

## Sydney Conference Honors Memory Of Richard Musgrave

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**R**ichard Musgrave, who died in January 2007, was a towering figure in public finance in the second half of the 20th century, defining the field with his landmark book, *The Theory of Public Finance*. In early June of this year, tax specialists from the four corners of the world gathered in Sydney to honor Musgrave and to continue his feisty search for answers to the many economic questions facing governments today. The conference was actually two subconferences rolled into one, the first dealing with basic issues in the design of a redistributive tax system and the second dealing with the taxation of risky investments.

The Sydney conference honoring Musgrave was the brainchild of John Head, professor emeritus at Monash University in Melbourne. Head, a leading public finance economist in his own right and a Musgravian to the core, had promoted a series of tax conferences in the 1980s and 1990s that played a major role in the development of Australian tax policy. Musgrave had participated in two of those conferences, including the first one. Reflecting the Musgravian view that tax policy is best made through collaboration of individuals from several disciplines and professions, the conference featured scholars from economics, law, and accounting, and tax officials from the Australian Treasury and New Zealand's Treasury and Inland Revenue Departments. It was sponsored by the Taxation Law and Policy Research Institute at Monash University.

Rick Krever, a law professor at Monash, took the laboring oar in managing the conference, with contributions from John Freebairn, an economist at the University of Melbourne. Peggy Musgrave, a highly regarded economist specializing in international issues, opened both subconferences, providing insights from her five decades of collaboration with her husband. As with their prior conferences, Head and Krever expect to edit and publish the conference papers.

The timing of the conference could not have been more fortuitous, as Australia's new Labor government has recently announced a plan to review existing tax arrangements in Australia. An issues statement from Treasury is due out in mid-October.

### Musgrave the Tax Reformer

The first day of the conference looked at the overall design of a redistributive tax system. Head opened the discussion with an essay (coauthored with Krever) on the Musgravian perspective on tax reform. Musgrave, it must be remembered, was not only a leading tax theorist but also a practical reformer, having headed tax reform missions to Bolivia, Burma, Chile, Colombia, Puerto Rico, South Korea, and Taiwan. He also contributed extensively to tax reform debates in the more industrialized world, particularly in the United States.

Musgrave did not view developing and emerging countries as potential laboratories for testing untried tax measures out of step with the practices of the leading industrial countries. Instead, his advice was to adapt for local conditions the tax measures, such as an income tax, that had proven successful in countries with a proven track record in achieving economic progress. He also rejected the claim that regressive taxation is a condition for growth. In this respect, he anticipated current research showing that a fair distribution of income provides a fertile ground for economic development.

### Income vs. Consumption

Following the Head presentation, Alan Auerbach, a professor of economics at Berkeley, gave a fair-minded summary of the efficiency case, made through idealized econometric models, for preferring a graduated and personal consumption tax over an income tax. He suggested that a consumption tax could be as progressive over most of the income range as an income tax if

sufficiently high tax rates were used. Auerbach acknowledged, however, that the consumption tax was steeply regressive at the highest income levels. In a later paper, Professor Neil Brooks of Osgoode Hall Law School presented evidence showing that income inequality at the top of the income band is increasing at an alarming rate in the United States after falling precipitously from the introduction of the income tax in 1913 until the Reagan tax cuts of the early 1980s. That same pattern is being repeated in many other countries.

The Auerbach presentation was followed by a defense of the income tax, delivered by Jane Gravelle, a senior tax analyst at the Congressional Research Service. She noted that much of the efficiency gains attributed to a consumption tax comes from the tax it would impose on previously saved income — in effect, a double tax on “old” savings. As one commentator noted, the same benefit could be achieved with an income tax through an explicit double tax, although the politics of imposing that double tax in a transparent way would doom it, due to the likely attacks on grounds of fairness and administrative complexity. Removing the double tax on “old” savings would create intractable administrative problems under a consumption tax.

Gravelle asserted that the chances are infinitesimal that any of the Western democracies actually would replace their income tax with a consumption tax in the next several decades. She suggested that additional modeling of a consumption tax may be a waste of time. Indeed, as Auerbach noted, the one effort at presenting a graduated consumption tax for consideration by the U.S. Congress — the so-called USA tax — was a political disaster. This “disaster” was due to its apparent complexity and its regressive distributional effects at high income levels. A commentator suggested that the practical effect of the consumption tax literature has been decidedly negative, giving political cover, for example, to those arguing for tax cuts for the rich.

