Taxation and the Labour Market

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Introduction

The last two decades has seen significant changes in the relationship between labour market institutions and taxation regimes. The traditional relationship between tariff systems and arbitration on the one hand, and arbitration and a 'residualist' approach to social welfare on the other, has given way to a view of labour market regulation and taxation regimes as potential substitutes in the pursuit of efficiency and equity goals.

A particularly relevant recent example of this new relationship occurred during the Accord negotiations on quarantining the inflationary effects of the large depreciation of the Australian dollar after its deregulation in 1983. An explicit deal was struck to maintain the real value of wages, in the face of rising import prices, by trading off wage increases for falls in income tax. In this way, after tax income remained relatively unaffected, and the inflationary consequences of the depreciation were held in check.

The explicit strategic linkage between policy areas appeared to have been downplayed following the election of the Howard government in 1996, as market-based regulation became the prevailing ideology in policy debates. As the three contributions to this symposium demonstrate, however, the linkage between taxation, social welfare policies and labour policies and outcomes are being reshaped and continue to play a major role in policy debates. The purpose of this introduction to the symposium is to canvass a broad range of policy considerations which effect the nature of the link between taxation and outcomes, and their implications for both appropriate taxation policy and appropriate labour market regulation. While it is clear that the traditional rationales for existing institutional arrangements have been bought into question by a number of economic developments, it is not clear, we suggest, that the prevailing views about the

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appropriate linkages are justified. We therefore seek to broaden the debate and help develop an agenda for future research which takes account of a number of important relationships between the various policy areas. Given its importance, it seems appropriate to begin with a consideration of changes to the current taxation regime.

Current changes in taxation policy

The traditional taxation regime relied principally on the taxation of income sources (wages, non-wage income and profits) in conjunction with a secondary system of tariff protection and an *ad hoc* regime of sales tax. The introduction of a broad based consumption tax (the Goods and Services Tax or GST) in July 2000, represents a shift away from the traditional reliance on tax on forms of income as the main source of revenue for the Commonwealth Government. As such, it represents a significant broadening of the government's revenue base, with the importance of the potential growth in revenue this represents for future fiscal policy being a major consideration in its adoption.

This has not been the only challenge to traditional forms of labour market regulation. Changes in tax structure have been accompanied by changes in tariff arrangements. Commencing with the 25 percent across the board cut in tariffs in July 1973, the general level of tariff protection to Australian industry has experienced a long term decline (see Glazer 1982). The effects of this on the structure of the labour market and the efficacy of traditional labour market regulation have been enormous. The decline in tariff protection has, for manufacturing in particular, been associated with a long-term decline of that sector, and a rise of service-based industry. While tariff cuts have not been solely responsible for this general development, it has nonetheless been an important contributing factor. The implications of this shift have been considerable: for the structure of the economy and of employment, for the typical forms of employment offered by employers and so on. The long-term effects of this have been to weaken traditional forms of labour market regulation. This is so for two reasons. To begin with, it has served to undermine the traditional link between arbitration and tariffs, in which employer acceptance of arbitration and award regulation rested on tariff protection (see Plowman 1992). In addition, as the structure of employment – and more importantly the types of employment – have changed, the efficacy of traditional award regulation, which assumed most workers were employed in standard forms of employment (see ACIRRT 1999), has inevitably been undermined. As Buchanan and Allen suggest in their contribution to this symposium, this has in part been due to a less formal and (perhaps) unintended linkage between labour markets and taxation through the incentives which current taxation arrangements provide for individuals and firms to employ non-standard forms of employment (such as sub-contracting arrangements) to avoid tax obligations. Whether such incentives will continue to under the GST regime remains to be seen.

In addition to these developments, there has been a growing perception that tax arrangements can be employed to more effectively pursue equity goals attached to traditional forms of labour market regulation (particularly wage regulation and collective bargaining). The rationale being that labour market regulation has perverse effects and is a blunt instrument in dealing with low-wage workers for a number of reasons. It is often argued that minimum wage regulation is unable to effectively target those individuals in low-income households who require assistance in order to avoid poverty. In addition, it is often argued that such interventions are likely to adversely affect the very groups they were intended to assist, namely low wage workers, through their employment effects. This view rests on the assumption that the wage elasticity of demand for labour is relatively high for low-skilled, low wage groups, and that a minimum wage induced higher reservation wage adversely effects the incentives for marginal workers to search for employment. The validity of these arguments is a theme explored in more detail by both Barbara and Gahan and Ingles and Oliver in their contributions to this symposium. In both contributions a range of issues are raised which suggest this prevailing view is not without its problems.

Taxation and Employment

Any substantial change in the tax regime, such as the one being implemented in Australia on 1 July 2000, can be expected to have a substantial impact on the level and composition of employment. With respect to the level of employment, the effects of the tax will be felt both through its impact on the aggregate level of domestic output, as well as through its effects on the way in which that output is produced.

The likely effect on output is unclear. As is discussed below, the change of tax regime will introduce adjustment costs to the economy. The burden of these costs may lead to some fall in the level of economic activity. In any case, due to the likely impact of the GST on the inflation rate, it is reasonable to assume that it will lead to tightening of monetary and fiscal policy so as to reduce inflationary pressures. So, at least in the short term, the new tax regime may lead to some job loss, due to a fall in domestically produced output.

The effect on the manner of production of that output is more ambiguous. Clearly, any change in the relative price of labour compared to that of capital is likely to change the way in which output is produced. The current emphasis of state taxation on the payroll tax is an example of taxation policy which, by increasing the costs of hiring and utilising labour, provides a disincentive to employment. To the extent that the implementation of the GST allows the rolling back of the payroll tax and other taxes on labour, its likely impact will be to increase the labour used to produce a given level of output by making that labour relatively cheaper.

