms of the acceptability of an overall tax package regardless of your in-principle opposition, which I understand, to generalised exemptions?

Ms Morton—Maybe if I start off and then Angela can follow on from there. I understand the position you are taking very clearly. However, you might also have a significant kickback from the community in terms of what is actually food—if you say that you are going to exempt food but then you tax takeaway food. If we look at the definition of the current food range, chips are taxed, lollies are taxed, coca-cola is taxed and biscuits are taxed—a whole range of products, which most people would consider—

Senator MURRAY—If I can interrupt you, you have brought me to my question on notice. Professor Dixon, in his sensitivity analysis, gave a narrow definition of food and arrived at the figure of \$2.5 billion. The Treasury, in response to a question on notice from us which I do not have in front of me, came to a wide definition of food and an amount of \$5 billion. I asked VECCI yesterday: if food was to be zero rated or exempted, would they, from the point of view of a professional or business approach, prefer a narrow definition or a wider definition? That is my question on notice to you. If food was to be dealt with differentially, where would you seek to place the definition—narrowly or widely?

Ms Morton—I think if you were going to take that move—and this is without consulting with my colleagues—then you probably would have to take the wide definition. If you were taking the decision from a political point of view, I believe that there would be significant resentment in the community if suddenly they found that a whole range of the products that they thought were food, and that they did not know were currently being taxed, were being taxed; if you had said, ‘Look what we’ve done for you—these are going to be zero rated or exempt from GST,’ but, when the tax actually came in, people found that items were not going to be zero rated, and they were items that many people considered to be essential in their basic food range.

So you would virtually have no choice, if you were going to make the political decision, but to make it very broad and not to have this exclusion even for takeaway foods. That means you would even have to give the exemption to restaurants, to McDonald’s, to all food that is in the supermarkets. And then you get back to your definitional problems such as the bicarb of soda. Is it always going to be exempt, even when it is on the cleaning aisle of the supermarket? I caution you on that, because if it is not a wide definition I think the community will be very cranky that they have been misled.

Senator MURRAY—Thank you for your response. Could you look at the question as a question on notice and perhaps consult with whoever you consult with in your organisation?

Ms Morton—Yes.

Senator MURRAY—It would be helpful, because it is one of the matters under consideration.

Ms Ryan—There is something important that I would like to say in relation to one of Senator Murray's questions. It is something we have not covered yet. One of the issues you were talking about was whether it would make community acceptance better if we took food out. In the first instance it might. But looking at the longer term, the experience of the larger OECD countries, at least the ones I am more familiar with, is that the ones with the narrower bases are the ones most inclined to put the rate up over time.

So while initially people might say, 'Food is out and that is good,' I still think the best security that you have to keep the rate where it is when it is introduced is to keep the base broad. That is really one of the main reasons for tax reform. And I think the reason a lot of the welfare groups, as well as business groups, have supported tax reform is that there is a recognition that you need a broad tax base that is going to grow as the economy grows. The best chance of that continuing to happen over time is to have a broad base. Where you take things out of the base, that connection breaks down and you find that rates increase.

Taking the New Zealand and UK examples again—and I know we seem to be labouring this, but it really is instructive to look at the them—New Zealand gets 8.6 per cent of their GDP from their GST at a 12½ per cent rate; in the UK, the standard VAT rate is 17½ per cent and they only collect 6.6 per cent of GDP with VAT revenue. So if ultimately you think what drives tax rates is how much revenue comes in, the broader base in keeping the rate where it is is a very important issue for people as well. The base is an issue that we have focused on today, but the rate is another big issue that came out and was widely discussed in the campaign too. Both those issues are related, and it is important to think of them both when you are thinking of change.

Senator GIBSON—Can you give me those numbers again, please?

Ms Ryan—Yes. It is a 12½ per cent GST rate in New Zealand, and that raises 8.6 per cent of GDP. The standard rate in the UK is 17½ per cent VAT and they get 6.6 per cent of GDP.

Senator SHERRY—For the past hour I think it is fair to say that we have heard very strong pleas from you as witnesses not to exempt food from a GST. At times you have put quite a strong and passionate case about the administrative complexity. One of the things that puzzles me is that I have not heard one word about the administrative complexity and cost to the 1.425 million new businesses which have to collect a new tax. Do you have any concerns about that at all?

Ms Ryan—All we have been saying really relates to that. We appreciate there is going to be a huge number of people paying sales tax for the first time who have never had to deal with the system before.

Senator SHERRY—A GST for the first time—

Ms Ryan—If you are thinking of it as a replacement for the sales tax. But I take your point, they are paying GST for the first time. I guess the point is that they have not had to deal with sales tax. So they are first timers. It is going to be a huge education exercise and the simpler we can make it for them the better it is going to be.

Senator SHERRY—Never mind the education. I have asked you about the cost. Do you have any concern about the additional cost, pain, effort, time that these 1.425 million new tax collectors will have to go through?

Ms Morton—We have considerable concern for them. That is precisely why we say, ‘Keep it simple and keep it administratively as easy as we possibly can.’ That is why we have been stressing this for the last hour. We are very concerned for them. That is why we also say, ‘Give them 12 months to implement it, make the date fixed, and try not to put in too many exemptions.’

Ms Ryan—One of the other things which we also have not mentioned today is that the requirement for GST returns from small businesses is going to be once every quarter, compared to larger businesses which is going to be monthly. We see that as a real advantage because that gives a cash flow advantage to a lot of those small businesses relative to the bigger players. That is one thing which does mitigate the relative compliance costs for those—

Senator SHERRY—And those small businesses will dash out to the money market, invest the money and make a killing because of the improved cash flow, will they?

Ms Morton—No. But at the moment those small businesses, if they are currently in the wholesale sales tax system, have to remit their sales tax 21 days after the month end in which that transaction occurred, and most of them do not get paid by that time. So most of them are in a negative cash flow basis.

Senator SHERRY—Yes, but most of them are not in the wholesale sales tax system, are they?

Ms Morton—No.

Senator SHERRY—We have only got 75,000 businesses in the WST system. The GST system moves an extra 1.25 million into the tax system, doesn't it?

Ms Morton—That is true, Senator. But all the discussion that has been going on is that if this GST does not come into place we are going to have to broaden the wholesale sales tax system and bring in more of these other businesses—

Senator SHERRY—Why?

Ms Morton—That is all the talk I have been hearing.

Senator SHERRY—Where is your evidence that we are going to have to broaden the wholesale sales tax system?

Ms Morton—If you want to reform these other taxes—

Senator SHERRY—What is your evidence? Show me a paper that provides evidence to us that we have to broaden the WST base.

Ms Morton—If you want to reform these other taxes, you have to get the revenue from somewhere. If you want to reduce personal income taxes, you have to collect the revenue from somewhere. If it is not going to be from a broadened wholesale sales tax, then what is it? Are we going to increase the corporate tax rate or are we going to increase personal tax rates?

Senator SHERRY—Okay, let us take up that issue. Isn't it true that the income tax rate reductions that are being proposed in this package are not coming from the GST? They are coming from a budget surplus; they are not being funded by a GST. That is true, isn't it?

Ms Morton—That is because people have been requesting that there not be a change in the tax mix. But there are other changes that are being proposed—for example, the removal of stamp duty that is funded effectively out of the GST.

Senator SHERRY—On the issue of efficiency, if we define efficiency of a tax in terms of the cost of collection as a percentage of the revenue collected by government, isn't it true that the WST is more efficient than a GST?

Ms Ryan—That is not a measure of efficiency that we would use. Under that sort of—

Senator SHERRY—My question is: if we define efficiency as the cost of collection as a percentage of the revenue gained by government, isn't the WST more efficient than a VAT or a GST?

Ms Ryan—What I am saying is that is not the relevant definition of efficiency.

Senator SHERRY—Why not?

Ms Ryan—Because efficiency covers a lot more than that. Under that definition, if you just double the rate, you would get twice as much revenue and you would say the efficiency cost is low, but all you have done is doubled the tax rate. So those numbers do not work.

Senator SHERRY—The WST is a very efficient tax to collect in terms of the cost to the government and the cost to the total private sector of collecting it, compared to a VAT or a GST. They are more inefficient taxes in terms of collection.

Ms Morton—I would like to see your numbers on that, Senator.

Senator SHERRY—I will send you the tax office's cost of compliance paper. It is quite clear: they are a more efficient tax to collect.

Ms Morton—That is currently only because there are very few people within the wholesale sales tax system.

Senator SHERRY—Exactly.

Ms Morton—And it is a discriminatory tax which penalises people who produce goods versus people who provide services.

Senator SHERRY—That is another issue. What I am asking you about is the cost of collecting a tax. In terms of the number of—

Senator O'CHEE—But he is not asking about the cost of compliance.

Senator SHERRY—You have your definition of efficiency, I have my definition of efficiency and I am asking you about that. There is one other issue I want to deal with. Mr Cloughton, you are the first person we have had before the committee who has had extensive experience with the wholesale sales tax system.

Mr Cloughton—Yes.

Senator SHERRY—In your experience—and it is obviously extensive—what will be the extent of the pass-through of the reduction in wholesale sales tax?

Mr Cloughton—The advice that we are giving to our clients, the work that we are doing with our clients, is that prices will be totally recast.

Senator SHERRY—I did not ask you what advice you are giving to your clients. You are a person in the system with a lot of experience. What do you think will be the extent of the pass-through of reductions in the wholesale sales tax?

Mr Cloughton—I think that at least at the retail level those reductions will be passed through completely.

Senator SHERRY—Completely, immediately, 100 per cent everywhere?

Mr Cloughton—At the retail level, yes, I think so, because the wholesale sales tax that the retailers have paid on their stocks on hand at 30 June 2000—

Senator SHERRY—Sorry, you sounded less sure—you said you think so.

Mr Cloughton—No, I said at the retail level. I am talking here—and I have to be a little careful here—about the wholesale sales tax reductions on the purchase of retail stock. Because retailers will get a refund of that wholesale sales tax on the beginning of the GST, they will do a stocktake at 30 June 2000, they will determine how much wholesale sales tax is in the price that they have paid, they will obtain a refund of that by way of input tax credit, and I think that those prices will be readjusted to take account of the fact that that wholesale sales tax has been removed.

Senator SHERRY—In total?

Mr Cloughton—In that element, yes.

Senator SHERRY—You do not believe that there will be anyone in any sector that will be able to, or will seek to, take advantage of the abolition of the wholesale sales tax?

Mr Cloughton—There may well be people who seek to take advantage of it. As I understand it, that is the reason for the commission to overview prices.

Senator SHERRY—You think that will be effective in ensuring 100 per cent pass-on?

Mr Cloughton—I do not think anyone could guarantee 100 per cent pass-on.

Senator SHERRY—It is just that all witnesses, when this question has been asked, have at least some concern that the full reduction of the wholesale sales tax will not be passed on immediately; that depending on the sector, on the individuals, businesses, firms et cetera, it may be quite a mixed flow-through over a different time frame.

Mr Cloughton—There is an element that needs to be taken into account. If we are talking production cost savings because you now do not pay 22 per cent wholesale sales tax on a computer, you pay 10 per cent GST and get an input tax credit, and if we are talking about the flow-through of those savings into prices, that does not happen immediately. Those savings do not occur until that capital equipment is in fact replaced. So you have to be careful when you do it that way. But just in terms of retail prices, I think what will happen is that one or more market leaders will do the full price reduction, which will force everyone else to do the same full price reduction.

Senator MURRAY—Can I give you a specific example so you can help us in this important inquiry. If your stock turn is three times a year, and you bought goods in May which would carry a wholesale sales tax component, you will be selling them on a three times stock turn in September. What happens to the price of those goods? How does it work? What is going to happen?

Mr Cloughton—I think that what will happen with the price of those goods is that, before the 10 per cent GST is added, any sales tax that has been paid on the purchase of those goods will be removed and they will be repriced—

Senator MURRAY—Removed by whom?

Mr Cloughton—By the retailer.

Senator MURRAY—Why would the retailer do that?

Mr Cloughton—Because, apart from anything else, I think the retailer will be forced to buy by market forces.

Senator MURRAY—Why? Already, retailers prices vary. If you take the sale of liquor in a city, the prices all vary all over the place. So why would they automatically pass it on if they are all on similar kinds of stock turns?

