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Taxation and the Comparative Advantage of Commodities

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1. Introduction

Reform of Commonwealth, State and local government taxes are high on many agendas as a key component of strategies to raise economic performance.[1] Among the many proposals, those involving rationalisation of the system of indirect taxation and of changing the tax mix are of interest to the capital intensive and export intensive agricultural and mining sectors. Proposals to rationalise current indirect taxes with their heavy emphasis on business inputs and their replacement with a broad based consumption tax would reduce the effective indirect tax rates on exports and on import substitutes. A tax mix change involving more taxation of expenditure and less on income effectively lowers the tax burden on capital intensive activities. The objective of this paper is to evaluate the first round and second round implications of the two forms of taxation reform on the comparative competitive advantage of the commodity sector In particular, it will be argued that the apparent large first round benefits of lower taxation of exports and of capital are largely eroded, and in some cases fully so, by second round price adjustments.

The paper analyses effects of the indirect tax rationalisation and tax mix change reform proposals on the comparative advantage of the export commodities under some common assumptions and under some alternative assumption scenarios. In all cases, the tax reforms are constrained to collect the current aggregate tax revenue, and thus the assessment is of the effects of changes in the composition of taxation. Comparative static, longer run assessments are made. The paper initially describes the impact or first round incidence effects of the reforms. It then allows for behavioural responses driven by economy wide resource availability, balance of payments and market clearing identities. For simplicity, Australia is assumed to be a small country or price taker in commodities and in capital,[2] and labour is

assumed to be geographically immobile. Both agriculture and mining are assumed to be relatively capital intensive and export intensive. Two scenarios representing different states or structures of the macroeconomy are evaluated. A base case is the full employment, flexible price, market clearing neoclassical model. A second set of scenarios allow for disequilibrium characteristics in the form of unemployment and rigidity of the nominal exchange rate and wage rate.

Subsequent stages of the paper are as follows. Section 2 describes the tax reforms in more detail, provides a simplified generic version of the various proposals, and indicates the initial or first round effects. In sections 3 and 4, the second round effects of the indirect tax rationalisation and tax mix change proposals, respectively, on the comparative advantage of the export and capital intensive commodity sectors relative to the rest of the economy are assessed under different scenarios of the macroeconomy. A final section draws implications of the analysis for the Australian economy in general and for the agricultural and mining sectors in particular.

2. Tax Reform Proposals

In 1994-95 Australian taxes yielded $136 billion, equivalent to 30% of national income. The Commonwealth dominates by collecting 76% of all taxes, then the States with 20% and Local governments under 4%. Direct or income taxes collected $75 billion or 55% of all tax revenue. A number of Commonwealth and State indirect taxes on expenditure collected $54 billion or 40% of all taxes.

Over recent decades there have been numerous proposals to reform the Australian tax system. These include official reports, for example Asprey (1975) and the Draft White Paper (1985), political manifestos, for example Fightback! (1991), and studies by academics, for example Head (1991) and Albon (1996). Reform proposals have been directed at each of the different income, expenditure and asset tax bases, at tax rate schedules, at the mix of taxes, and at administration.

Indirect Tax Rationalisation

There have been many proposals to replace most of the existing indirect taxes with an aggregate revenue neutral broad based consumption tax, including Asprey (1975), Draft White Paper (1985), Fightback! (1991), Freebairn (1993) and Productivity Commission

(1996). Particular proposals envisage use of a multistoge value added tax (VAT), or goods and service tax (GST), or a single stage retail sales tax (RST) to replace some or all of the wholesale sales tax, payroll tax, stamp duties, financial taxes and the general revenue raising components of the excise and franchise fees on petroleum, alcohol and tobacco products.

Current indirect taxes are characterised by narrow tax bases, a high initial incidence on business inputs rather than final consumption expenditure, high and variable tax rates, and complexity (Chisholm, 1993, Freebairn, 1993, and Albon, 1996).