Musgrave found the equity arguments made on behalf of a consumption tax “strange.” Auerbach suggested that most economists today would not find those arguments strange at all. One wonders why. Under a consumption tax, a rich person earning more than he can spend is allowed to shelter the saved portion of his income from taxation. At the same time, individuals facing hard times are taxable not only on the meager amount of savings they draw down to pay their bills but also on the proceeds of loans incurred for that purpose. Similarly, parents taking out loans to pay for the college expenses of their children would become taxable on their loan proceeds. Some consumption tax advocates, not insensitive to the unfairness of taxing loan proceeds at the time of the loan, have suggested that a consumption tax system could tax loan proceeds indirectly over time by denying taxpayers a deduction for interest payments. Those advo-

cates apparently are unaware that a normatively correct consumption tax already would deny taxpayers a deduction for interest paid on loans used to finance consumption.

## New Zealand and the VAT

With the nearly obligatory debate over consumption and income taxes out of the way, the conference turned toward more practical issues. David White presented his much-anticipated report on New Zealand’s tax reform. New Zealand is famous among tax reformers for several bold initiatives. One of those initiatives was the taxation of multinational companies on an accrual basis, without allowing the companies to defer tax on income earned through their foreign affiliates. The New Zealand experiment demonstrated, first of all, that accrual taxation of foreign earnings is practical, fair, and efficient. It also demonstrated the difficulty of preserving major reform when it is opposed aggressively by the business community and is out of step with the tax regimes of a country’s major trading partners.

### **The New Zealand experiment demonstrated that accrual taxation of foreign earnings is practical, fair, and efficient.**

White, formerly with the New Zealand Treasury and now a professor at Victoria University in Wellington, also discussed the reasons for New Zealand’s success in adopting and maintaining a VAT with the world’s broadest base. As one commentator noted, the New Zealand VAT also has the world’s highest effective tax rate (12.5 percent), although many countries have higher rates on particular goods and services. A key to New Zealand’s success, according to White, was the prompt compensation the government provided to all major groups to offset the regressive nature of the VAT. The other key was the transparent way in which the VAT was adopted.

The proper role of a VAT as part of the tax mix was addressed at various points during the conference. Reuven Avi-Yonah, a professor of law at the University of Michigan, argued in favor of the introduction of a VAT in the United States. He observed that most of the people proposing a consumption tax in the United States want to substitute it for other taxes, primarily the redistributive taxes on personal and corporate income. Avi-Yonah recommends that the United States follow the worldwide model of making the VAT a supplement to the income tax.

Acknowledging that a VAT is regressive and does nothing to address the growing problem of income inequality, Avi-Yonah argued eloquently for maintaining and strengthening the income tax. He would use VAT revenues primarily to fund the exploding costs of healthcare. Avi-Yonah acknowledged the political difficulties that would arise if the federal government were to poach on a tax base traditionally reserved to the U.S. states, but he suggested that Canada's experience with its goods and services tax offers some reason for optimism that those difficulties can be overcome.

### Other Issues

Various other topics were addressed during the conference. Australian economists Geoffrey Brennan (Australian National University) and Michael Brook (University of Tasmania) provided a public choice perspective on tax reform. Michael Devereux, an economics professor at Oxford, gave a fascinating presentation on the taxation of foreign income. He also spoke on the taxation of income from risky investments. Kim Brooks, a law professor at McGill University, gave a paper on international equity, building on a seminal paper written by Peggy and Richard Musgrave on that same topic. Neil Warren, an economics professor at the University of New South Wales and the director of the Australian School of Taxation, discussed his extensive but inconclusive efforts at determining the distributional effects of various consumption taxes. Chris Evans, a professor of taxation at the Australian School of Taxation, gave an overview of various strategies that might be employed by governments to control tax evasion and avoidance.

I presented a paper on the reasons for applying the same quarantining or capitalization rules to interest deductions that are routinely applied to other types of rental payments in a tax on realized income. I stressed the importance of that quarantining in combating tax shelter abuses and in limiting the unfairness and inefficiency resulting from the deferral of tax on income earned by multinational companies through their foreign affiliates. Drawing an analogy from inventory accounting, which is itself a quarantining mechanism, I noted that the fungibility of money simplifies the tracing required for quarantining and does not complicate it as some commentators have asserted.