Mr Cloughton—It is quite possible that those prices vary because their purchase prices vary over time due to the payment of volume rebates and other special deals that the manufacturers are passing on. I would fully expect retailers to recast their prices—the larger retailers especially—to exclude the wholesale sales tax that was previously within their price and cast a new price with 10 per cent GST. That is the advice that we are giving to our clients.

Ms Morton—Having come from a retail sector myself, I know the competitive forces in the retail industry. It would be very difficult for one retailer to not comply with the competitive pressures out there. Even though it is a small economy, we actually have very strong competitive forces operating in our community, including pressure from imports. So if they do not pass through all of those wholesale sales tax benefits, they just will not be competitive with imported products.

Senator MURRAY—If you are right, no retailer anywhere would have ever taken a stock profit, because they would be forced to compete at the new price—and they always do take stock profits.

Ms Morton—Were you saying that people would not take profits on their stock? I could not quite follow—

Senator MURRAY—I simply say to you that the real retail world is as follows: if there is a price movement, and you have the opportunity to take a stock profit, most retailers will take the stock profit and not be forced to adjust their prices immediately. That happens all the time in retail.

Ms Morton—Yes.

Senator MURRAY—I think Mr Cloughton is right that it will pass through in time; the question is when.

Ms Morton—I agree with that. But mostly, because they are actually going to get cash refunds of the wholesale sales tax that is in the system, there will be an incentive to reduce prices. The ACCC will be reviewing prices and there will be a competitive influence in the market to say, ‘Look what I’ve done—I’ve been a good retailer and I am reducing the prices.’ That will put pressure on the other retailers.

CHAIR—We are well over time and we are over the allotted time for these witnesses. I understand there is a question that the Deputy Chairman wishes to ask. I will allow that question, then we will adjourn for lunch.

Senator FERGUSON—Ms Ryan, we have heard Senator Sherry talking emotively about compliance costs and the pain that people have to go through and the time it will take. You have probably had more international tax experience than anybody here in this room. To the best of your knowledge, has the issue of compliance, the time taken to fill out a GST return and the cost of it ever been an issue in the countries that you have been involved with?

Ms Ryan—I have only had personal experience from New Zealand, but in that case no.

Senator FERGUSON—And that is more like ours than any other one, isn't it?

Ms Ryan—That is right. In that case, compliance is not an issue. As I mentioned at the outset in this inquiry, having talked very recently to a whole range of small business organisations there and to accountants who advise them, they were firmly of the view that the GST was the easiest and least costly tax for them to comply with.

Senator FERGUSON—Thank you.

CHAIR—We are well over time. In fact, we are about to come back from lunch in about five minutes and hear evidence from Professor Quiggin, whom I note is in attendance. I am going to adjourn the proceedings now until 2 o'clock. I apologise to Professor Quiggin and to the Business Coalition for Tax Reform, who will have some of their time taken because of that, but I have no alternative.

Thank you very much, the witnesses from the Australian Society of Certified Practising Accountants, for the evidence that you have provided and for your assistance to the inquiry.

Proceedings suspended from 1.24 p.m. to 2.02 p.m.

QUIGGIN, Professor John Charles (Private capacity)

CHAIR—I welcome to the witness table Professor John Quiggin. Professor, you have no doubt been briefed on this, but the normal practice is for you to give an overview, if you choose, of the paper you have supplied to the committee and make yourself available for questions.

Prof. Quiggin—Thank you. I will try to keep my opening remarks fairly brief. There are basically a few points I want to make that I think have not received sufficient attention in the debate. The first relates to the regressivity of taxing food, and it is a very simple point. The claim has been made repeatedly that a food tax is not really regressive because high income households get substantially larger benefits than low income households.

What I have done in the table is to take the household expenditure survey data on which that claim is based—and a superficial reading of the data supports that view—and I have then made two adjustments to it. The first has been to separate out restaurant meals, which are heavily consumed by the rich, from grocery expenditure. As far as I know, no-one is proposing that restaurant meals should be exempted from the GST. The issue is precisely about grocery foods.

The second, which is even more obvious, is that people have not noticed that the households are ordered in terms of total household income without regard to the number of people in the household so that the poorest households tend to have fewer people. That is not at all relevant when we are asking: is the tax regressive? What we want to know is: how heavily does the tax fall on people with low income per capita?

Ideally, if I had access to the full records I could order the households in the correct way, but what I have done is simply divide total grocery expenditure by the number of people in the household to get expenditure per person. That varies hardly at all from the poorest households to the wealthiest, presumably because the tendency of the wealthier households to eat more expensive cuts of meat is offset by the fact that they also go out to dinner more and so consume less grocery food in total. What that means is that a food tax is effectively a poll tax.

I assert at one point that that is the most regressive of taxes, but that is not quite true. You can think of more regressive taxes than a poll tax, but it is certainly the standard academic example of the most regressive class of taxes. It is a tax that falls equally on everybody without any regard whatsoever to the capacity to pay. That is the first point: the food tax is highly regressive. We are not talking about a small blemish in the system but around \$4 billion of revenue raised from this highly regressive tax.

Firstly, I make the point that, because of these arguments of practicality and simplicity, it is just neater to have a food tax of the kind that I heard about from the previous speakers. They might justify a tax feature of the policy which raised, say, \$50 million a year that had no significant burden on households, but a tax that is raising \$4 billion a year cannot be justified in that kind of ad hoc way.

Secondly, I want to briefly assess the standing of those arguments and make the point that has been made by other submissions, that most countries which have a GST give special treatment to food of one kind or another. Once you give special treatment, the administrative cost and complexities are pretty much the same, whether you give a concessional rate or exempt the item altogether. The big cost comes in giving any sort of separate treatment.

More significantly, in the government's own proposal there are at least a dozen different commodities which are going to require special treatment of one kind or another, many of which are going to create greater definitional difficulties than is food. Education is the most obvious example. Our universities and TAFEs give all sorts of courses, in sport science, tourism and all sorts of subjects. Some of those courses, for quite valid reasons, include trips to sporting events, tourist destinations and so forth, and I think it will be interesting to see. We are of course taking fee paying students on those courses. It will be a fascinating question as to whether those items are subject to GST and, if so, how they are going to disentangle the various costs.

The same is true in relation to health, although it appears that the recommendation has been to try to tackle this by various sorts of fairly arbitrary discrimination, that medicines bought on prescriptions will be tax free but medicines bought from the supermarket will be taxable, and so forth. But there are certainly big definitional difficulties, bigger than the definitional difficulties which we hear so much about, about whether a hamburger is a restaurant meal or not.

Senator FERGUSON—Is it?

Prof. Quiggin—Is a hamburger a restaurant meal? We can choose either way.

Senator FERGUSON—So we have to make a choice. How do you define that?

CHAIR—We are on a tight timetable. We will allow the Professor to complete his presentation.

Prof. Quiggin—The third point I want to make is about the evaluations of the impacts on various households. There are two main deficiencies in that. We can see, when we look at the arithmetic support in the package, that there is about \$10 billion more given back to taxpayers than there is taken out. So it is not surprising that the government gets the conclusion that most taxpayers are better off. When we ask: where does this come from? there are essentially two sources. The first is real and nominal bracket creep—that is, the fact that, as incomes rise in both real and nominal terms, the government's income tax share of that revenue tends to rise.

The second is that, on taking office, the government made serious cuts in public expenditure and justified those cuts on the basis that they were vitally needed as long-term structural repair of the budget deficit. In providing an unbiased calculation of the effects, we need to compare it to a neutral scenario in which taxpayers get back bracket creep, as they would almost certainly do in any case, and also in which those expenditure cuts are restored. That leaves us with a choice in which we do not have \$10 billion of money plucked out of the air, which of course always makes anything look a good deal better.

On doing that analysis, as I have done in the supplementary tables, it turns out for single income taxpayers, who are the simplest group to assess, that the gains which the government shows for most low income taxpayers are wiped out completely. They are replaced by a pattern of a mixture of small losses and small gains. Meanwhile, the very large gains which accrue to high income earners remain in place because the compensation for the adjustment of the higher brackets is much more generous than the very limited changes to the rates in brackets at the low end of the income tax scale.

It is my policy conclusion that, firstly, food should be exempted from the GST. Preferably, that should be financed by scaling back the income tax cuts given to upper income earners but, if that were not acceptable, I would suggest, contrary to the previous speakers, that we would be better off with a tax at a somewhat higher rate and food exempted than with a tax with food included, regardless of the numerical appeal of a 10 per cent rate. I am happy to take questions now.

CHAIR—Thank you, Professor.

Senator FERGUSON—Have you ever supported any initiative taken by the coalition government?

Prof. Quiggin—I have certainly supported a GST without food when it was proposed by the coalition parties, then in opposition, in Fightback mark II. In fact, Mr Reith got quite a nice headline quoting my assessment that Fightback mark II was considerably more just and fair than was the Keating government's One Nation package.

Senator CONROY—Shame on you!

Senator FERGUSON—I am not sure who is giving the answer—Senator Conroy or Professor Quiggin?

Prof. Quiggin—To clarify, on this policy I have supported the same position consistently for the past six years. When it has been the policy of the coalition, I have supported the coalition on it. When it has not been the policy of the coalition, I have opposed it. I have not changed my views on this matter. And they are on the record for the past six years.

Senator FERGUSON—You are a supporter of a goods and services tax?

Prof. Quiggin—That is correct.

Senator FERGUSON—When you talk about the exemption of food and how it is treated in overseas countries, could you tell us what effect that has on the rate of value added taxes that those countries then put into place? I understand that, once food is treated differently, either with a lower tax rate or a zero tax rate, those countries then tend to have a very high value added tax rate of between 15 and 25 per cent.

Prof. Quiggin—Those countries also raise substantially more revenue, as a proportion of GDP, than the Australian taxes propose to do. My estimate is that, if we attempted to raise

the same revenue from the GST, with food exempted, the likely rate would be about 12½ per cent.

Senator FERGUSON—How do you equate to the evidence that was given to us earlier that, in fact, New Zealand with a 12½ per cent GST across a broadly based indirect tax provides 8.6 per cent of GDP revenue and yet the United Kingdom, which was an example that was given to us, with a 17½ per cent VAT, with some food excluded, provides only 6.6 per cent of their gross domestic product?

Prof. Quiggin—As I have said previously, I agree that it is fairly clear that any exemption with revenue constant requires a higher rate. I think it is also clear that a 12 per cent or 12½ per cent GST, with food exempted, would be much fairer than a 10 per cent GST with food included. There are, as I suggested, other ways in which we could finance it, such as scaling back the extremely generous income tax cuts given to upper income earners, but if those are ruled out I am happy to go on the record saying that, given the choice between a higher rate on a fairer tax and a lower rate on an unfair tax, I would prefer the higher rate and the fairer tax.

Senator FERGUSON—Given the fact that less than \$1 billion of the revenue collected from taxing food comes from low income earners and figures up as high as \$3 billion to \$4 billion collected from the GST on food would be paid for by high income earners, why wouldn't it be better to compensate the lower income earners by way of compensation rather than giving the wealthy people that reduction on food where they spend so much of their income?

Prof. Quiggin—They do not spend so much because, as I pointed out, it is a whole tax. Depending on how you classify the proportion of low income people in the community, that is precisely the proportion, or very close to precisely the proportion, that they will pay. I think your question seems to be presuming the point that I refuted in my submission, that high income households spend more per person on food than low income households. That is not correct. What we are seeing, therefore, is a tax which hits everybody equally without capacity to pay.

In my first submission, I do address the question of compensation. The big problem with compensation is that you can compensate in two ways. Firstly, you can give back to everybody an amount equal to the amount paid by the lowest income households. That would be non-distorting and it would compensate low income households. It would also wipe out entirely the revenue raised by the GST. The alternative is to give compensation to low income households but not to high income households.

That requires, at some point in the system, a clawback, a higher effective marginal tax rate, which is going to create precisely the kinds of distortions that people who criticise progressive taxes always worry about. My analysis suggests that, essentially, if you attempt to compensate for the food tax, you are bound to create incentive problems at least as great as those that you could then alleviate with the revenue from the tax.

Senator FERGUSON—Although there is a dispute about the level of compensation to fit those on fixed income and low income people, there is an amount of compensation which

has been set using a set of figures which the government has used, which has been disputed by others, that in fact compensation has been provided which was designed to compensate people for the extra costs or the extra increase in costs because of a GST.