For this paper the key criticism of current indirect taxation is the high initial incidence of the indirect taxes on business inputs. This is nearly 100% for payroll tax, 60% for the wholesale sales tax and the financial taxes, and nearly 50% for petroleum products excise and franchise fees and for motor vehicle taxes. Taxes on business inputs are passed on as higher costs for goods and services exported and for import competing products as well as to non-traded domestically consumed products. That is, the present indirect taxes are very much an origin base expenditure tax.

By contrast, reform proposals for a replacement broad based consumption tax, whether it be VAT, GST or RST, is a destination base expenditure tax. It falls on final consumption expenditure, whether of domestic production or import origin, and exports are tax exempt.

To appreciate differences in taxable sums with current indirect taxes and a replacement broad based consumption tax, as proposed with an indirect taxation rationalisation reform, it is useful to compare generic representations of a pure origin and pure destination tax. Given the GDP accounting identity, $GDP = A_d + A_m + X - M$, where A_d in aggregate expenditure (in terms of consumption, investment and government outlays) on domestic produced goods and services, A_m is aggregate expenditure on imported goods and services, X is exports and M is imports, the origins tax base, OTB, is given by

$$OTB = A_d + X \qquad (1)$$

and the destination tax base, DTB, is given by

$$DTB = A_d + M \qquad (2)$$

Then, the indirect tax rationalisation proposal, by shifting the tax base from (1) to (2), effectively would reduce the tax burden on exports, X, and increase it on imports, M.

If the indirect tax rationalisation reform is approximately revenue neutral, and given similarity of exports and imports of goods and services, the indirect tax burden on production sold domestically, A_d, will not change. Then, the first round or impact effect of a revenue

neutral replacement of most existing indirect taxes with a broad based consumption tax would be a fall in the indirect tax burden on exports and a rise in the indirect tax burden on imports, both absolutely and relatively to non-traded goods and services. This first round effect improves the competitive position of the agricultural and mining sectors with their reliance on export sales.

Effective indirect tax rates on Australian exports due to the business input taxing characteristic of those taxes are large and have been highlighted by Hughes (1989) and Dwyer and Larkin (1993). ABS estimate that all Commonwealth and State indirect taxes add 9.3% to the cost of exports.[5] More disaggregated industry level estimates for the wholesale sales tax by Chisholm (1993) find that around the national average there is considerable variation by industry. That is, effective indirect tax rates on exports are high and variable.

The initial or first round beneficial effects of an indirect tax rationalisation reform proposal on the export commodities is however just the beginning of a sequence of further economic adjustments. These are considered in Section 3 below.

Tax Mix Change

There have been a number of proposals to shift the tax mix away from income and onto expenditure. In the Draft White Paper (1985) Option C and in the Fightback! (1991) proposals, part of the revenue collected by a broad based consumption tax was to fund reductions in the aggregate level of income taxation. Alternatively, the present income tax, which is really a hybrid or mongrel taxation system when it comes to capital income (see, for example Albon, Findlay and Jones, 1983, and Pender and Ross, 1993), could be shifted more to a direct expenditure base tax as initially promoted by Meade (1978) and recently for Australia by FitzGerald (1993).

Changing the tax mix from income to expenditure effectively defers the taxation of income saved until some time in the future when it is spent. This in turn means a reduction in the effective tax burden borne by saving and investment, that is the income of capital. Aggregate tax revenue neutrality then means a tax mix change raises the effective tax burden on labour income spent on consumption.[6] Reductions in the statutory income tax rate associated with a tax mix change reform proposal indicate the order of reduction of the direct tax burden levied on capital income. However, because of the existing hybrid income tax

system and because of various exemptions and concessions, such as accelerated depreciation allowances, a more accurate measure would be changes in effective tax rates.

To the extent a tax mix change reduces the effective tax burden on capital and increases it on labour, such a reform proposal in its impact or first round effect favours the competitive advantage of capital intensive goods and services relative to labour intensive products. Since the export agricultural and mining sectors are capital intensive relative to other sectors of the economy it follows that a tax mix change initially favours these industries.