In terms of the composition of employment, the main influence of the tax changes will be through their impact on relative prices. As is known, some goods, particularly those which previously had wholesale taxes paid on them, will fall in prices, while others will rise. The effects of these price changes will lead to further changes in the structure of output, and therefore of employment. Of course, transition costs will arise, both those involved in the movement of capital between sectors and in the movement of labour. In both cases, rigidities relating to the fixidity of capital and the non-transferability of labour skills means that there will be substantial costs to the economy.

There is little evidence that the new tax regime will have any significant effect on efficiency, as there is no evidence, either theoretical or empirical that it is likely to do so. Its long run effects are mainly likely to be on equity and on the ability of government to increase their tax base. In other words, their likely impact on the economy is of a very small order, if at all significant. However, this is not to say that they will have no impact on the short run. As has been noted, in the initial stages, there will be a substantial compliance cost to the economy of changing the basis on which tax is raised. This will impose large costs onto business, especially small business. It is this transition costs, not to mention its inflationary potential, which will lead to significant problems. It is in the transition that the main costs of the tax will be felt. This indicates that the ideal timing for such a major change to the economy would be during a boom period, where substantial growth and investment would allow the burden of the change to be gradually absorbed into an expanding economy. Unfortunately, the indicators are that the tax will be introduced into an economy which is just about to enter the recessionary stage of its cycle. In other words, the timing of the move leaves much to be desired, as the move is likely to lead to a severe dampening of a already downward trending cycle.

GST and Prices

According to the traditional neo-classical assessment, the imposition of a GST should lead to the burden of tax being spread on both producers and consumers. The impact on cost will depend on the elasticity of both the demand and supply. A consumption tax will shift the supply curve, but its final impact on prices and quantities will be dependent on the responsiveness of consumers and producers to the resultant price changes. However, except for the limiting case where the demand curve is totally inelastic (vertical) the theory tells us that the full impact of the tax should not be passed onto the consumer in higher prices, i.e. the producer should bear some of the cost. This contrasts with the non-neoclassical theories, where price is not determined by demand and supply, but rather as a mark up on costs, with demand determining the level of output. According to these theories, the GST will be treated either directly as a cost of production, or indirectly and will be incorporated into the mark up. In either case, we would expect the full value of the tax to be passed onto the consumer in the form of price rises. Interestingly, all of the discussion around the current proposals, by economists, media commentators, politicians, and by business and labour lobby groups have explicitly assumed the latter case. In other words, they have assumed that the full effect of the GST will be passed on, in the form of price increases, except for those goods which either previously had some form of wholesale tax, which will now be removed; or which used inputs which were subject to that tax. This is likely to fuel the inflationary effects of the tax, leading to stronger contractionary economic policy, with the level of unemployment increasing as a result.

Taxation and Globalization

The globalization literature also poses a number of important questions for labour market regulation and taxation linkages. Most important have been the effects of taxation on direct foreign investment, most notably on the incentives to invest in specific countries. This linkage is thought to work in two ways. First through firms seeking taxation concessions and initiating a auction between countries willing to provide low tax regimes to encourage investment. And second through the supposed effects on the costs of employing labour. Yet the evidence of these relationships is piecemeal and ambiguous. Potentially taxation arrangements may have countervailing effects on such incentives by influencing both costs, incentives to use capital intensive forms of production and on the productivity of labour. When taken in conjunction with a broader policy of labour market deregulation, it is not clear that these policy directions produce desirable labour market outcomes or efficient outcomes more generally. This is one area, while not explored systematically in this symposium, that is in dire need of systematic research effort.

The arguments canvassed here tie into some broader debates concerning globalization and labour markets. It is often asserted that globalization implies that labour market regulations become more costly and from the perspective of the capacities of nation states, less effective mechanisms to achieve efficiency and equity goals. This rests on two general assumptions about the process of globalization. The most important is that this transformation can be equated with increased competition, such that both product markets and labour markets are gradually converging with the ideal of the perfectly competitive market. This in turn has diminished the capacity of the nation-state to regulate such matters to pursue equity and efficiency. These assumptions, however, seems at odds with the concomitant trend towards market domination by a large international firms. If anything, it could be argued that these developments have accentuated assymetries and power imbalances in many markets, including labour markets. This, in turn, may suggest a growing need for regulation and coordination of regulatory regimes between countries. Moreover, there is some international evidence to suggest that exposure to world markets, particularly for small economies such as Australia, require a strong relationships between labour market regulation, welfare regimes and taxation policy to produce an environment for both capital accumulation and human capital development (see Gahan and Harcourt 1999 for a more detailed discussion). Once again the need for systematic research here to confirm existing research and understand the effects of different labour market regimes require substantial work.

Conclusions

In this brief introduction to the symposium, our aim was to highlight some of the key issues which tie together the three policy areas of labour market regulation, social welfare policy and taxation. These linkages are of both historical and contemporary importance. This symposium has been motivated by the observation that these linkages are now in the process of being recast. This is due to the changing nature of labour markets, perceptions of the inefficiency of traditional forms of taxation, changes to the existing tax regime and due to the changing environment in which these policies must pursue policy objectives of efficiency and equity. Contrary to the directions of a great deal of research in economics and to a lesser extent industrial relations, which has taken the view that political economy concerns and institutions are less relevant, this introduction asserts that the political economy approach is likely to provide more insights into the changing nature of the relationship between taxation, welfare and labour market regulations. We must conclude that there remains a great deal of research to be done.

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