Prof. Quiggin—As I said in my analysis, that compensation design failed to take account of bracket creep. On the benefits side, it failed to take account of the fact that, under a normal pattern without any change in policy, benefits would have been adjusted in line with average weekly earnings. What you get is compensation relative to the extremely unrealistic hypothesis that existing rates are held completely unchanged, with no allowance even for inflation, and the existing benefits are adjusted merely in line with inflation, with no average weekly earnings adjustment.

Obviously, in that context, if that was the case the government has billions of dollars in extra revenue which it can use to give away to upper income earners. If you take the more reasonable basis that the government at least does not claw nominal bracket creep out of low income earners, that it at least adjusts the bottom income thresholds for inflation, not allowing for real bracket creep—that is, the increase in average real earnings—and also that it continues the standard practice of giving benefit recipients an adjustment in line with average weekly earnings, you will find that the compensation is clearly inadequate.

I will not go on with the points about the CPI model because I think other speakers, who are better qualified than I am, have made that point, as far as I am aware, unanimously within the economics profession. No-one outside the Treasury has believed that the CPI calculations produced in the package were defensible.

Senator FERGUSON—How would you define food? It is easy to say that food should be exempt, but the difficulty in other countries has been defining what is food and what should be exempt. We have heard all the definitions of hot pies, cold pies and all sorts of things. How would you define food?

Prof. Quiggin—I would say a good definition to start with is the definition which applies under the existing wholesale sales tax. This is not a new problem. It is not as though people are proposing to introduce an exemption for food into a system which has never had one. We currently have a wholesale sales tax which exempts food.

Senator FERGUSON—This is the system that took about two years to decide whether frozen yoghurt was a food or a confectionery, the system that had caviar exempt. This is the system we are talking about?

Prof. Quiggin—The proposed system is the system which discriminates between marriages according to whether they are performed by a civil celebrant or not. The fact is that every tax system has boundaries. There is always a problem defining those boundaries. To suggest that we should impose a \$4 billion poll tax on low income households in order to save ourselves the trouble of defining the difference between hot and cold yoghurt seems to me to be a complete mismatch of ends and means.

Senator FERGUSON—Can I summarise your position: you are in favour of getting rid of the existing wholesale sales tax system and replacing it with a GST, as part of a tax overhaul, at a higher rate of GST in order that food could be exempt?

Prof. Quiggin—I state my position: I am in favour of replacing the existing wholesale sales tax and a number of other taxes with a GST and maintaining the existing exemption for food. My preferred way of achieving that, with a 10 per cent rate, would be to scale back the very generous income tax cuts given to upper income earners in the package.

ACTING CHAIR (Senator Ferguson)—The chairman is gone; I could have kept going forever.

Senator MURRAY—I want to come back to the issue of rates. One of the swords hanging over both the government and the committee is the sword of prediction. That sword says that every country which has introduced a GST or VAT has increased the rate and also that, with the exception of at least Japan—there may be other countries that I cannot recall—the rates are generally higher than 10 per cent. I have a two-part question. The first is: is it your view that there is a kind of inevitability about increasing the rate as a result of economic trends, taxation trends and whatever else you might think of? The second part of my question is: are the higher rates in other countries because, in fact, they are higher taxed countries and they spend more on social security, infrastructure, industry policy and all the things we do not spend on?

Prof. Quiggin—Yes, I think the first question more or less answers the second. If we look at the general balance of tax, it is not that there is anything particularly special about GST, although this kind of claim has been made, I guess, in the opposition to it.

It is typically true that the countries we are talking about have higher indirect and direct taxes than has Australia and that they spend a higher proportion of their income. It has also been true over time that the proportion of income taken as tax revenue and returned as public expenditure, in most countries, over a very long period, has tended to rise. That tendency has slowed down to some extent in the last decade or so, but most of the experience we are talking about relates to periods before that when GST rates went up, as did other tax rates.

I personally think that the issue of ensuring that the GST rate should be fixed is not really conducive to good public policy in the sense that we are obviously going to have a tax system in which rates are going to change. To focus on one particular tax and say that tax must be guaranteed to be fixed at such and such a rate forevermore does not seem to me to be good economic policy. It may be politically necessary to get the tax introduced. But I make the point that, if as a community we decide in 10 or 15 years time that we need to spend more and we need to raise more tax revenue, to then say, 'Well, the only way we can raise it is not from the GST' is probably a mistake. I think we have had enough of that problem with the income tax in that people, for political reasons, have been utterly unwilling to ever raise income tax rates. If we had two major taxes, both of which were utterly fixed, I think we would see a return to the kind of problem, which to a significant extent this package is fixing up, of a proliferation of small bad taxes being introduced because the big, relatively efficient taxes have been deemed politically untouchable.

Senator MURRAY—Professor, as you know, our first report which comes down has to deal with the modelling side—the statistics and the assumptions. One of the key issues within that is how the committee should treat the finite projections that the government has come up with—CPI, GDP, et cetera. The best advice we have had from modellers is that we need to look at a range and that there needs to be a cushion or an acceptance of margins of error particularly where the data input is weak at the disaggregated level or is insufficient.

You made a very interesting remark which I was thumbing through to find and I could not. You indicated, I think, that over the last 10 years if the Industry Commission's projections of the GDP consequences of their recommendations had been realised we would have \$20 billion more in income to dish out than we have right now. In other words, they got their projections very wrong.

The second thing we know, annually, is that the government always get their projections wrong. And you cannot blame them for it. The budget every year is different to what actually transpires. My question to you is this: particularly at the lower quintile ends, is the cushion or the margin of error for the compensation being afforded to those households too finite and too narrow?

Prof. Quiggin—Yes, I think it is. Obviously, I have pointed out what I regard as a number of errors in the basis for comparison that is being used: the failure to take account of bracket creep in the case of low income wage earners and the failure to incorporate an expected increase in real benefit levels in the case of beneficiaries. But also, the points you make are entirely correct and I think I would amplify them.

First, any modelling exercise is subject to error. That is particularly true, I think, of the kind of macro-economic models containing predictions of job impacts because to make a prediction like that you really have to also make a prediction of the way the macro-economy is going to be behaving at the time that the policy is introduced. The policy which would be conducive to job growth in one set of economic circumstances might be entirely unfavourable in another. There is a big margin of error on that side of things.

In terms of the modelling of the impact on households, I would make the second point: in my view, what we see here is a piece of advocacy research. It is clear that, if you ask somebody to design an estimate which made the tax look as good as possible while retaining at least minimal credibility, this would be the estimate you would choose. You would completely ignore differences in household expenditure patterns. You would use disposable income rather than expenditure as the base for assessing the impact and you would make ad hoc adjustments like using revenue from a tobacco tax increase as part of the package, but then saying it does not count for purposes of calculating the impacts.

I see nothing wrong with the notion that, separately from this package, the government might choose to change its treatment of tobacco products. But to use the revenue from that to finance other tax cuts and say, 'But we're going to ignore it because that's for your own good', is a clear example of the kind of stuff that goes on when policy analysis is produced not to produce an objective analysis of the consequences of the policy but to produce a piece of advocacy.

Senator MURRAY—Thirdly, it is my assessment that the Australian tax system has always had a redistributive component in it and that this government has yet again carried on that tradition by attempting to redistribute incomes and benefits to various sectors of the community. If that is a consistent policy, is it your judgment that to restore not only poor people and lower income people to their relative ranking in wealth terms but also better-off Australians to, say, what those relationships were at 20 years ago would require substantially greater benefits delivered to those sectors than is proposed in the ANTS package?

Prof. Quiggin—I believe that is correct. Essentially, the one clearly robust finding in all the analyses of the package that have been put forward is the very large gains for upper income earners. Those gains are not coming out of nowhere. Those gains are coming from other members of the community and in very large measure they match up pretty closely with the revenue, in particular, from bringing food into the tax base.

Senator MURRAY—As you know, one of the criticisms against the campaign to zero rate food is that, in quantum, the greater benefit of that zero rating goes to higher income Australians. I think the figure the Treasurer has used is that \$1 billion goes to the poorest and lowest income and \$4 billion goes to the highest income. You have outlined your belief that that should be paid for by income tax cuts but in a sense if it were \$4 billion going to better off Australians you would be taking \$4 billion away from them in income tax cuts and giving it back to them in food. In terms of the government's intent, they are no worse off but the poorer people are better off.

Prof. Quiggin—Yes. Obviously this is a definitional question. As I have pointed out, the tax is effectively a poll tax. I think the Treasurer's analysis has looked only very briefly at the household expenditure survey and therefore imagined that it is more progressive than that. But my analysis demonstrates the opposite.

It is certainly true that only one-fifth of the benefits go to the poorest fifth of the population. The next fifth go to the second one-fifth of the population, people on incomes in the low 20s and so forth. If you want to call them the richer Australians who are benefiting then of course you get the Treasurer's results.

If, however, we look at the group who are benefiting in large amounts from the current income tax cuts, they are essentially just the top 20 per cent of the population. It is they who are only paying about \$1 billion of the food tax and they are getting the great bulk of the \$4 billion or \$5 billion in net benefits after bracket creep is taken account of in the income tax cuts. Certainly for that group if we took away the tax cuts and gave them exemption from food it would not be a wash in any sense. That group would be significantly worse off, relative to the package—still, of course, no worse off than they are today. Meanwhile, the groups who are going to lose from the package would be better off.

Senator MURRAY—One of the key elements within this debate is the question of pass through and it has a considerable psychological component. If working Australians, waged Australians, believe that the costs to them are greater than the benefits of this package, principally because the price effects take place before the saving effects and as a consequence wage demand surges forward, there is the danger that that will impact negatively on jobs, GDP growth, et cetera. We have had that clearly spelt out by Professor

Dixon earlier. Is it your view that, if you make food GST free and you increase the compensation level below whilst keeping the overall cost of the package the same, the wage demand surge will be significantly lessened?

Prof. Quiggin—It is hard to tell on these questions. It depends to a significant extent on the state of the labour market at the time the package is introduced. If, for example, unemployment blows out above eight per cent, it is probable that there will not be a wage surge, whatever happens, because employees will be too worried about their jobs to worry about the question of the purchasing power of their wages. On the other hand, if the package were introduced, as is hoped, at a time when unemployment is falling pretty steadily and people who had not had a wage rise for a while who look at the package and do not ignore bracket creep, as the government has done—look at the real purchasing power of their post-tax wages—see that they are getting very little out of it, I think there is significant danger of a wage surge occurring and therefore aborting the recovery.

More generally, I would just like to make a point on the employment consequence of the package. Although I have not put this as a recommendation, because I do not see an easier way of modifying the current package to incorporate it, I think it is a very great shame that this package—and indeed the alternative package that was proposed—did not tackle what I think would be the most beneficial reform in that respect; that is, the abolition of payroll tax. That is particularly disappointing, given that the psychological barrier that said we cannot touch state taxes has been broken—there are a number of state taxes to go. I think it is highly unfortunate that the package does not tackle payroll tax.

Senator MURRAY—I have seen figures which say that, in terms of priorities, if you had to take at least half of the money that has been proposed for fuel excise cuts and instead cut payroll tax by the equivalent, the economic effects would be greater and more beneficial than the fuel cuts. Have you any data, information or views on that?

Prof. Quiggin—I think the simple economics of it is: reducing tax on fuel is going to encourage purchase of cars; reducing tax on workers is going to encourage hiring of workers. We do have more complicated long-run effects which suggest that, in the end, the behaviour of the labour market might wash out some of that effect. But I certainly think—especially looking at the initial impact effect—that, if we had tackled payroll tax as part of the package, we would be looking at much bigger employment benefits and much more robust employment benefits, and we would be much less dependent on optimistic assumptions about the way the labour market works, than with the package as it stands.

Senator MURRAY—So if you applied the fuel tax cuts only to heavy transport and off-road use and used the money so saved—the remainder of the proposed fuel cuts—to cut payroll tax, do you think that would be a better policy choice than the government's policy choice?

Prof. Quiggin—I think it would. Indeed, I have long held the view that urban road user charges in general are inadequate to compensate for the total social cost of road use. My view would be that, while there is clearly a reasonable case for lower taxes on certain sorts of rural—particularly off-road—use of diesel, in general, the notion that road use is undertaxed I think is a fallacy. Even if the tax were in some sense proportionate to the social

cost, I think it is pretty clear that dealing with that, as opposed to dealing with payroll tax, is a mistaken priority.

Senator MURRAY—Did you mean what you just said about the notion of fuel being undertaxed or did you say overtaxed?

Prof. Quiggin—That is correct.

Senator MURRAY—You say that they are undertaxed?

