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State income taxes: The past and lessons for the future

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Looking Forward at 100 Years: Where Next for the Income Tax? 27-28 April 2015

Aim:

- describe key trends and features of Australian States' income taxes during the period 1915 to 1942, within the context of evolving Federal/State financial arrangements, and
- show how these State tax policies were related to Commonwealth income tax design in the post Uniform Income Tax era.
- consider the lessons for current income taxation and federal financial arrangements, in context of globalisation.

Australian income taxation, war and funding of social services



- The Commonwealth Income Tax of 1915 was a War Tax - introduced 100 years ago, amidst a sentiment of conscripting Capital alongside conscription of Labour
- In May 1942 the Uniform Tax reforms fundamentally changed the character of the Commonwealth income tax.
- What was its relation to States' income taxation?



Reflections on federal financial arrangements

“The federal government, having control of a revenue far greater than it needed for its own expenditures, would be exposed to the temptation of gaining cheap popularity in two ways: either by embarking on a policy of extravagant expenditure, or by an equally reckless remission of federal taxation”

(Robert Garran 1897, p. 164).



Sir Robert Randolph Garran GCMG KC (10 February 1867 – 11 January 1957)

*We thank you for the offer of a cow
But we can't milk and so we answer now
We answer in a loud resounding chorus
Please keep the cow and do the milking for us!*

Attributed to Sir Robert Garran 1951 regarding the prospect of income taxation being returned to the States

'States' dominance of income taxation

Table 4.1
Income Tax Share of Taxation 1901–1945

<i>Year ending June</i>	<i>Commonwealth income tax, percentage of total taxation</i>	<i>State income tax percentage of total taxation</i>	<i>Income tax, percentage of total taxation</i>
1901	0	6	6
1905	0	9	9
1910	0	8	8
1915	0	14	14
1920	27	11	38
1925	14	16	30
1930	12	16	28
1935	9	21	30
1940	11	23	34
1945	59	0	60

Source: Derived from Barnard 1985.

States' income taxation constrained by Commonwealth income taxation

Table 4.2
State Taxes on Incomes, 1919–20 to 1941–42
(£, 000)

<i>Year ending June</i>	<i>Income and dividend taxes</i>	<i>Other taxes on income^a</i>	<i>Total State taxes on income</i>
1920	9,413	-	9,413
1923	9,549	-	9,549
1924	10,294	-	10,294
1925	11,775	-	11,777
1926	12,969	-	12,969
1927	15,189	-	15,189
1928	15,192	1,013	16,204
1929	15,630	53	15,682
1930	15,052	1,887	16,939
1931	14,033	6,876	20,909
1932	9,288	9,608	17,966
1933	9,607	13,167	20,284
1934	8,772	10,434	18,207
1935	9,794	10,480	20,236
1936	11,508	12,039	23,475
1937	13,706	12,832	26,514
1938	16,391	13,347	29,725
1939	17,270	12,526	29,791
1940	19,035	14,416	33,450
1941	21,684	13,775	35,459
1942	32,881	3,990	36,870

Note: ^a Family Endowment Tax was counted by the Statistician in 'other taxes on income' until 1941–42; also includes unemployment relief, social services, special income and wages, financial emergency, State development and hospital taxes.

Source: Commonwealth Bureau of Census and Statistics, *Finance Statistics*, various years.

States' revenues insufficient for funding rising demand for social services

Table 4.3
Commonwealth and State Social Services, 1921–22 to 1940–41,
(£ '000)

<i>ending June</i>	<i>YearCwlth</i>	<i>NSW</i>	<i>Vic.</i>	<i>Qld.</i>	<i>SA</i>	<i>WA</i>	<i>Tas.</i>	<i>Total States</i>
1919	4,504	3,129	2,002	1,554	722	697	290	14,817
1921	12,369	5,819	2,828	2,234	989	862	471	27,493
1922	7,228	5,575	3,152	2,285	1,034	935	483	22,614
1923	6,593	5,286	3,288	2,142	1,020	954	463	21,669
1924	8,915	5,497	3,486	2,443	1,131	971	449	22,892
1925	8,689	5,701	3,851	2,205	1,243	1,008	484	23,181
1926	9,266	5,953	3,976	2,362	1,411	1,040	511	24,519
1927	10,477	6,089	4,271	2,173	1,617	1,087	494	26,208
1928	11,222	7,448	4,641	2,215	1,574	1,115	531	28,746
1929	12,459	9,543	4,649	2,589	1,659	1,171	562	32,632
1930	12,434	9,185	4,663	2,907	1,799	1,218	545	32,751
1931	12,497	7,649	5,460	2,681	2,225	1,526	539	32,577
1932	11,658	7,280	5,324	2,365	2,260	1,663	483	31,033
1933	12,248	15,704	6,633	2,442	1,981	1,326	478	40,812
1934	11,566	15,983	6,524	2,415	1,915	1,217	639	40,259
1935	12,368	15,031	6,821	2,617	1,812	1,224	767	40,640
1936	13,508	14,244	8,530	2,619	1,922	3,078	780	44,681
1937	14,702	13,258	7,941	2,747	1,891	2,914	893	44,346
1938	16,190	13,180	8,641	2,696	1,979	2,407	918	46,011
1939	16,424	12,727	7,946	3,701	2,170	2,523	995	46,486
1940	16,811	15,671	8,639	3,605	2,316	2,643	912	50,597
1941	17,729	16,130	7,321	3,583	2,268	2,405	884	50,320
1942	30,913	11,244	6,296	3,459	1,835	1,393	895	56,035
1943	36,586	10,918	6,474	3,218	1,833	1,621	861	61,511
1944	64,898	11,507	6,327	3,482	1,835	1,695	863	90,607
1945	66,703	12,185	7317	3,831	2610	1859	1061	95,566