However, a tax mix change represents a policy shock which likely will set in train a number of second round adjustments. These second round effects are explored in Section 4 below.

3. Origin Vs Destination Tax Base Adjustments

The indirect tax rationalisation reform proposal to introduce a broad based consumption tax to replace most existing general revenue raising indirect taxes can be characterised as replacing an origin tax with a destination tax in terms of effects on export commodities. In equations (1) and (2) above the first round effect was to reduce the indirect tax burden on export products, increase it on imports, and leave it unchanged on non-traded goods and services. The resulting stimulus to net exports will initiate a number of second round responses to be assessed in this section.

A key relationship for evaluating the second round effects of shifting from an origin base to a destination base indirect tax is the balance of payments identity

$$CAD = M - X + NY = \Delta K = I - S \qquad (3)$$

where CAD is the current account deficit, M is imports, X is exports, NY is net foreign income transfers, ΔK is net foreign capital inflow, I is domestic investment and S is domestic saving. The import demand and export supply functions can be expressed in terms of domestic prices as

$$M = f(P_m^d),\ f^1 < 0 \qquad (4)$$

$$X = g(P_x^d),\ f^1 > 0 \qquad (5)$$

where P_m^d is the domestic price of landed imports and P_x^d is the return to producers from exports. These domestic prices in turn can be expressed in terms of the world price, P^w,

which under the small country simplifying assumption is constant, the effective indirect tax burdens on imports and exports, t_m and t_x, respectively, and the exchange rate, E, expressed as $A per unit of foreign currency, yielding

$$P_m^d = P^w (1 + t_m) E \quad (6)$$

$$P_x^d = P^w (1 - t_x) E \quad (7)$$

Formally, the substantive tax effect of an indirect tax rationalisation reform is to reduce t_x and increase t_m, with no change in the effective tax on non-traded goods and services. Using equations (3) through (7), the first round effect of the reform is to increase exports, including of agricultural and mineral commodities, reduce imports, and thereby improve the current account deficit.

A change in the current account position initiates subsequent adjustments. These responses will be influenced by assumptions about the general economy.

Flexible Price, Full Employment Scenario

Suppose initially, and as a benchmark, an economy of flexible prices, including for products, factors and the exchange rate, and full employment; essentially a long run neoclassical equilibrium.

The indirect tax rationalisation reform proposal is unlikely to influence the domestic net saving term, I - S, and the net foreign capital inflow term, ΔK, on the right hand side of the balance of payments identity (3). With full employment, no significant change in income, and no change in taxation involving saving, domestic saving, S, will remain unchanged. Initially the reform proposal increases prospective investment returns in the traded sector. However, at the same time the relative price move against the non-traded sector dulls incentives for investment in that sector. The opposing forces loosely offset each other. Thus, the I - S and ΔK terms in (3) are not affected by the reform proposals, yet the CAD = M - X - NY is reduced.

Improvement in the current account position, with no change in the net foreign capital flow, means an increased demand for $A. With a flexible exchange rate assumption, a currency appreciation will follow. Via equations (4) through (6), this second round effect reduces exports, increases imports, and accordingly causes the current account deficit to reverse.

Equilibrium will be reestablished when the exchange rate appreciation offsets the first round effects of the indirect tax rationalisation on net exports. In the simple case of a shift from a pure origin tax at a single rate to a pure destination tax at a single rate, and collecting the same revenue, the second round exchange rate adjustment will just offset the first round benefit of the tax change to exporters.

In reality the situation for Australian agricultural and mineral commodities is more complicated than the simple pure case just described. For example, imports already bear some indirect taxes, and the effective tax rates vary from one export commodity to another. Nonetheless, most of the apparent first round benefits of an indirect tax rationalisation reform for the export commodities would be offset by an induced compensating appreciation of the exchange rate.

Sticky Exchange Rate

An extreme case of a sticky nominal exchange rate is a fixed exchange rate. For argument, assume also a full employment equilibrium before the indirect tax rationalisation reform.