Prof. Quiggin—That is right. If you look at the cost recovery imposed on railways, for example, they are supposed to win a return on the land used in railways. When people calculate the impact of urban road use, no similar charge is made for the very large urban land areas, the costs of accidents and pollution. My calculations suggest that there is not any economic case for further reducing the tax burden faced by urban motorists.

Senator FERGUSON—As long as you do not do it in rural Queensland.

Prof. Quiggin—As I just said, I specifically said that this was urban and my arguments apply almost exclusively to urban rather than rural areas. I endorse the view that, for example, diesel fuel use off-road should be exempted from the tax.

Senator CONROY—I just wanted to come back to that point on payroll tax. My understanding is that, while traditionally payroll tax is advertised as tax on labour, the incidence is actually the same as a consumption tax.

Prof. Quiggin—That is true if you ignore all the problems like pass-through and labour market behaviour—that is, in the long term when everything is fully adjusted. There are actually some complications which make even that not quite true once you do not have absolutely perfect capital markets, and I did refer to that in my comments a moment ago. Over time, if wages fully adjust to take account of the removal of payroll tax, then the benefits in terms of employment will go away. That result only applies if you assume a perfectly smooth functioning labour market, which is really a labour market with no unemployment. That certainly is a fairly correct statement, but it applies to a full employment labour market operating in a smooth fashion.

Senator CONROY—You said you were supportive of a GST with food zero rated? The only mention you made of why you were a supporter was something to do with some bad taxes that were inefficient. Could you take me through some of that?

Prof. Quiggin—There are two elements to what is called a goods and services tax or a VAT. The first, which I think is the most important, is that it applies to services as well as goods. While everybody can think of services that are very desirable and we might not want to be taxed, the same is true of goods and, in particular, the same is true of food, I would argue, more than any other good or service. There is no general reason why we should think it desirable to tax goods and not tax services. We just get an excessively narrow tax base and that narrowing will continue as services take up a larger and larger share of economic activity, which will inevitably happen.

Senator CONROY—What do you assume from that?

Prof. Quiggin—In general, from an economic point of view, it is undesirable on arbitrary grounds to have a high tax rate on one good or service and a low tax rate on another. We could, if we wanted to, raise all our taxes on a very few items of consumption, but that would produce inefficient patterns of production; it would change people's patterns of consumption in ways that would reduce their welfare. In the current circumstances, we are discouraging the consumption of goods and subsidising the consumption of services. That leads to a somewhat less efficient use of our resources—in the technical economic sense of the term—than would otherwise be the case.

Senator CONROY—You use terms like 'excessively narrow'. I am trying to get an understanding of that.

Prof. Quiggin—It simply means that, as the proportion of goods in the economy decline—even most goods now have a significant retail service component added to them—if we stick with an indirect tax primarily on goods, we will get a narrowing base. That then leaves open the field for state and local governments to say, 'Here are all these activities going on untaxed, and we are desperately short of revenue'—as state governments always are—'Let's introduce a bunch of taxes on them. Let's have a tax on bank deposits. Let's have a stamp duty. Let's have a bed tax on hotels.' So we get this patchwork of little taxes coming in that are expensive to administer, expensive to comply with and are fairly arbitrary in their incidents.

The case for uniformity says that, basically, we should not have non-uniform taxes unless there is a good reason for doing so. I argue that there are very good reasons for doing so in the case of food, and we always have treated food differently. I do not believe there are good reasons for not taxing, for example, nights in hotels but taxing all the various physical items of consumption that we have taxed. It is a simple matter of efficiency and fairness. We are going to get a better system if we do not have arbitrary exemptions. The existing system, in my view, has arbitrary exemptions.

The second point relates to the mechanism. We could have a goods and services tax in one of two forms. We could have a retail sales tax, as the US does, which applies both to goods and services. Alternatively, we could have the VAT mechanism in which each stage in the production process is taxed on the entire sales and then the proceeds that they have committed are claimed back as inputs.

My general view here is that experience appears to suggest—and this is certainly the opinion of the vast majority of OECD countries—that this seems to be a more effective way of ensuring compliance, of getting total compliance costs of collecting a tax on all goods and services more reasonable, than does the final stage retail sales tax, which only the US still persists with. I am not an expert on that point, so I am merely accepting the general judgment of the profession that the VAT mechanism is superior to the once only retail sales tax mechanism. Unfortunately, I do not think we have seen a lot of argument, one way or the other, that would convince me. My main concern is that I think it is definitely desirable that, other things being equal, services should be taxed in the same way as goods.

Senator CONROY—You have the uniformity question. You say that there are arbitrary exemptions under this proposed system—other than food, health, education and things like that.

Prof. Quiggin—Yes.

Senator CONROY—You seem to put a reasonable stock on whether or not those small taxes lead to inefficiencies.

Prof. Quiggin—The kinds of taxes that the state governments have resorted to have been gambling taxes—the various pseudo gambling taxes such as licence fees and so forth—and stamp duties. In general, they are costly to administer. They are fairly arbitrary. They are just not very good taxes. As the wholesale sales tax base narrows, you are going to see more and more states jumping into taxing those items because they are such an attractive target.

Senator CONROY—We had evidence this morning from Professor Dixon. I do not think you were here before lunch.

Prof. Quiggin—No.

Senator CONROY—Professor Dixon has modelled the impact on economic growth, economic efficiency and those sorts of things. He says that government and Treasury claim the tax package will strengthen the economy, make it more efficient and boost economic growth. Yet his results suggest negligible change in economic growth in the long run and no real improvements in efficiency. He says:

The long-run resource allocation gains flowing from the proposed tax changes will be negligible. A detailed investigation, using a comprehensive model such as Monash or Murphy's MM303, is likely to show that the proposed tax changes will lead to a negligible change in the economic efficiency with which households allocate their budgets across commodities.

That is from his modelling. You seem to be supporting the Treasurer's argument about the ramshackle and inefficient nature of the existing system. Professor Dixon described that as lightweight rhetoric with no substance.

Prof. Quiggin—What we are talking about here is questions of degree. I would say that the gains are going to be small. I made that point in my book *Taxing Times*. The rhetoric of crisis that the system is about to fall over simply does not stand up. If we chose to maintain the existing system, we could do various other things. For example, choosing between a retail level sales tax and a VAT, the effects would be very small compared with total GDP. It would not make a difference that would substantially change our macro-economic environment, but it would still be a better tax system.

Senator CONROY—He goes on to question that as well. He questions the efficiency gains. His argument is essentially that the GST is not necessarily more efficient. He says that we have an existing system and we want to introduce this new system and that at the end of the day none of the macro gains are claimed. Therefore, you have to make a judgment of, as you said, whether it is more efficient to put up with all the new compliance costs, all the structural changes and all of that, plus the relative efficiency, and measure those things

against the existing relative efficiencies? He makes the judgment, at the end of the day, that it is not, because the gains to those efficiencies from those little taxes are overstated in terms of the gains that are being claimed and the current claims on how inefficient the existing system is. Under the current proposal—I am not sure whether you have had a chance to read the whole piece of legislation—there are anything up to 10 rates already inside the existing system that is being proposed.

Prof. Quiggin—I am aware of that.

Senator CONROY—When you take that into account and what is being proposed—and you are suggesting further change which would mean more exemptions—and even if you kept food in, Professor Dixon’s argument is that there is no great efficiency gain between the existing system and what the government is proposing, and therefore what you are proposing will probably fall heavily on the negative side in terms of efficiency losses. Am I making sense?

Prof. Quiggin—You are making sense. Just as I deny the large effects, I deny that moving food from one of the existing rates to another one—because, of course, there is already a zero rate—is going to have any significant efficiency effects. In fact, I justify that claim in the submission.

I have sympathy in the sense that we have heard all sorts of claims about this proposal, that there is a \$12 billion jobs fund, or something like that, which seems to suggest very large economic gains. I do not think those claims stand up. Equally, we have heard suggestions that it is going to create an economic catastrophe, and I think those claims do not stand up either.

In issues of this kind I do not think Professor Dixon’s or my modelling expertise really comes into it. It really is a matter for judgment because you are talking about the micro level of tax compliance about which not a lot is known. My judgment is that there is a small net benefit from replacing a combination of a wholesale sales tax and an assortment of services taxes with a GST—not a large benefit but a positive one.

Senator CONROY—One of the other things the committee asked Professor Dixon to do was to model the claim that the existing system is not a growth tax system. If I can just run through Professor Dixon’s report, it states:

ANTS implies that a major change in indirect taxation is necessary because, without increases in tax rates, the present array of indirect taxes will raise insufficient revenue in relation to Australia’s future public sector requirements.

... ..

We find no evidence to support the ANTS proposition.

... ..

In motivating the tax package, particularly the introduction of the GST, the Treasury has asserted that a major change in the tax mix is necessary because the present array of indirect taxes will raise insufficient revenue to meet Australia’s future needs. Using a MONASH forecast simulation, we find no support for this proposition.

In actual fact he finds that the existing system will grow slightly faster than forecast GDP. In other words, the revenue base that we have at the moment is sufficient. It is a growth tax situation.

Prof. Quiggin—I have not modelled this question closely, I must admit, so I will defer to Professor Dixon on that point. But I would make the general point that over a very long term there is a trend for the proportion of the economy made up by services to expand—not rapidly. If you did the analysis over five or 10 years other variables might well give you the reverse result, but my view would be that, if we look at the question of what kind of tax we would like to have in 50 years time, I would certainly not like to have a tax which fell exclusively on goods. That is not to say that the system is ramshackle and near to imminent collapse. It is merely to say that, in the absence of a good reason for excluding a growing component of the economy from the tax base, I am in favour of including it.

Senator CONROY—To me, you are putting forward an argument for a services tax rather than suggesting they take food out.

Prof. Quiggin—That is right.

Senator CONROY—I remember waking up one morning and opening the newspaper to find that you were advising the Liberals how to make Fightback one better. Eventually they took your advice and so you came out and said, ‘This is a much fairer document now.’ I also remember choking on my weeties that morning. I am just concerned that, if the government suddenly decided they were prepared to take your solution, you would suddenly be sitting in front of this committee saying that this is a good thing. On balance, Professor Dixon is saying—and he has also modelled the food in/food out stuff—that the efficiency claims are bunkum, the jobs claims are bunkum and the national savings claims are bunkum, and I would just be concerned that, if you got the one change you are looking for, you would suddenly be sitting in front of us saying, ‘No, it is okay now.’

Prof. Quiggin—My view would be that, one way or the other, the jobs and national savings effects are going to be essentially trivial. The jobs effects are unpredictable. There will be a short-run macro impact which depends essentially upon what stage we are in the cycle when the changes are introduced, and it would be very hard to predict in what sequence the changes would be introduced.

My general view is that all of the arguments about efficiency are secondary to equity. Therefore, certainly if the government took my advice and took food out of the package, I would stand up, as I did before, and say that this is a greatly improved package. That said, there are lots of other things, particularly the failure to do anything about payroll tax, that I think are wrong with the package. If we are going to revive the notion of the package having to do something about unemployment, there are still a lot of things wrong with the package.

But my general view is, and always has been, that it is a good idea, although not a high priority, to extend the tax base to include services. I would not say that the idea of a GST or VAT has gained grossly excessive priority in the Australian policy debate for historical reasons to do with the fact that this is an issue on which the economic rationalists have been rolled two or three times and it has become some sort of test of faith.

Senator CONROY—This could be described as the last great campaign of the economic rationalists, which I have just been shocked to see you signing up to.

Prof. Quiggin—Unfortunately, although they usually exaggerate their case, they are sometimes right. As far as the question of whether we should tax services as well as goods is concerned, the argument is a valid one.

Senator CONROY—But 52 per cent of the total tax cuts go to the rich 20 per cent.

Prof. Quiggin—As I have said, my proposal for removing—

Senator CONROY—But you are going to describe that as fairer, if you get the change that you want.

Prof. Quiggin—Supposing they remove food, they have to finance that from somewhere. If they finance it by taking \$4 billion out of that 52 per cent tax cuts that you describe, my analysis suggests it will be quite a lot fairer.

Senator CONROY—And if they do not and put the rate up to 12½ per cent?

Prof. Quiggin—If they simply put it up to 12½ per cent, the package will still be unfair because the benefits are all going to the upper income earners. It will be less unfair than it was, but it will still be unfair. The only way of making the package approximately fair would be if the exemption of food was paid for entirely out of the very large tax cuts going to upper income earners.