Source: Barnard 1987.

Rate convergence due to tax competition

Table 4.4
State Income Taxes, Highest Marginal Rates

	1921	1933	1937
New South Wales	13	29	21
Victoria	3	12	8
Queensland	27	43	36
South Australia	11	26	21
Western Australia	45	22	22
Tasmania	7	13	35
Unweighted average	18	24	24
Standard deviation	16	12	10
Coefficient of variation	89	48	43

Sources: Royal Commission into Taxation 1922, pp. 89, 95; South Australia, Office of the Government Statist 1924; New South Wales, Office of the Government Statistician 1928; Victoria, Office of the Government Statistician 1926; Queensland, Government Statistician's Office, *ABC of Queensland Statistics* 1933; *Queensland Year Book* 1939.

Table 4.5
State Income Taxes, Highest Marginal Rates on Property Incomes

	1921 %	1933 %	1937 %
New South Wales	16	29	25
Victoria	6	18	14
Queensland	27	45	36
South Australia	14	28	24
Western Australia	45	22	22
Tasmania	7	15	35
Unweighted average	19	26	26
Standard deviation	15	11	8
Coefficient of variation	77	42	32

Sources: See Table 4.4.

Commonwealth-State Tax Conflict and Fiscal Crisis of the States 1920-1933



Financial Agreement of 1927 – Loan Council and Per Capita Payments, and Commonwealth Grants Commission

Fiscal policy responses to the Depression

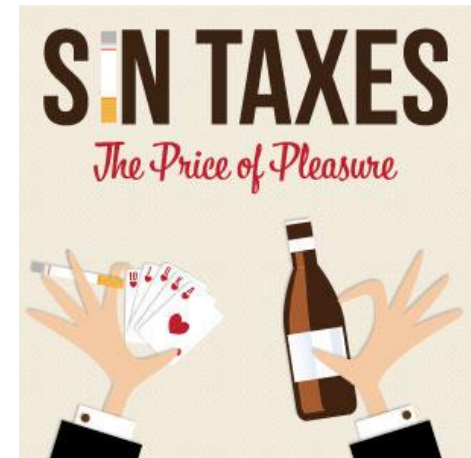
Benefit principle of taxation required that wage earners contribute to costs of unemployment relief

Commodity taxation of the lower incomes was preferred

- **allowed those of limited means to choose their level of tax contribution by directing consumption to untaxed necessities.**

HOWEVER ..

- **Constitutional constraints on States' excise taxes**
- **Commonwealth WST introduced to replace decline in customs revenues from 1929 as imports fell**
- **Several States seeking special assistance in 1933, WA threatening to leave the federation**



“The best taxes are such as are levied on consumptions, especially those on luxury; because such taxes are least felt by the people. They seem in some measure, voluntary; since a man may chuse how far he will use the commodity which is taxed. They are paid gradually, and unsensibly: They naturally produce sobriety and frugality if judiciously imposed: And being confounded with the natural price of the commodity, they are scarcely perceived by the consumers.”

Philosopher David Hume 1752

New regressive, earmarked income taxes to fund States' social services

Table 4.6
State Income Taxes Per Capita, 1926–27 to 1938–39
(£)

<i>Year ending June</i>	<i>Income and dividend taxes £ s d</i>	<i>Depression taxes^{a)} £ s d</i>	<i>Total State income taxes^{a)} £ s d</i>
1927	2/3/4	-	2/3/4
1920	2/6/11	0/5/11	2/12/10
1931	2/3/3	1/1/3	3/4/6
1932	1/8/6	1/9/6	2/18/-
1933	1/9/2	1/19/11	3/9/1
1934	1/6/5	1/11/5	2/17/10
1935	1/9/3	1/11/5	3/0/8
1936	1/14/2	1/15/9	3/9/11
1937	2/0/5	1/17/9	3/18/2
1938	2/7/10	1/19/-	4/6/10
1939	2/10/-	1/16/3	4/6/3

Note: ^a Includes Family Endowment Tax.

