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**Institutions and Factor Endowments: Income Taxation in
Argentina and Australia**

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‘there is a lack of agreement between those that determine public expenditure and those that pay for it. The State undertakes commitments ... and taxation isn’t always concomitant with the magnitude and quantity of plans assumed by the State.’ (Peire 1959), p.37

‘In sum, it is the LACK OF SOLIDARITY between the taxpayer and the treasury that is the cause of evasion. Without that indispensable bond, without an acceptance, not formal but REAL of joint responsibility, it will not be possible to tackle those actions needed to achieve the common good.’ [Emphases from original] (Peire 1959), p.41

‘For some time an apparently inexplicable transformation has been occurring in the general moral climate of the country [Argentina] ... in a single word, dissatisfaction.’ (López 1957), p.47

‘In Argentina legal and illegal tax evasion arose with extraordinary force with the beginning of the political war against the economy.’ (López 1957), p.54

‘The Argentine tax system has been managed regressively from a social point of view. Income tax, instead of continuing its growth as it has in the most advanced countries, has been declining in Argentina, and regressive forms of consumption tax have been increasing. Argentina is following the opposite evolution followed by those countries advancing most quickly in economic and social terms.’ (Prebisch 1956), p.19

Why compare Income Taxation in Argentina and Australia?

The comparison of income taxation in Argentina and Australia is part of a larger thesis interested in the big question of what determines development. Both Argentina and Australia were settler economies with seemingly similar prospects for development, but after rapid convergence in the late nineteenth and early twentieth centuries, there was clear divergence from the mid twentieth century. This paradox of similar environments for development and starkly different outcomes once attracted much attention. It holds the promise of getting beyond deterministic explanations of development such as factor endowments and geography, as Argentina was far better positioned in these terms than Australia. Argentine institutions ultimately failed to generate the compromises required for development, entering a ‘latent civil war’¹ from the 1930s onwards, one that hopefully exhausted itself in the early 1980s. In the Argentine-Australian comparison, the construction of the state and its credibility explains much of their divergence. Argentina and Australia took different development paths due to their differing institutional environments. Their example could clarify the more fundamental reasons for development elsewhere.

Argentina and Australia shared the external environment of developing on the periphery of the world market with similar opportunities determined by their underlying wealth in land. Australia transformed its limited factor endowments into development from the early nineteenth century. Argentina did not until much later in the nineteenth century, despite its evidently more abundant endowments. Commodity export opportunities were the main development paths taken by each and were highly successful. Despite Argentina’s late start, it caught up with the wealthiest 12 European countries in terms of GDP per capita by the turn of the twentieth century, and was nearing the leading ‘western offshoots’ of Australia, New Zealand, the USA, and Canada.² It reached its peak in the late 1920s, when it exceeded or rivalled European GDPs per capita and was almost at a par with Australia. Relative failure set in some time thereafter, but this was not clear until the postwar period. During the interwar period Argentina and Australia turned away from the world market,

¹ Díaz Alejandro, C. F. (1970). *Essays on the economic history of the Argentine Republic*. New Haven,, Yale University Press.

² Maddison, A. (2003). *The World Economy: Historical Statistics*. Paris, OECD Development Centre. 2005.

beginning largely unsuccessful attempts at internally led development. After World War II (WWII) the world market re-emerged as a powerful option for development. Australia managed to continue its former export led development path alongside a newer protectionist path, whereas Argentina could not maintain such a balance, abandoning export led development in spite of renewed opportunities. How did similar factor endowments and external environments translate into such different experiences of development? Institutions determined the ability of geography to engender development, an argument for which the Argentine-Australian comparison is particularly well suited. The comparison also gets beyond the particular argument that highly concentrated land tenure was to blame for Argentina's later difficulties, as Australia also had highly concentrated land tenure. If these countries had so much in common geographically, why did they take such starkly different paths? The answer is their differing institutional environments, and the legacies these had for social consensus and collective action.

Within the institutional approach, property rights are often seen as the fundamental causation of development. A different approach is taken here. The state and its credibility, as the largest potential collective actor, are seen as more fundamental. State credibility is the faith that a society has in its state to act collectively in its interests. Without it the state will struggle to erect viable and substantial fiscal institutions, as society will be highly uncooperative in providing taxation. The state will be largely limited to indirect, regressive, and less productive sources of taxation, and is much more likely to resort to inflation taxation or seigniorage. This will impair its ability to provide the public good of a stable money, inhibiting the growth of a capital market and financial institutions, with predictable consequences for development. A lack of lucrative direct taxation also hinders the state's ability to provide public goods (directly or via regulation of the market) that are typically necessary for development, such as roads and other public works. Fiscal institutions, especially income taxation, are a promising means for investigating state credibility. Income taxation is the most lucrative of all forms of direct taxation, but is also highly dependent upon cooperation, i.e. state credibility. State credibility can be measured and compared through: fiscal institutions, the provision of public goods (including the ability to provide a stable and widely accepted money) and public credit. State credibility, especially the fiscal institutions that emerge from it, is the fundamental

explanation for development in Argentina and Australia. The comparative history of income taxation is important to determine the role that state credibility, and thereby institutions, played in the story of divergence.