Senator CONROY—It just seems you are using a large hammer to crack a small nut to say, ‘I want a services tax. I think it is wrong—this growing sector of the economy needs a services tax.’ You are prepared to sign up to something that contains all these other elements which have dubious benefits, depending on which side of the argument you look at. But, on balance, Professor Dixon’s modelling and Murphy’s modelling and the Melbourne Institute have all said, like yourself, that there will be minimal other gains, and all you are really after is a services tax.

Prof. Quiggin—I make the point that the benefits of a services tax do not justify a regressive change in the tax system. The current proposal is precisely that and I oppose it. If the present government or a future Labor government comes up with a proposal, including a services tax, which is fair, then I will support that. Without seeing what changes the government might propose, if indeed they propose any, I am not going to commit myself as to what I will say about them. I am certainly not saying, ‘Take food out and you will have my support for the package,’ because obviously it will depend critically on what other changes are made.

Senator FERGUSON—In your submission on page 78 you talk about when you are considering compensation packages. The second paragraph states:

Next consider a compensation package which would provide full compensation for the bottom three quintiles of the distribution of household incomes.

Why on earth would you want to provide compensation for the third quintile, which is particularly middle income, who are probably getting the benefit of substantial tax cuts?

Senator MURRAY—Just before you proceed, remind me what their income band is?

Prof. Quiggin—I can tell you the quintile that will be phased out and that is couples without children in the income range of \$50,000 to \$70,000. Especially bearing in mind that if any of those are two income households, anybody below that will not be getting any significant benefits from the tax cuts.

Senator FERGUSON—The third quintile is somewhere between \$35,000 and \$50,000, is it?

Prof. Quiggin—That is household income, remember. In most cases that typically means two income earners under \$40,000. It is certainly true that the package tends to treat single income households in that income range better than dual income households in that household range.

Senator FERGUSON—The compensation package that the government has devised is specifically designed for low and particularly fixed income earners—social welfare recipients, et cetera. We know of the poverty trap and the effect of family benefits, et cetera, on families up to \$35,000 and, I think, just beyond. I am just surprised that you would want to model a compensation package that includes the third quintile.

Prof. Quiggin—Obviously I had to pick a cut-off point. Generally, when political rhetoric says ‘low and middle income earners’ it typically means at least the bottom 60 per cent of the population. I have rarely heard anybody in that 50 per cent to 60 per cent range say, ‘I am not a middle income earner; I am an upper income earner.’ Indeed, I have regularly heard people who must be well into the 90 per cent range call themselves middle income earners. I chose the third quintile exempted in order that the cut-out would be people who I unambiguously regarded as reasonably well off; namely, households with an income above \$50,000. You could do the exercise with the phase-out happening over the third quintile. You would find even more significant poverty traps because, in the case of two income households, you are looking at households for whom that is quite a major issue.

Senator FERGUSON—The tax breaks are less.

Prof. Quiggin—So I could have done the analysis just with the bottom two quintiles. Obviously there would be a bit more revenue to play with but, correspondingly, the efficiency cost of the phase-out by doing it in the third quintile rather than in the fourth would be that much greater.

Senator FERGUSON—Most analyses or most other commentators who are talking about compensation packages tend to concentrate on the low and fixed income and not necessarily those that we would consider to be in the third quintile which are starting to become middle income earners.

Prof. Quiggin—Sure.

CHAIR—I think you have rendered the inquiry speechless, Professor Quiggin. We have no further questions for you. Thank you very much for your attendance. I apologise, again, for bringing you on late, but I am sure you have excelled yourself. Thank you, again.

Proceedings suspended from 2.57 p.m. to 3.11 p.m.

BURN, Dr Peter, Secretary, Business Coalition for Tax Reform**RYAN, Mr Fergus, Chairman, Business Coalition for Tax Reform**

CHAIR—We will hear from witnesses from the Business Coalition for Tax Reform. The normal form, which I am sure you have been acquainted with, is for our witnesses to take a short time to address the committee in overview on their submission, if they choose to, and then make themselves available for questions from the committee. But it is your call, and it is now over to you.

Mr Ryan—I have a brief introduction and then we can proceed with questions, as you suggest. Firstly, thank you for inviting us here today. We appreciate the importance of the measures proposed in ‘A New Tax System’ and the role the Senate committee can play in raising the quality of the debate and improving the understanding of the issues surrounding the government’s tax reform proposals. Mr Chairman, I draw your attention to the submission lodged by the Business Coalition for Tax Reform and would like to add the following observations.

By way of introduction, the Business Coalition for Tax Reform comprises almost 40 industry associations that represent large, medium and small business across all sectors of the Australian economy. The BCTR is committed to building a better tax system that will improve international competitiveness and fairness in taxation and will contribute to a climate favourable for investment, job creation and saving. We explicitly recognise and emphasise the fundamental interdependencies between improvements in competitiveness and fairness.

The BCTR first met in October 1997 to inform ourselves of the problems with the current tax system, to better understand why tax reform had failed in the past and to see if we could establish some common ground on which we could build a better tax system. From the outset the BCTR embraced an inclusive approach to the discussion of how to build a better tax system. We recognised explicitly that tax reform had failed in the past partly because business had failed to be united across proposals for change and partly because we had failed to identify common ground with broad groups in the community.

At the tax summit in October 1996 the Australian Chamber of Commerce, which is one of the leading members of the BCTR, and other key groups met with the Australian Council of Social Service and a wide range of community organisations to highlight the importance of getting tax reform on the national agenda. Since that time, we have continued to meet with ACOSS, the Brotherhood of St Laurence, the churches and other community groups. Our approach has been to concentrate on building areas of agreement and to improve our understanding of those areas on which we may disagree.

We have sought to communicate with all stakeholders the need for reform and the problems with the current system of taxation. We have sought to emphasise the importance of both fairness and competitiveness to achieving a better tax system. We have set out to base our case on facts and well-researched arguments. We have brought together leading experts, practitioners and academics to provide the best available advice.

In summary, the BCTR is committed to comprehensive tax reform that is fair, that enhances international competitiveness and that creates a climate favourable for investment, job creation and saving. Out of our process of research and wide discussions we have developed what we call five foundation principles to guide the rebuilding of our tax arrangements. They are: elimination or reduction of as many of the existing indirect taxes as possible; adoption of a single rate tax on domestic consumption, levied on as broad a base as practicable; remodelling of federal-state financial relations; reductions in marginal rates of tax on income and simplifications to company tax; and a reworking of the interface between tax and social security systems to reduce the highly effective marginal tax rates confronting low and middle income Australians.

We have assessed the government's package for tax reform against our objectives and principles. In our view, there is good reason to believe that the proposals contained in 'A New Tax System' represent the most comprehensive attempt to re-fashion the Australian tax system since Federation. We believe that measures in 'A New Tax System' form an integrated approach to tax reform that will improve our international competitiveness, encourage investment and job creation, encourage savings and improve fairness. Our case for believing this is set out in our submission in some detail.

I emphasise the importance of comprehensive tax reform—take away one element and we would risk undermining the integrity of the package overall. In that regard GST is only one element. It is, however, an important element because it allows us to get rid of a raft of taxes—in fact, nine hidden indirect taxes—that undermine the competitiveness and fairness of our tax system. The benefits of the proposals in 'A New Tax System' to improve the fairness and competitiveness of our tax system are significantly eroded if food is excluded from the indirect tax base.

In summary, excluding food would add significant compliance costs, particularly for small business; tend towards creating a culture of non-compliance and activity that seeks tax avoidance; increase the administrative costs and the time spent by tax administrators and the courts in deciding what is and is not food for the purpose of tax; and reduce the general competitive advantages of a single rate, broad based indirect tax. We would lose an estimated 15 per cent of the GST revenue, which either would have to be found elsewhere or would mean that programs would have to be cut. We would reduce the amount of GST paid by the wealthiest 20 per cent of households by double the reduction for the poorest 20 per cent of households. In other words, for every dollar benefit received by the poorest 20 per cent of households, granting a GST-free status for food would deliver a benefit of \$7.60 to the rest of the population.

We believe that equity concerns should be dealt with by using some of the additional revenue to compensate for any additional tax paid by low income earners. This approach is endorsed by a wide range of experts, including Professor Neil Warren.

In conclusion, I would like to emphasise the importance of staying focused on the whole package to achieve a comprehensive approach to tax reform. I would further like to emphasise the interdependence of fairness and competitiveness—both can and should be achieved. I would like to say in closing that going down the path of cutting and pasting the

indirect tax system brings into question the integrity of the whole package. Indeed, we would have to question the value of what is proposed.

As you are aware, we are here as members of the BCTR team. I play a coordinating role in an organisation with a diverse membership. I do not pretend to be fully informed on the full range of issues that may be of particular interest to members. They will be addressing their specific concerns in separate submissions to you. What is important is that BCTR collectively represents a broad based unparalleled unanimity of views among all major sectors of Australian business on the fundamentals of tax reform. I hope that I can be of assistance to the committee in speaking about our approach to reform and in conveying to the committee the importance the business community attaches to the reform process. Dr Peter Burn, who accompanies me today, is the head of the secretariat and is responsible for coordinating our research efforts.

CHAIR—Thank you, Mr Ryan. Is it your desire for Dr Burn to make supporting remarks?

Mr Ryan—No. But, with your permission, we will share the questions appropriately.

CHAIR—Okay. I will ask the Deputy Chairman, Senator Ferguson, to ask some questions in a moment. But if I may abuse my position as chairman and lead, is it true that the Business Coalition for Tax Reform, trading as Australians for a Fairer Tax System, spent \$4½ million before the last election telling Australians that tax reform was necessary by way of television advertising and newspaper advertising?

Mr Ryan—The Australians for a Fairer Tax System is a distinct organisation from the Business Coalition for Tax Reform. It evolved in about April-May. It followed two years of consultation with government and oppositions at federal and state levels. Those discussions were dedicated to the BCTR articulating its views on the need for comprehensive reform across all modes of politics that we could find, across the community groups and the churches. In about, as I say, May-June of last year the natural evolution of that was to extend that educational campaign for the need to reform to the public. A distinct organisation called Australians for a Fairer Tax was formed at that time and, as you say, there was an advertising campaign.

CHAIR—But isn't it true that the Business Coalition for Tax Reform constitutes, if not wholly then overwhelmingly, the distinct organisation, as you have characterised it, that named itself Australians for a Fairer Tax System?

Mr Ryan—It is certainly true that the 40 members of the Business Coalition—not all, but certainly quite a number—were participants in that effort. It is certainly true that a number of members of those 40 organisations were contributors to that coalition—and some of them, by the way, are members of more than one business association. It is certainly true that there were individuals that contributed to that effort. The dollar number that you described is roughly accurate.

CHAIR—Why then did what is a basic business lobby group not call itself a business lobby group in authorising those ads but characterise itself, more blandly, as Australians for a Fairer Tax System?

Mr Ryan—Firstly, I think it would be oversimplistic to characterise the people who contributed as only having business as their focus. The core purpose was to recognise the need for comprehensive tax reform for all Australians. I can perhaps bring this to life by describing to you some factual background. In my capacity as Chairman of the BCTR I was reminded constantly of a number of things: firstly, that tax reform would not succeed for business unless it succeeded for the community. Those were part of the terms of reference, if you like, that I was given: go and talk to government, with members of the coalition; go and talk to the opposition; go and talk to the churches; go and talk to ACOSS.

The second term of reference that I had—and this can certainly be supported by any of the 40 members—was that at practically every meeting I was at I was reminded that this is a process about comprehensive tax reform; that whoever we can convince to that point of view we should be mutually supportive of, whether it was the party in power or the opposition, whether it was state or federal. So what we are on about is a comprehensive tax reform review for all Australians, of which business is an important part but just a part. That also goes to explain the almost 2½ years of investment in time that we and others—ACOSS, churches—have put in talking together.

Finally, by way of my terms of reference, I was told to concentrate on the matters in which the business community could agree with other parts of the community as the first priority, and then to the extent possible to narrow the disagreement, because it was recognised that in the past we really had two camps. We had a competitiveness conventional camp and a fairness conventional camp—almost predictable—and we had to get through that. We, and others—I do not mean just business—have come to the recognition that these have to be interdependent, that we cannot have two independent concepts such as fairness and competitiveness. They are interdependent. That was the background to the concern. It was much broader than only business, although business clearly was a core motivation.

CHAIR—But coming back to the \$4½ million that was spent on advertising and going to truth in advertising, would it have been more honest to have said, ‘These ads are sponsored by the business community—

Senator CONROY—The big end of town.