Source: Commonwealth Bureau of Census and Statistics, *Finance Bulletin*, various years.

Declining progressivity of States' ordinary income taxes ...

Table 4.7
Indices of Global Tax Progressivity, Victorian Ordinary Income Tax, 1917–18 to 1938–39 (taxable income)

<i>Year ending June</i>	<i>M-T</i>	<i>S</i>	<i>K</i>	<i>Average tax rate per cent</i>
1918	1.01	0.22	0.17	2
1919	1.01	0.22	0.14	2
1923	1.00	0.18	0.12	2
1924	1.00	0.20	0.10	3
1925	1.00	0.19	0.10	3
1926	1.00	0.19	0.10	3
1927	1.00	0.17	0.09	3
1928	1.00	0.17	0.10	3
1929	1.01	0.17	0.09	4
1931	1.01	0.16	0.09	4
1932	1.01	0.15	0.08	4
1933	1.00	0.15	0.08	4
1934	1.00	0.14	0.08	4
1935	1.00	0.14	0.08	4
1936	1.00	0.14	0.07	4
1937	1.00	0.14	0.07	4
1939	1.01	0.18	0.13	5

Source: Victoria, Office of the Government Statistician, *Victorian Year Book*, various years.

Table 4.8
Indices of Global Tax Progressivity, New South Wales Ordinary Income Tax, 1920–21 (taxable income)

<i>Year ending June</i>	<i>M-T</i>	<i>S</i>	<i>K</i>	<i>Average tax rate per cent</i>
1921	1.03	0.43	0.23	6

Source: New South Wales, Office of the Government Statistician 1925.

... declining progressivity

Table 4.9
Indices of Global Tax Progressivity, Queensland Ordinary Income Tax,
1917–18 to 1938–39^a

<i>Year ending June</i>	<i>M-T</i>	<i>S</i>	<i>K</i>	<i>Average tax rate per cent</i>
1924	1.01	0.30	0.07	9
1927	1.00	0.41	0.09	8
1932	1.00	0.42	0.04	6
1933	1.00	0.51	0.05	7
1935	1.02	0.49	0.19	8
1936	1.01	0.53	0.16	7
1937	1.01	0.54	0.16	8
1938	1.02	0.38	0.17	7
1939	1.02	0.37	0.18	7
1942	1.67	0.43	0.35	12

Note: ^aTaxable income in 1924, 1938 and 1939; net income in 1933, 1935, 1936 and 1937; gross income in 1927 and 1932.

Source: Queensland, Government Statistician's Office, *ABC of Australian and Queensland Statistics*, various years and *Queensland Year Book*, various years.

Table 4.10
Indices of Global Tax Progressivity, South Australian Ordinary Income Tax,
selected years 1918 to 1940^(taxable income)

<i>Year ending June</i>	<i>M-T</i>	<i>S</i>	<i>K</i>	<i>Average tax rate, per cent</i>
1926	1.01	0.29	0.16	4
1927	1.01	0.25	0.14	4
1928	1.01	0.23	0.14	4
1929	1.01	0.23	0.14	4
1920	1.01	0.22	0.13	5
1935	1.00	0.03	0.00	9
1940	1.01	0.07	0.04	8

Source: South Australia, Office of the Government Statist, various years.



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The Depression taxes on wages



- ❖ typically earmarked to fund unemployment relief and social services

- ❖ different incidence from the ordinary State income taxes



Taxing wage earners at source

- Closely associated with these changes in the nature of income tax from the early 1930s was the introduction of a new tax collection mechanism — ‘group schemes’ — for collecting income tax on wages at source
- Advent of the group schemes responded to the tax administration problems presented by the special Depression taxes.
- Taxation of wage earners at source not cost-effective because of the need for end-of-year-tax adjustments arising from the progressive Commonwealth income tax structure.

Progressive scales made taxing wage earners at source difficult

- A number of States experimented with various arrangements for collecting the special wage taxes
- Taxing wage earners at source through ordinary income taxation was led by poorest states with lower tax capacity
 - In 1930, South Australia was forced, ‘by the extraordinarily high rates of taxation imposed in that year’, to adopt a new method of tax administration, known as ‘group schemes
- Deduction of tax at a flat rate seen as unfair and undermining progressivity, because whatever withholding rate was adopted would be too high for some taxpayers and too low for others.