Patricia Apps, a professor of public economics at the University of Sydney, gave an eye-opening presentation concerning the high marginal taxes paid by some married women as a result of tax changes introduced in Australia by the conservative Howard government. Taking a comparative approach, she showed that the marginal rates on married women in Australia's separate filing regime were considerably higher than those in the United States, which uses a joint filing rule, and in separate filing Sweden. Australia's high

rates result primarily from its unorthodox phaseout of various benefits provided to low- and moderate-income households.

Malcolm Gammie, a U.K. barrister and visiting professor at the London School of Economics, gave a review of the activities of the Mirrlees Committee, of which he is a member. That committee is following in the footsteps of the Meade Committee, which published a famous report on U.K. tax reform in 1978.

### Global Warming

Addressing what some commentators view as the major moral issue of our age, John Freebairn discussed the possible use of tax measures to reduce the impact of greenhouse gas emissions on global warming. He argued that various types of carbon taxes have some advantages over the use of tradable pollution permits. Tradable permits have been enshrined in the Kyoto Protocol and are favored by the European Union. He argued against the free distribution of pollution permits to existing polluters, as seems to be favored in Europe and, of course, by the major polluters.

One commentator on the Freebairn paper noted that Europe favors tradable pollution permits on political grounds — tax measures, such as carbon taxes, require the unanimous agreement of all EU member states, whereas regulatory measures having similar effects require only a weighted majority for approval. Another commentator suggested that a combination of regulatory measures and taxes might provide some political flexibility, which may be needed to overcome the serious political obstacles to a worldwide agreement on control of greenhouse gases. A third commentator noted that the public choice literature offers little reason for believing that countries will escape the prisoner's dilemma that results from the fact that emission of greenhouse gases is advantageous to individual countries and is catastrophic for countries collectively. A fourth commentator described global warming as the greatest market failure in world history.

### Tax Treatment of Losses

A conference honoring the memory of Richard Musgrave would be incomplete without hearing about tax reform from the perspective of government tax professionals working to implement actual reforms. The government perspective was provided by Shane Johnson and Thomas Abhayaratna of the Australian Department of Treasury. They discussed in appropriate detail the theoretical and practical issues that arise in providing taxpayers with a refundable deduction for losses.

As a commentator on the Johnson-Abhayaratna paper noted, a major problem in allowing loss offsets is that most losses appearing on a tax return are not the result of risky investments gone sour. Many of those losses are merely accounting losses, resulting from the

improper expensing of capital costs or from the rigidity of the annual accounting requirement. Others are the result of tax shelter abuses, and still others are the result of the incompetence or rent-seeking activities of the entrepreneur. The presenters noted that alternatives to full offsets, such as loss carryovers, may present inefficiencies of their own.

In a famous paper written in 1944, Musgrave (with coauthor Evsey Domar) made a case for full tax offsets for losses resulting from risky investments. The Domar-Musgrave hypothesis has been elaborated on by later commentators and is widely accepted as valid under certain defined circumstances. The hypothesis has received attention recently as a result of the claim by Louis Kaplow and others that a Haig-Simons income tax cannot raise any revenue from the gains from risky investments. That claim is based on a series of counterfactual assumptions, the most notable of which is that governments would eliminate their risk of loss from an uncertain Haig-Simons income tax through hedging arrangements.

Auerbach gave a dispassionate overview of the Domar-Musgrave hypothesis and its current variations, suggesting that the assumptions underlying the variations do not always hold and summarizing evidence that the violations are significant. Presentations by

Head and Gravelle followed. Gravelle noted that no government in the history of the world has ever engaged in the hedging activities that Kaplow assumed. A commentator observed that a government generally would be acting irrationally if it were to do so. Head called the Kaplow variation a “caricature” of Domar-Musgrave. In his paper on the VAT, Avi-Yonah cited several recent tax articles that have poked holes in the Kaplow variation. In brief, the Kaplow variation received the feisty response appropriate for a conference honoring Richard Musgrave.

Having attended and presented at four previous conferences organized by Head and Kreyer, I was not at all surprised at the energy emanating from the conference hall and from the many delightful sidebars when tax policy matters were addressed informally. In deciding whether to attend an Australian conference, overseas visitors always have to weigh the potential benefits of the conference against the annoyance of the cross-Pacific flight — an annoyance that is not lessened even a little by repetition. After the fact, I can affirm that the balance tipped in favor of the conference by a considerable margin. In a word, the conference was electrifying. It was a fitting tribute to a great man and a reminder of his salubrious and much-missed influence on public finance. ◆