Changing from an origin base to a destination base indirect tax in the first instance raises domestic prices of traded products relative to these of non-traded products. Given the small country assumption and the fixed exchange rate assumption, traded product prices are exogenous. Then, the indirect tax rationalisation reform leads to increased demand for non-traded products and also for resources now employed in this sector. Against the constraint of full employment, both demand and supply forces work to increase non-traded prices and factor returns. Further, the increase in net exports will increase the monetary base, unless it is fully sterilised by the monetary authorities, to facilitate the stimulus to inflation.

Equilibrium would be restored when inflation achieves a real exchange rate appreciation to restore the initial relative prices in the traded and non traded sectors. Again, second round effects largely reverse the initial round impact benefits for the export commodities.

Unemployment

In the context of a starting point of unemployed resources, an indirect tax rationalisation reform might be assessed as a form of stimulus to aggregate demand with

exports rising, imports falling and no adverse effect on the non traded sector. The effects on net domestic saving are unclear. To the extent real income rises with increased employment, there would be some increase in saving, S. But also, the demand expansion likely will induce additional investment, I.

Second round inflationary pressures will be initiated by the indirect tax rationalisation reform. The net demand stimulus will lead to some additional inflation unless the aggregate supply curve is perfectly elastic. Reductions in unemployment almost always provide a net impetus to higher wage outcomes, and the moreso the steeper the Phillips curve. If, as seems likely, net exports increase more than any fall in net domestic savings, an increase in money supply, unless fully sterilised, will facilitate general inflationary outcomes. These second round inflationary pressures will offset some of the first round benefits of a shift from an origin base to a destination base indirect tax system on the export commodities. However, the offset is likely to be less, thus yielding a net gain for the export commodity producers.

4. Capital Vs Labour Tax Base Mix

A revenue neutral change in the tax mix to less reliance on income taxation with lower income tax rates and more taxation of expenditure means a decrease in the tax burden on capital and an increase in that on labour. Initially this means a net downwards shift of the supply curve for capital intensive products, including agriculture and mining, and an upwards shift of the supply curve for labour intensive products, including most non traded products.

Important economy wide constraints to understanding the second round effects of the tax mix change are the labour and capital resource supply functions and the balance of payments identity. Labour is assumed to be immobile, and generally it has a fairly low supply elasticity (Kenyon and Wooden, 1996). Australia is a net importer of capital. The domestic supply of savings is assumed to be a positive function of the after tax return on investment, that is the pre-tax return less the capital income effective tax rate. Australian demand for investment funds is a downward sloping function of the pre-tax cost of funds. These functions are important in their own right and also as determinants of the net demand for foreign savings, and foreign capital inflow terms of the balance of payments identity, $I - S = \Delta K$ in (3).

For purposes of simplicity, but also as a reasonable approximation to reality, Australia is assumed to be a small country capital importer. That is, the foreign capital supply curve is

almost perfectly elastic. Further, the required world after tax return sets the Australian return. In general, unless changes in Australian taxation of capital are fully reflected in changes in recognised and useable foreign tax credits, changes in Australian effective capital income tax rates will lead to changes in foreign investor required pre-tax returns.[8]

Formally, the capital market relationship can be represented in terms of pre tax returns and effective capital income tax rates as

$$S = f(r^d - t_c),\ f' > 0 \qquad (8)$$

$$I = f(r^d),\ f' < 0 \qquad (9)$$

$$r^d = r^* + t_c \qquad (10)$$

$$I - S = \Delta K > 0 \qquad (11)$$

where S is domestic saving, I is investment, r^d is the before tax domestic return, t_c is the capital tax rate, r^* is the required after tax foreign return, and ΔK is the net capital inflow, with (11) being the right hand terms of the balance of payments identity (3).

With this background we turn to assess the second round effects of a fall in the effective capital income tax rate, t_c, associated with a tax mix change on the economy and the capital intensive export commodities in particular. As for the assessment for indirect tax rationalisation reform, a number of different macroeconomy scenarios are considered.