CHAIR—Or ‘by the big end of town’, as Senator Conroy has just interjected. Wouldn’t that have been more honest, rather than to say that these were Australians for a fairer tax system—in that way concealing who in fact was paying for it? If the business community believes this tax reform is necessary, why aren’t they prepared to put their own name to their own ads?

Mr Ryan—Let me say first of all that nothing has been concealed. We have fully discharged our responsibilities and obligations under the Australian Electoral Act. So we have not concealed anything. Let me also say that we are business Australians, that there were people who are not from the big end of town. If I could draw your attention to the 40

organisations, and I will, because I think it is important to get rid of the myth of ‘the big end of town’—

CHAIR—There is a list of organisations in your submission. Is that the list?

Mr Ryan—Yes; such as the tourism industry on page 2 of the submission, the retail industry—

Senator CONROY—Did they donate any money to the advertising campaign?

Mr Ryan—Our obligations in terms of that disclosure has been fully met under the Electoral Act.

Senator CONROY—That is not what I actually asked you.

Mr Ryan—Yes, there were contributions—illustratively—from members who were not from the big end of town. I include in the submission on pages 2 and 3 a listing of such industries as retailers, hotels, and the Australian Chamber of Commerce and Industry, which literally has thousands of members. So I respectfully suggest that the idea of it being exclusively big end is a myth.

CHAIR—I accepted that interjection from Senator Conroy and I am sure he may ask you some questions about it later. My question in essence is, why didn’t the business community say to Australia, ‘These ads are brought to you by the business community’ rather than saying, ‘These ads are brought to you by a nebulous organisation created for the effect—Australians for a Fairer Tax System’? Why didn’t you just fess up?

Senator FERGUSON—Are you suggesting they are not Australian, Senator Cook?

CHAIR—No, I am not suggesting that at all.

Senator CONROY—St Vincent de Paul’s did.

CHAIR—Why didn’t you just fess up, saying, ‘This is the business community, this is what we think tax reform should consist of’?

Mr Ryan—Because we have in our membership a number of different interest groups. Mr Chairman, I would regard myself certainly as a business person; I would also regard myself as an Australian.

CHAIR—I do not dispute that, Mr Ryan. But you see my point, don’t you? People participating in public life and in public debate trying to persuade others to their point of view are quite at liberty in this democracy of Australia to do so, but it is always important for people to understand what is being said, and who is saying it as well. My question is, why did you choose to hide your light under a bushel? Why didn’t you just call yourself business people?

Mr Ryan—We did not. We called ourselves Australians for Fairer Tax. We had a group of people contribute. It is perfectly clear. We have met all of our obligations. We did not hide behind a bushel. I refute that.

CHAIR—I note your answer. Last Wednesday, the *Australian Financial Review* on its front page led with a story that the business community were not going to put all of their views to this committee on the government's so-called tax reform package but rather they were going to seek to privately persuade the government to make some changes within its package. A number of business organisations have been before this committee. I have asked them this question; let me ask you this question. Are you putting views to the government, in private, different to what you are putting to this committee?

Mr Ryan—No. Let me first of all say that I do not know the source of that article. Let me make a couple of comments. Firstly, and without qualification, the BCTR and its constituent membership have absolute respect for your purpose, your authority and the whole context of this inquiry. We will support it to the ultimate. If there are exceptions to that, they are outside of our power, they are outside of our influence. Frankly, whilst I understand why the question was asked, because it appeared on the front page of the paper, the simple answer is no. We respect this committee and why it is there and your authority.

Let me also say that for three years now we have been talking to the federal government, going back to October 1996—this is not the *Financial Review* of last Monday, this is October 1996—with countless thousands of hours by committed people to get comprehensive tax reform. We have talked to the federal government, the federal opposition—I am sure you recall—the state governments, the state opposition, ACOSS, the churches and everybody else that will talk to us. To me, whether somebody made that remark is totally irrelevant to the broader issue. Please accept from me that the BCTR says with absolute conviction, under oath if you wish, that we are committed to this process. I reject any slur on the BCTR on that basis.

CHAIR—I accept your remarks, Mr Ryan. I conclude from them that what you are putting to us is what you would be putting to the government, to the extent that you are seeking changes, if you are, in the package of bills the government has introduced in the parliament.

Mr Ryan—The answer in substance to that is yes, in the context of the integrity of the question. Let me, however, qualify it by saying this. There are countless avenues of communication that are open at the moment between the BCTR, where we represent, if you like, the five core foundation points that we agree on. We have never said that our membership cannot and should not confer with whom they wish, be it the opposition, the government, the Treasury, the countless numbers of people that are involved in this. Hopefully, there is a lot of communication, a lot of discussion going on there. Whether it is all entirely consistent, I cannot say. I can tell you that in substance, if you asked me a question about what we are communicating, what our view is, I will try to provide the component of consistency in it to you.

CHAIR—My reason for asking you this question is that, as other members of this committee would be aware, during the period of higher tariffs in Australia business

organisations would lobby government about tariff reduction and argue that in the national interest. Then later, in my direct experience, individual members of such organisations would come to the government and say, 'But in our case make an exception. Do what is in the national interest, as our organisation asked you to, but in my particular case make an exception for me.' I just want to get out in the open in this process that we are all talking openly about the same things and we are having a debate on the public record about them and no special pleading is going on. At the end of the day, this committee has to make recommendations to the Senate as to what the Senate should do with the legislation. It is important to us to know what business thinks about the legislation, whether it thinks any element of it should be changed or varied in any way.

I note in passing that a business organisation last week said to us that it was putting things to the government but it was not asking us to recommend those things to the Senate at this particular point of time and that it would get back to us as to whether it would ask us in our report to recommend those changes to the Senate. It was honest and up-front about that and I accept its word, and I am sure it will advise us, but I do think it will help public debate and scrutiny if all things are out in the open. That is the reason for my line of questioning.

Mr Ryan—May I respond in the same spirit, because I think it is entirely appropriate. The BCTR has tried to evolve through research to some good foundation principles that business can unify around, and indeed others, hopefully, as we have said. We have never tried nor been in a position to suggest to the individual members that there are not issues that they should take up directly with Treasury, government, opposition or who you will. In some respects in this environment we encourage that sort of debate. So, in giving you the undertaking, what I cannot undertake is that there is a single channel of communication. I am saying there is a lot happening out there that we can't and won't control but, to the extent we are aware of issues of public significance, we will certainly be entirely open and direct with you.

Senator FERGUSON—Mr Chairman, I listened carefully to your earlier questions to Mr Ryan regarding the funding of an election campaign. I must say I failed to see what they have to do with our terms of reference to this inquiry, but I chose not to interrupt because obviously Mr Ryan was quite prepared to answer all those questions. The issue of funding of campaigns for or against a tax system is not one that I think is part of the terms of reference of this inquiry.

I would like to get down to some of the issues that have been raised by other people in giving us evidence today. Mr Ryan or Dr Burn, I would like you particularly to comment in more detail on the issue of compliance costs. Opposition senators have continually raised the issue of compliance costs and the 1.4 million people who will now be required to put in GST returns. Could you comment in general on the issue of compliance costs, how it affects your members and how it affects the business community.

Mr Ryan—Mr Chairman, I might ask Dr Burn to respond to that. Senator Ferguson's introduction triggered something that I should have said about your earlier question. That education campaign was carried out well before the Labor Party or the government came up with the tax package. I just want to make sure that the timing of that is understood.

Senator CONROY—Senator Ferguson mentioned the election.

Mr Ryan—I just wanted to be clear.

Senator FERGUSON—I did because Senator Cook mentioned it.

CHAIR—We are beginning to debate among ourselves, which of course we will do, but I think it is better we do it in private rather than in public. I am sorely tempted to take the matter on but I will resist temptation on this occasion.

Dr Burn—We regard compliance costs as very important. One of the central reasons for the business community to have an interest in tax reform is the current level of compliance costs and the expectation that, if the current tax system remains unchanged, compliance costs will increase further. We are concerned about compliance costs for a number of reasons. They disadvantage business. They impose extra costs on business. Extra compliance costs are also passed on to consumers in the form of higher prices. Compliance costs also represent a waste of resources that could be used elsewhere. So a tax system that reduces compliance costs is advantageous both from a business point of view and from a general community point of view.

The issue of compliance costs is central to our advocacy of a single rate, broad based consumption tax including food because, as exemptions from that tax rise, so do compliance costs. They rise very dramatically. As you know, compliance costs fall disproportionately on small business and small business would be disadvantaged disproportionately in terms of compliance costs if food were exempt from the GST.

Senator FERGUSON—Although we are a select committee into a new tax system, one of the problems is that most of the questioning seems to have degenerated into the issue of a GST and we have not been considering, in many cases, all of the other implications of a new tax system. When we have been talking about a GST, much has been made of the issue of the exemption of food.

In your press release, that has been passed around today, you talk about the estimated 15 per cent of GST revenue that will be lost. You also talk about reducing the share of GST revenue paid by the wealthiest 20 per cent of households by double the reduction for the poorest 20 per cent. Where do those figures come from?

Dr Burn—Those figures came from work we commissioned by Professor Neil Warren. That work is referred to in the preliminary submission that we made on 23 December to this select committee and again in our full submission which you have before you. As indicated in both the preliminary submission and in this submission, we are very happy to make that material available to the select committee.

Senator FERGUSON—I would like to see that. Because food is one of the main issues that we are talking about, I think it is important that we do have that information. I notice also that the Australian Food and Grocery Council are amongst the people in your coalition.

Senator CONROY—They are appearing tomorrow.

Senator FERGUSON—That is correct, Senator Conroy. You are always helpful, as ever. The Food and Grocery Council, I take it, are totally supportive of the position of the Business Coalition for Tax Reform?

Dr Burn—Yes, they are.

Senator FERGUSON—The increase in compliance costs because of an exemption on food is one of the issues that has been talked about a lot. Have you ever done any work in the estimate of compliance costs for business, whether it be tax advice, professional advice or whether it be filling in returns under the current system? Do you have any estimate of the total cost to business now—of the compliance costs of those sorts of requirements that are placed on business?

Dr Burn—We have not done a study of the current level of compliance costs facing business. What we have done, which is referred to in both the preliminary submission and in the main submission, is to commission a study of the impact on the compliance costs of the proposals in a new tax system. That study has been conducted by Dr Jeffrey Pope of Curtin University, and he evaluates the overall effect on compliance costs in the totality of the proposals in ‘A New Tax System’.

I refer you to the main submission, part 3, section 3.2 on page 29, in which the central conclusion of that study is set out, and in which the impact of exemptions to the GST are spelt out. Like the other studies referred to in both documents, we will be happy to provide this select committee with a copy of Dr Pope’s study.

Senator CONROY—Yes, please.

Dr Burn—This is the conclusion in relation to the totality of the proposals in ‘A New Tax System’ and their effect on overall costs facing business. The central conclusion is this:

The real question is whether the likely administrative and compliance costs of the GST and associated reforms are a price worth paying in order to achieve a more modern, efficient and simpler tax system overall. The question can be asked of the community generally in terms of gross compliance costs i.e. the resource costs to the country as a whole and to business in terms of its estimated net compliance costs, after allowing for offsetting benefits, particularly the value of cash flow benefits. This paper points to positive answers to all of these questions.

Senator FERGUSON—I think I will leave my questioning there. I know Senator Gibson has some later, but I think we will spread it around from this side.

Senator MURRAY—Mr Ryan, you acknowledge—and I think it is a great virtue of our democracy—that you have engaged in the public debate and a publicly funded campaign for tax reform. You read out a very impressive long list of supporters for your case. Many business organisations also, as you know, donated millions and millions of dollars to the National Party and the Liberal Party, for the election that just passed, in support of those parties’ policies, which include tax reform.

The assumption, both by the media and the community at large, is that business at large and business organisations support the GST in particular, and tax reform. How then do you explain very many businesses and business organisations donating millions and millions of

dollars to the Labor Party to help fund their no case? Isn't it the case that many business organisations are closet opponents of the GST?

Mr Ryan—Chairman, could I seek guidance from you as to whether we are about party contributions or tax reform? I am a little confused as to the direction of a couple of the questions.

CHAIR—I think I may well be considered to be tainted in this debate, Mr Ryan.