Wage earners taxed to pay for social services from 1944 via PAYE

- Diversity of state income tax scales made taxation of wage earners problematic at time of tax unification – WST used instead
- In 1944, the Commonwealth introduced a ‘Pay As You Earn’ (PAYE) scheme, which first applied for the 1944–45 income year .
 - Better suited to taxes such as the SA income tax, flat single rate over an exemption
- Heavier taxation of wage earners in the post war era was not feasible until the innovation of PAYE, and flatter, unified tax scales
 - Commonwealth income tax funded establishment of the National Welfare Fund which financed new social security measures such as unemployment benefit and widows pension (sole parents pension)

Benefit principle and earmarking of income tax gave it legitimacy

- The National Welfare Fund was earmarked to provide for child endowment, unemployment benefit and widows pension.
- A proportional social security contribution identified this earmarking until the early 1960s.
- Over subsequent decades, inflation, fiscal drag and growing tax avoidance reduced the legitimacy and progressivity of the Commonwealth income tax
 - Progressive redistribution came to be achieved mostly through expenditure side of the Budget
- Negotiations in the 1950s unsuccessful in returning income taxation to the States,
 - less affluent States were better off if the Commonwealth raised the income taxes, and provided social services on a uniform basis

- **Social services development from early 19th century and especially during the 1920s was increasingly constrained by limits on state (and federal) income taxation, resolved 1942 by unification of income taxation**
- **Australian income taxation started changing from a class tax to a mass tax during the depression, when state income taxes were introduced to finance social services. This principle was embedded in the postwar commonwealth income tax via the “social security contribution”.**
- **Tax progressivity shifted from progressive rates of income taxation, to a revenue raising role, assisted by PAYE which made income taxes less ‘voluntary’ for wage and salary earners.**
- **Indirect taxation has been viewed historically as the appropriate way to tax the working class because essentials were exempted from broad based indirect taxes eg the WST. (Luxuries taxed via excises)**
- **State income taxation was constrained by economic integration, an issue resolved by uniform taxation and fiscal equalisation**
- **‘Fiscal peace’ on distribution of the nation’s direct and indirect tax revenues was bought by institutionalising horizontal equalisation through CGC – states did not agree on return of income taxation in 1952 as had different economic interests in changing status quo – the glue that had prevented fractures in the fiscal federation was becoming more firmly set.**

Reflections on the past: Implications for the future





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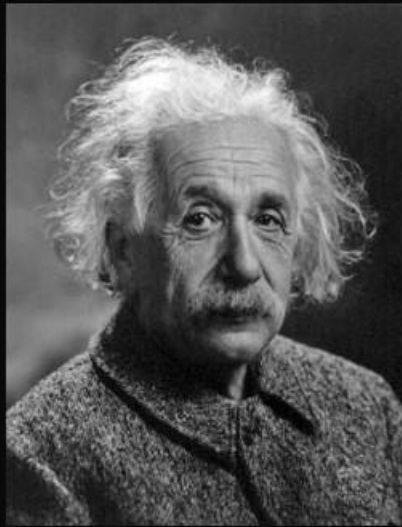
LESSONS



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Taxation and philosophy..



The hardest thing in the world to understand is
income taxes.

(Albert Einstein)

izquotes.com

Taxes are the price we pay for infrastructure and social services...

*“Revenue acts are not the acts of a hostile enemy of occupation.
They are the means by which the community maintains itself as a
community responding to the needs of its members”*

(Pedrick 1981, 134).

Inflation, transparency, tax inequity and legitimacy of taxation



Tax expenditures on superannuation cost \$40 billion a year. Super silly tax/expenditure priorities? ask Bernie Fraser!



The dynamics of tax compliance and morality

The honest taxpayer would willingly bear his fair share of the burden, but even he cannot concede his obligation to pay other men's taxes.

(Seligman Essays in Taxation, 1900, 31)

- ***'The lone honest taxpayer in a country of shirkers is a fool not a moral paragon'***

(Scholz 1994 21)

- ***If the Devil Himself had sent a representative here to institute a means of destroying the morality of the people, he could have found no better instrument than an income tax***

(1886, NSW Parliamentary Debates)

'Executing' income taxation... killing it or reforming it?

*Whoever hopes a faultless tax to see, hopes what ne'er was, or
is, or e'r shall be.*

(McCulloch, quoted in Groenewegen 1985b, 322).

*'The practical policy question is not so much whether a
tax is perfect, but whether it is less perfect than the
alternatives*

(Brennan 1977, 63)

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