Flexible Price, Full Employment Scenario

A tax mix change in the first round initially affects both the current account and the capital account sides of the balance of payments (3). The drop in the effective capital tax reduces the pre tax return required by foreign investors by the amount of the tax fall, via equation (10). Effectively, the foreign capital supply curve shifts downwards by the tax reduction. In turn, via the investment demand function (9), domestic investment rises. In the domestic savings function (8), the lower effective tax is offset by the fall in the pre tax return, and domestic savings change little, if at all. Net capital inflow therefore increases via (11).

Initially lower taxation of capital favours the capital intensive export commodities at the expense of labour intensive products. Whether Australian imports rise or fall depends. To the extent import substitutes are relatively labour intensive, and this seems to be the case, imports will rise. Also, the increase in GDP associated with the use of additional capital due to the net capital inflow increase noted above, and continued full employment (by

assumption) and a low labour supply elasticity, will increase imports. Overall, it seems likely the export increase will exceed the import increase resulting in a reduction of the current account deficit.

The increased net capital inflow, supported by the likely reduction of the current account deficit, increases the demand for $A and induces an appreciation of the exchange rate. This will affect adversely the traded sector, via the mechanisms shown in equations (4) through (7), including the export commodities, thus offsetting some of the apparent initial benefits of the tax mix change. The exchange rate will continue to appreciate until the increase in the current account deficit matches the increase in the net capital inflow, and balance of payments equilibria is restored.

While the second round offset effects of the currency appreciation reduce the first round beneficial effects of a tax mix change on the capital intensive export commodities, almost certainly the net outcome for these commodities is positive. The supply elasticities driving the output expansion in response to lower capital taxation is the same as that driving the negative response to the currency appreciation induced fall in output price. Also, the investment demand elasticity driving the increase in net capital inflow is closely related to the supply elasticity of the capital intensive industries. The real GDP increase with a more capital intensive economy means an overall positive sum game, and labour intensive activities in the traded sector are clear losers. A detailed empirical general equilibrium model would be required for more precise answers.

Sticky Exchange Rate

A sticky nominal exchange rate, with the extreme case of a fixed nominal rate, at first sight might sustain the gross first round gains for the capital intensive export commodities of a change in the tax mix which lowers the effective tax rate on capital. However, second round effects, particularly monetary supply increases, will provide a stimulus to higher inflation than otherwise and appreciation of the real exchange rate.

As described above, the first round effects of lower effective taxation of capital income is an increase in net foreign capital inflow and a likely reduction in the current account deficit. The net increase in foreign currency reserves will mean an increase in the Australian money base and money supply, unless the monetary authorities embark on a policy strategy of complete sterilisation. In turn, an increased money supply will in time lead to

higher prices given the starting full employment state. Against a fixed nominal exchange rate, higher wages and higher prices for non traded sector inputs used by the traded sector will squeeze profitability and increase the current account deficit. The process will continue until balance of payments equilibrium is restored.

That is, re-establishing equilibrium following a drop in the taxation of capital requires a real exchange rate appreciation to effect an increase in the current account deficit to match the increase in the net foreign capital inflow. The required real exchange rate appreciation can be achieved by a combination of nominal exchange rate increase and an increase in inflation.

Unemployment

Beginning with involuntary unemployment, the first round effects of a tax mix change on the aggregate employment level will be ambiguous depending on the relative sizes of scale and substitution effects. Lower effective taxation of capital income, with no change in domestic saving and an increase in foreign capital inflow, means an economy wide increase in investment and of the capital stock. A larger capital stock and associated national income provides a positive scale effect expansion to employment. But, the tax mix change with lower taxation of capital lowers the pre tax cost of capital. The tax change also increases the effective tax rate on labour leaving the pre tax labour cost constant at best, and more likely at a higher level if after tax wages are sticky. Resulting changes in the relative factor prices induce substitution of capital for labour in all sectors of the economy.