Senator MURRAY—Let me be clear to you. What I am putting as a proposition is that it is the case put by business organisations that come before us, and in their submissions, that business, in the broad, supports the government's tax reform package. I accept that on the face of it. It is confirmed as well by the advertising campaign your group ran and by the political donations made to the party which has proposed that. What I find difficult to understand is why rational business people should donate millions and millions of dollars to the Labor Party, which vigorously promotes the no case, if in fact they did not support the no case. My assumption is, because they are rational business people, that therefore those businesses and business organisations actually support Labor's position.

CHAIR—I have been conferring with my deputy, Mr Ryan. You asked me a direct question, on which I have not ruled. I did honestly say, since I opened with a line of questioning that borders on this matter, that I am not sure whether I am the right person to actually make a guidance to you.

Senator FERGUSON—In answer to your proposition, Mr Ryan, I think you should only answer that sort of question if you choose to. It is a question that has been put to you by Senator Murray, but I am not sure that it is within the terms of reference of this committee. I am sure you would have read the terms of reference when you made your submission, and I am not quite sure just where it could be tied up into our terms of reference what people's position is prior to an election, when we are now dealing with a piece of legislation that has been passed by the parliament.

Senator MURRAY—On a point of order, all I am trying to establish is whether support within the business community is total, or at large, for the tax reform package, or is there substantial opposition to it, which seems to me evidenced by donations to the Labor Party.

Senator FERGUSON—I think that is a legitimate question.

Mr Ryan—Leaving aside the technicality of the terms of reference and in the spirit of our earlier discussion, let me take a shot at answering. I was just interested in where the borders lie to these questions on politics versus tax reform, which is what I am here to speak about.

CHAIR—The deputy chair has ruled.

Senator FERGUSON—I think the final question is a legitimate question.

Mr Ryan—Thank you. I would have answered it in any event for that reason. I think the core answer is that we are here to promote comprehensive tax reform, not political parties. Why people contribute to political parties runs to dimensions that certainly include factors other than tax.

My fundamental point is that all of our efforts have been about comprehensive tax reform and convincing people, of whatever political persuasion, that that is what we should do. Yes, we have formed views on how we think it should best be done and, yes, where we have needed to spend money on policy development and so on, it has been directed towards that purpose, but why people give money to political parties has dimensions that go way beyond tax reform. My core point is that we are about comprehensive tax reform, irrespective of who implements it. Is that a fair response to your question?

Senator MURRAY—It is your response. I must say I am puzzled by the phenomenon, but we will move on. Dr Burn, you have had a great deal to do with the technical side of it. Is it a correct summation to say that BCTR takes the view that the fewer exemptions, the broader the band of the GST, the simpler and easier and better a GST system is? Is that a correct assumption?

Dr Burn—That is right.

Senator MURRAY—If that is your position, from the point of view of theoretical and practical integrity, do you therefore oppose in principle the idea of exempting education and health?

Dr Burn—Our principle is that the GST would be simpler and less costly to comply with if there were no differentiation between consumption items at the point of sale. That has been our consistent position. The GST proposed under 'A New Tax System' comes close to that. In fact, the base proposed in 'A New Tax System' would be the second broadest indirect tax base in the world. For that reason it has attracted our support. I guess your question is: was that the tax base we were originally proposing and that we campaigned for?

Senator MURRAY—Let me put it clearly to you. We have asked this question of people such as the CPA and VECCI and the top 100 business tax people and so on. Essentially, there are two positions. From a point of view of intellectual and theoretical integrity, either you believe in as few exemptions as possible or you believe in the number of exemptions. The government has chosen the number of exemptions. The business tax group, the top 100, said that ideally they would prefer education and health with GST, and so did the CPAs. That is my question. Do you fall in the government's group that there should be some exemptions or do you fall in the business tax and the CPA group, which says that they do not agree with education and health, but that is the government's choice?

Dr Burn—Our position has been clear all along. We support a GST on as broad a base as practicable.

Senator MURRAY—So, ideally, you would prefer GST to have been on education and health?

Dr Burn—On all consumption expenditure.

Senator MURRAY—My next question relates to the issue of wages. This morning, Professor Dixon outlined a set of modelling assumptions and within them he did some sensitivity analysis. One of the key determinants as to the consequences of imposing a GST, withdrawing other indirect taxes and providing the direct tax is trying to anticipate what the response of wage earners will be. Within that there is the consideration of the pass-through situation.

The imposition of the GST will be immediate, which is obvious. So the costs apply immediately, but there is dispute as to when the savings come through in terms of pass through. The professor was saying that, if the wage earners by and large believe that the costs are greater than the benefits, there will be a push to increase their wages to adjust. It does not matter what the reality ends up being, it is the perception and the feeling which will drive that in the short term. I am sure it is a matter that has been considered by the BCTR. I would appreciate knowing how you propose to deal with such a thing or such a phenomenon if it occurs.

Dr Burn—Your question, as I understand it, relates essentially to the timing of the pass through of the effects of reduced indirect taxes. Is that correct?

Senator MURRAY—It goes much further than that. The professor is saying that, if the demand for wages drives upwards, it will force down jobs and the economic effect of this package will be negative. Therefore, the ability to restrain wage demand is a very important part of the policy consequence of this package. It is business that has to deal with wage earners, so what is your anticipation of the likely result and how will you deal with it?

Dr Burn—I understand the next stage of the reasoning, but I am trying to get at your concern that wages would rise. Of course, I am not familiar with what Professor Dixon said this morning. I would not have a clue.

Senator MURRAY—Perhaps I could ask you take it on notice?

Dr Burn—I will.

Senator MURRAY—Have a look at the *Hansard* record and at Professor Dixon's submission and, perhaps, give us some views on that, because that situation is an important one. I will move on to the pass-through effect. The question we are all asking business is: what is in it for you? This is what the Treasury, the modellers and the government are saying. The government and the Treasury are saying that there is going to be 100 per cent pass through in year one. That means, therefore, that the entire savings benefits—the lower cost that person has experienced—will be passed on to consumers, and the additional cost provided by a GST will be imposed. Therefore, there is no difference in the relationship between cost and profit. If you pass through 100 per cent of both, nothing changes—they are just lower.

The Treasury and the government are also saying—and the modellers agree—that there will be no export benefit because exchange rate adjustments will even out the consequence

of greater export competitiveness. The two modellers, Professor Dixon and Mr Murphy, say that the economic impact of this package is marginal. One says it is marginally positive, one says marginally negative.

As a committee, we are faced with a series of statements, modelling judgments and so on, which say that, whilst the tax system may be simplified and improved and all those things, the actual economic benefit to businesses is zero. There is certainly economic benefit to consumers because their disposable income is changing and their costs are going down, but to businesses, because of the 100 per cent pass through, there is no benefit. What do you see as the economic benefits? How will this thing make businesses more profitable?

Dr Burn—It might not make businesses more profitable. However, we believe it will have them operating at a higher level of output, at a higher level of investment and a higher level of employment. There is no reason to think that this would make them more profitable. They would be more productive, but not necessarily. For no reason would this change their profitability. It would make them more productive.

Senator MURRAY—Take me through the economics of that, if you will. The economics of that are as follows: if demand remains the same and you increase supply—which is what being more productive means—your price falls. The modellers are telling us that will be compensated for by exchange rate changes. Where is the benefit?

Dr Burn—The assumption that demand would remain constant is not realistic. We have a number of measures in the package defined narrowly that would increase demand. The reduction in effective marginal tax rates will increase real disposable income for those in receipt of benefits. The decrease in tax rates to all income earners below \$75,000 will also increase spending power. Furthermore, as you will understand, the improvements in economic decision making, which are at the heart of the improved overall productive performance, will increase investment and will increase employment, which will stimulate demand and result in a higher level of demand.

Senator CONROY—Has your organisation commissioned anybody to do any modelling looking for this animal spirit that is out there?

Dr Burn—Can I answer this question first and then come to your question? Mr Chairman?

CHAIR—Yes.

Dr Burn—The assumption therefore that demand would not increase is not realistic. My next point may well have a bearing on Senator Conroy's comment. Most of the models that are around do not factor in the dynamic benefits of tax reform. That is a shortcoming of models. This committee has heard evidence going back to December about the shortcomings of models. That does not mean that those benefits are not there and will not be realised. There is every expectation that they will be. The fact that a certain conclusion is reached from those models is not the be-all and end-all of the predictions of economic reasoning.

Senator MURRAY—I ask you to take this question on notice because it is a fundamental one. The modellers have put at question the economic benefits. There are lots of other benefits, and we see those. I specifically put a question to Treasury: in terms of the list, could they provide the empirical evidence for the six economic benefits that they said arose from the ANTS package. They wrote back and said no, they would not, that these were just qualitative statements. We are left with no international evidence and no local evidence that the committee can use which clearly shows the actual consequences of introducing this new tax system. I am not saying they are not there. I am just saying we have not yet been provided with the evidence on what effects are expected on investment, jobs growth, capital ownership, et cetera. I am sure you will clearly understand the question. If you would consider it and come back to us that would be helpful.

My next question relates to food. Your position on food has been made very clear and I will not explore that further. I think that is very apparent. But it is hypothetically possible—let us not say it is probable—that the Senate or the government may decide to deal with food in a different way from that which they propose at present. We have put the question to a number of business organisations and again I would put it to you on notice that food can either be narrowly defined or widely defined. Professor Dixon defined for the purposes of modelling narrowly and said that the cost would be \$2.5 billion.

The Treasury in answer to a question we put to them defined it widely and put it at about \$5 billion. The question we asked business was, ‘Knowing your position, if you were forced into a situation where food was either partly or totally GST free, which would be your preference as a business organisation: a narrow definition of food or a broader definition and why?’

It is difficult for you to take notes while this is going on. This question will be recorded in *Hansard* and you can pick it up. I have a number of others, but I am conscious that I am probably hogging the floor. Perhaps you would like to come back to me on that.

CHAIR—You should not be unduly conscious. You are out of time but we can find some more time for you, if you wish. Time has been given by the coalition to you, Senator Murray, if you want to take a little more time.

Senator MURRAY—Thank you. It is my last area of questioning and it relates to the issue of payroll tax. I understand that in a perfect policy world—let us have that qualification—your organisation would rather there was not a payroll tax, for good reasons. That is true, isn’t it?

Mr Ryan—Yes.

Senator MURRAY—If you were faced with a policy choice, as we are, of choosing between fuel tax cuts—either partly or totally, as recommended by the government—and either partly or totally getting rid of payroll tax, in your view which one would provide the greater economic benefit and the greater benefit to business? Again, I suggest to you that this might be a question you would like to take on notice. You are welcome to answer it immediately, if you would.

One of the propositions that we have had put forward is that it is appropriate to deliver the government's package to heavy road transport and off-road use; in other words, primarily to the commercial area but not primarily to the consumer area. That would halve the petrol excise cuts, which would leave money available to cut the payroll tax. The question is: how well does business respond to that? You can answer it now or on notice, as you see fit.

Dr Burn—Can we do both? Any detailed answer and analysis of a comparison between changes in taxation arrangements would require some thought and thinking through the issues and evaluation of the alternatives proposed. But I can say something about the criteria and the way that would be done. Of course, the BCTR has clear objectives for reform, and these would apply to our attitude to any proposals and to any evaluation of change between payroll tax and fuel or carbon taxes as well as the proposals in 'A New Tax System'. Those objectives are to improve international competitiveness and the fairness of the tax system and to create an environment favourable for investment, for job creation and for saving.

What we would do—and we are happy to provide you an outline of where that analysis would take us—would be to evaluate the proposed change in taxes according to those criteria, according to those objectives. How would it influence international competitiveness? How would it influence fairness? How would it influence investment? How would it influence job creation? How would it influence saving? Those are the questions that we would be asking in an evaluation of that issue. We would be very happy to provide you with more details of an evaluation.

Senator MURRAY—You would appreciate that I asked the question because there is some evidence before us that getting rid of payroll tax actually delivers a higher economic benefit than cutting fuel excises. But you may agree or disagree with that and I would like to know your response.

Senator CONROY—I return to the question I asked before. Has your organisation commissioned any modelling of the ANTS package that includes or does not include the dynamic benefits that you mentioned before?

Dr Burn—We have commissioned modelling of the ANTS package and I referred to a study earlier on compliance costs which we treat as very important because a reduction in compliance costs themselves generate dynamic benefits that would be felt throughout the economic system. Those benefits themselves would result in higher levels of investment and job creation. The answer is strictly, yes, but have we commissioned any specific modelling of the details of the proposals in 'A New Tax System'? Formal modelling—I stress the word 'formal'—no.