As for the previous scenarios, the tax mix change sets in motion pressures for a real currency appreciation. These pressures stem from the initial effect stimulus to an increased foreign capital inflow and to an increase in exports. If the tax mix change also leads to higher employment and real income, the initial effects will be partly modified, but not in full, by an increase in domestic saving and by more imports. The increased demand for $A exerts pressure for a currency appreciation and the increase in money supply facilitates a rise in inflation, both of which combine to affect a higher real exchange rate.

5. Implications and Conclusions

Calls for taxation reform in Australia are motivated for a number of reasons including neutrality, equity, simplicity and revenue sustainability. In addition to economy wide efficiency gains, particular sectors will gain from reforms if the tax burden is reduced either

on the sector output or on inputs it uses relatively intensively. To many in the export and capital intensive agricultural and mining sectors, proposals to rationalise the indirect tax system and to change the tax mix are seen as ways to improve the competitive position of these industries relative to overseas and relative to other sectors of the economy. An initial first round incidence effect of these areas of tax reform supports the conclusion of gains for the export commodities.

But, the economic or final incidence of tax reform seldom is the same as the legal or initial incidence. Second round effects are important in the case of reform proposals to rationalise the present indirect tax system with a broad based consumption tax and in the case of changing the tax mix to rely less on income taxation. In particular, these areas of reform set in motion forces leading to a real exchange rate appreciation. The second round effects are more clearly assessed for a simple neoclassical model of flexible prices and full employment, but they also occur in models with sticky prices and with unemployment.

Current indirect taxes on business inputs are estimated to raise costs of export products by about 9%. Replacing these indirect taxes with a consumption tax would remove most of the input taxes and represent a shift from an origin base tax to a destination base tax. The ensuring real exchange rate appreciation will offset most of the initial first round gains. That is, indirect taxation rationalisation reform will have a negligible long term effect on the comparative advantage of the export commodities.

A tax mix change involving lower income tax rates on capital favours capital intensive sectors, including the mining and agricultural sectors. But, the initial first round effects will be partly eroded by a real currency appreciation required to accommodate the associated increase in net foreign capital inflow. Detailed quantitative general equilibrium models will be required to estimate the magnitude of the net competitive gains.

ENDNOTES

[1] See, for example, Productivity Commission (1996), and the October 1996 unofficial Taxation Summit jointly organised by the welfare group ACOSS and the business organisation ACCI.

[2] The small country assumption for export commodities is at variance with reality, and in particular for wool, alumina and mineral sands. Except for terms of trade effects on magnitudes, relaxing the assumption does not affect the general character of the results. While the supply curve of capital to Australia is not infinitely elastic, and there is debate about the elasticity, it likely is large (see, for example, Industry Commission, 1992).

[3] While mining clearly is capital intensive, the case of agriculture is less clear. ABS data on the capital stock of equipment and non-dwelling construction by industry (catalogue 5221.0) and an employment by industry (catalogue 6204.0) give capital stock per worker numbers for 1993 of $504, 378 for mining, $70, 024 for agriculture, $76, 064 for manufacturing and $92, 064 for the economy. The addition of livestock and improvements would add to the capital stock of the agricultural sector and bring its capital intensity above the economy average.

[4] Since some existing indirect taxes, particularly the wholesale sales tax, fall on imports, this effect is exaggerated by use of the generic model, but not in the case of the payroll and other taxes.

[5] Catalogue No. 5209.0, p.63.

[6] For a detailed discussion of the formal similarity of tax incidence of a consumption tax and of a tax on labour see Samuelson (1966) and Bascand (1989).

[7] The net income term, NY, is assumed to be unaffected by the changes analysed as a reasonable approximation.

[8] This style of model is in the Australian international tax analysis studies of Findlay (1986) and Bruce (1992). Brean (1993) argues that almost all of changes in host country effective tax burdens will change the investor country after tax returns because of the dominance of direct equity investment, of which much is reinvested, restrictions on tax credits, and the observation that net overseas lenders collect little tax on overseas investments.

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