Senator CONROY—You have half answered my next question. You obviously then believe that the GST will lead to more jobs?

Dr Burn—The totality of the tax package includes a modernisation of the indirect tax system, and that in itself comprises the introduction of a single rate goods and services tax on a very broad range of consumption to finance the removal of the wholesale sales tax, financial institutions duty, debits tax, stamp duty on marketable securities, conveyancing duty on business property, stamp duties on credit arrangements, instalment purchase transactions

and rental agreements, stamp duties on leases, stamp duties on mortgages, bonds, debentures and other loan securities, stamp duties on cheques, bills of exchange, promissory notes and bed taxes and reductions in petrol and diesel excises. Those measures are the indirect tax measures. There are five other dimensions to the proposals in 'A New Tax System'. We believe that the totality of the proposals will be beneficial to investment and job creation.

Senator CONROY—Trying to summarise, you are saying that the switch from all those taxes to the GST, based on your compliance cost argument, is a job generator. Within the whole ANTS package?

Dr Burn—The compliance cost argument is a component. I am referring to the indirect tax portion of the totality of the package. The key to it, which operates in addition to compliance costs, is the improved economic decision making that arises for the very simple reason that economic decisions become less affected by differential rates of indirect taxes, less distorted and more conducive to productive performance. Those effects will be felt in just about every economic decision made in Australia—

Senator CONROY—It is almost mystical.

Dr Burn—It is quite simple. Those economic effects will be felt in almost every economic decision made in Australia. Individually, it might be quite a small improvement, almost imperceptible for any given transaction, but there are millions and millions of transactions conducted. The decisions behind those transactions will be less distorted by taxation arrangements, more favourable to the most productive use of Australia's resources and conducive to higher levels of economic activity, of investment and higher levels of job creation.

Senator CONROY—As you have already been made aware, the Senate commissioned Professor Dixon to model the ANTS package. You probably have not had a chance to see the whole study yet as it was only released today. I would like to read you some quotes from that:

Employment is stimulated . . . only because the government's tax package involves a net movement towards deficit, allowing larger reductions in income taxes. More generally . . . the government could achieve short-run employment gains simply by cuts in income taxes without changing indirect taxes.

Thus we conclude that the short-term employment gain associated with the package is entirely the result of fiscal stimulation. The employment gain could be generated simply by cutting income taxes without a GST or other changes in indirect tax rates.

Dr Burn—I cannot comment on the paper presented this morning by Professor Dixon because, as you will appreciate, the conclusions of any study are a function of the assumptions made at the outset. I can, however, express some opinions based on a December paper that Professor Dixon made which gives me considerable doubt as to whether he captures the full benefits of the package. This, of course, is not an answer to your question, but it may be relevant upon closer examination. I am happy to take on notice further questions, but in the Dixon December paper there are some very important assumptions

which are very relevant to the conclusions that he reached and, in fact, were explicitly stated to be very relevant.

Firstly, the December paper assumes that there is no increase in domestic investment, despite the removal of taxes on business inputs. That is the first assumption—very important. Secondly—and this you might see as mystical—is that there is a curious asymmetry in the assumptions about world prices. In his model—this is the December version—import prices are assumed to be unchanged. Fair enough. A common assumption is that world prices would not be changed by Australian economic events. So import prices are consistent with that experience; they are consistent with that conventional approach. However, export prices are assumed to fall as a result of Australian decisions—this is in the December paper; I would have to check whether that still is there—and that has a very profound effect on the terms of trade because we are talking about the differences in import and export prices. In the December paper, Professor Dixon points out that the driver of his results is the terms of trade effect. We have to be very cautious, therefore, about the conclusions that we draw from that paper, given that a very curious assumption is driving that, and that is the key driver.

There is another characteristic of the December paper, and that is that it is not a model of the totality of the government's tax package. For instance, it did not include the impacts of decreased marginal tax rates on income; it did not include the effects of lower effective marginal tax rates on low income earners—both measures highly likely to be stimulatory in terms of demand and economic performance. For those reasons I am hesitant to worry too much about the paper that you refer to that was mentioned this morning but, of course, I will read that paper with interest.

Senator CONROY—The good news is we will take on board the comments you have made and refer them to Professor Dixon for comment, just for the committee members' further information. Has anybody attempted to model the dynamic benefits that you described earlier? Has anyone attempted a model that actually incorporates them in any way? Is it possible to incorporate them into a model?

Dr Burn—Without wanting to appear obtuse, there is a sense in which all our thoughts are filtered through models. This is the way we have ordered the information that we have. In science there is a discipline to that process. In what is narrowly conceived to be modelling—that is, in this case, econometric modelling—there is an explicit attempt to assign numbers to some of those complex interrelationships that we have in our heads that help us think things through. In the sense of the former model, no, we have no commissioned any work; in the sense of the broader of sense of modelling, yes, we have thought through the economic impacts of the proposed changes in 'A New Tax System' with the aid of the insights of economic science.

Senator CONROY—In economics, usually, empirical evidence is what people toss around when they want to support their assertions one way or the other. Have you got any empirical evidence at all?

Dr Burn—You cannot have empirical evidence about the future. There is no such thing as empirical evidence about the future.

CHAIR—By definition.

Senator GIBSON—I would like to follow up on the questioning from Senators Murray and Conroy on the economic modelling. As a preliminary, we have had evidence out in the public arena of various economic modellers making predictions about the effect of the government's package on the economy. As you are well aware, Econtech has suggested that economic growth will be improved by 1.8 per cent; Salomon Brothers were suggesting 3½ per cent, and so on. There have been estimates of increased employment arising from that modelling. This morning Professor Dixon said that, in his view, from his main model, the improvement would be slight, if anything. But he did say that he thought there would be some slight improvement in employment in his main model.

However, when I questioned him this morning about what you call the dynamic benefits—firstly, on the supply side for labour of marginal tax changes not only on the income tax scale but quite rightly also from the welfare benefits side of reducing the poverty traps and, secondly, on the business side of improved efficiency within the business community from the tax reforms, removing the various indirect taxes, et cetera, and, as you said, improved economic decisions—he admitted that his model had no chance of incorporating those effects.

I guess we should not be expecting an econometric model of a few hundred equations to correctly predict what is going to happen with an Australian economy of 18 million consumers, eight million employees and 1½ million businesses. But I would like you to emphasise again to us what you believe is going to happen with the economy with regard to economic growth and, secondly, with regard to employment from those dynamic benefits which you mentioned before.

Dr Burn—Essentially, we anticipate that the long-term benefits, the substantial and sustainable benefits, will arise from improvements in economic decision making, that the summation of millions of better economic decisions and better allocation of resources will release resources for other productive uses. That will improve the cost structure faced by Australian businesses and enable Australian businesses to produce more with less. That will stimulate demand and feed back into greater supply and greater levels of employment and investment that, in turn, feed into higher levels of demand because there are more people employed and because there is more capital equipment demanded. The Australian economy will operate, we would expect, on a higher plane.

In addition to that, there are the compliance cost benefits and improvements to international competitiveness. Those factors do not just operate in summation; they compound upon one another. We would expect the long-term benefits to be demonstrably favourable to output, investment and job creation.

Mr Ryan—Could I supplement that and say that, whilst this is not documented, I think the associations making up the coalition would be very comfortable with what Dr Burn has just said in terms of the impact of your question on their particular area of interest.

Senator O'CHEE—While we are on that subject, this morning Professor Dixon criticised other models—for example, Murphy and others—because he said that they

overstated the change in investment. But, Dr Burn, you are saying that it was a starting assumption of Professor Dixon's that there would be no change in investment?

Dr Burn—In the December paper the level of domestic investment was assumed to be constant. I cannot comment on why Professor Dixon said what he said this morning. If he were using that assumption as a benchmark against which he was judging the Murphy model, the Melbourne Institute model, the Treasury model or any other model, that would explain his conclusion. But I do not want to presume that that was what was behind his comments this morning.

Senator O'CHEE—One of the criticisms—and I just want to get this clear in my head—you are making of Professor Dixon's model is that he misses many things that maybe he cannot mathematically describe. Is that the case?

Dr Burn—That is a very good way to put the limitations of models in general, and I would not confine that to Professor Dixon's. That is not meant to be a criticism of him; it is a reflection of the state of economic science. I think Dr Henry made that point in an earlier hearing.

Senator O'CHEE—And that is because when you are involved in economic modelling you create a series of equations which represent your assumptions, you assign numbers to what you think is a propensity to do something or the price of something and then you multiply all the numbers. But it is really as much a product of your assumptions as it is a product of your guesses as to what things are worth.

Dr Burn—That is a very good way to put it.

Senator O'CHEE—It follows from that that if you have not factored into your series of assumptions changes in compliance costs and greater efficiency for business then you cannot accurately describe everything that is going to happen in the economy. That is not a criticism of Professor Dixon; it is just a criticism of any model.

Dr Burn—I think that is right. I do not want to criticise modellers either, but there is a degree to which, in understandable self-interest terms, they perhaps understate the qualifications that they should link to the conclusions they put forward.

CHAIR—In Professor Dixon's case he said, 'Pay less attention to the numbers; pay more attention to the arguments as to how we arrived at these figures.'

Senator O'CHEE—If you are going to do that, you always have to look at the assumptions first, don't you.

Dr Burn—You have to look at the assumptions because they determine the limits. Any modeller will say, 'I am only interested in a portion of reality,' and one purpose of the assumptions is to carve out that portion of reality that they are interested in. The complexity of the interrelationships in what is outside or inside those assumptions is therefore not felt because of those assumptions.

CHAIR—Order! I think we are out of time.

Senator O'CHEE—Mr Chairman, according to my watch we have a couple of minutes.

CHAIR—A couple of minutes is fine; go for it. I just make the point that we are beginning to lose a quorum. I will not detract from your couple of minutes, Senator O'Chee, by intervening now and making this explanation, but I do think it would be the desire of the committee to invite the Business Coalition for Tax Reform back in phase 2—if they are willing to come—so this is not the last opportunity for questions.

Senator O'CHEE—One of the things that Professor Dixon did not address in any great detail is the black economy. He spoke about how big the black economy might be, because he said that he excluded 680 households out of the household expenditure survey because their spending level was unbelievable. Have you given any consideration to the size of the black economy and the effects of the tax package on the black economy—how it functions and so on?

Dr Burn—Yes, but we were very cautious about how we would treat the black economy because the black economy, by definition, does not appear in the statistics; it appears in gaps in the statistics. So it is very hard to get solid evidence that confirms what we all know happens through our day-to-day experience that does not fall out in that experience. I will not go into that. However, we made an estimate, what we thought was a conservative estimate, of the size of the black economy, then we halved it and we said, 'There is some extra revenue that would be obtained if measures could be designed to capture it.' This estimate was very much above the estimate that underlies the approach taken in 'A New Tax System' to estimating the size of the black economy.

The proposals in 'A New Tax System', however, are very likely to reveal to the tax authorities a sizeable portion of the cash economy. That is because of the nature of the GST and the proposal to link GST returns with income tax returns, the improved reporting requirements associated with the Australian business number proposal and the uniform nature of the proposed pay as you go system. Those factors combine to give good reason to think that there will be a degree of the black economy which is taxed under the proposals in 'A New Tax System' which currently fall through the net.

As to the size of that, as I say, the estimates in 'A New Tax System' were below the estimates that we came to through that conservative process I described. That experience is, as I understand it, consistent with the New Zealand experience. I have had some informal discussions with New Zealand Treasury officials, and their experience is that the introduction of a comprehensive goods and services tax and the mechanisms associated with that even in New Zealand exposed a much greater black economy than they have anticipated. Of course, the proposals in 'A New Tax System' go much beyond the proposals adopted in New Zealand because of the whole system of the integration of the income tax and the GST returns, the Australian business number proposal and so on.

CHAIR—I think that might be a point at which we can now pause. I thank the Business Coalition for Tax Reform for being available to the Senate committee today. I foreshadow that doubtless we would welcome you back for phase 2 of our inquiry. I invite members of

the committee, if they have any further questions, which I am sure they do, to place them on notice for you, if you would be kind enough to receive them and to answer them. Thank you again.

I adjourn the meeting to Sydney tomorrow morning. The public proceedings of this committee will commence at 9 o'clock, but I indicate to the committee that we will have a private meeting of the committee at 8.45 a.m.

Committee adjourned at 4.34 p.m.