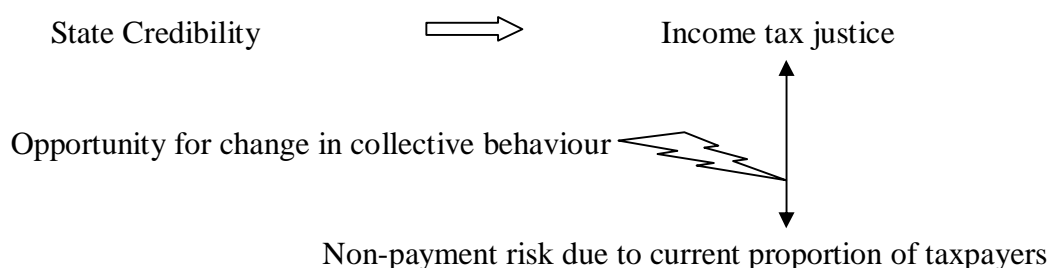
The Crux of Divergence

The key experience in the postwar history of Argentine and Australian fiscal institutions was the respective failure and success of income taxation. In both it became the single most important fiscal institution in the second quarter of the twentieth century. Argentina belatedly introduced income taxation in 1932, which rapidly became very successful, but clearly began to fail from the 1950s. It quickly degenerated into an insignificant fiscal institution in the latter half of the twentieth century. Australia successfully introduced federal income taxation in 1915 during World War I (WWI), which became its most important fiscal institution by the mid twentieth century. Income taxation emerged as the fiscal foundation of most developed societies over the first half of the twentieth century due to its powerful ability to raise revenue. The rapid postwar decline of Argentine income taxation was peculiar, and was remarked upon at least as early as 1963.³ Yet its failure continued and it has yet to be resurrected. Historical fiscal paths should be fairly path dependent due to their vicious and virtuous natures of self-reinforcement. For instance declining state credibility should make it increasingly difficult to maintain income taxation. Decreasing revenues from income taxation should reinforce declining state credibility by reducing the state's ability to positively intervene in the economy, as well as increasing its propensity to negatively intervene, e.g. inflation tax. State expenditure typically proves difficult to reduce, and seigniorage is a politically tempting stopgap. This cycle can operate in reverse, as increasing revenues from income taxation make it easier for the state to provide public goods that foster development and thereby increase income tax revenues. States that represent their societies desires' for public goods should eventually foster societies that are more capable of development no matter what their initial geography. The different Australian and Argentine trajectories in income taxation are an important proximate cause of their postwar

³ Secretaria del Consejo Nacional de Desarrollo, S. P. E. N. (1967). Estudios de Política Fiscal en la Argentina (Versión Preliminar), Republica Argentina, Presidencia de la Nación.

divergence in fiscal institutions, and, more importantly, their wider divergence in development.

Income taxation strongly indicates state credibility as it is a direct tax requiring much cooperation from individuals. Even when the state is capable of measuring incomes at their source, workers can still choose to opt out of the legal labour market. Individuals calculate how much they are willing to pay, measuring the cost and benefits of paying against those of not paying. Yet, as one Australian study points out, the majority of Australian income taxpayers pay despite the very low chances of being caught, and the practice of self-assessment and voluntary compliance.⁴ In the long run, the state's credibility determines both the justness of taxation and the risk of being caught, as people will choose to pay income tax if they judge it to be fair to do so.⁵ In the short run this is less true, as the prevailing proportion of taxpayers paying greatly determines the risk of being caught. If many people pay, it is much easier to detect those who do not, and vice versa. The prevailing proportion of taxpayers is akin to path dependency in the short run. As a result, even if many feel income taxation is unjust, the risk of not paying will remain high as long as most people pay. This relies upon the difficulty of coordinating individuals' collective behaviour, and will work to maintain the status quo until an opportunity arises for change (for instance war, depression, and inflation). In the long run state credibility determines income tax cooperation, but has to await short run opportunities for collective expression. Path dependency can thus give previously credible states plenty of rope, and may make it more difficult for newly credible states to increase their fiscal resources. The process described can be somewhat condensed into an illustration:



⁴ Torgler, B. and K. Murphy (2004). "Tax Morale in Australia: What Factors Shape it and has it Changed over Time?" Manuscript re-submitted to Journal of Australian Taxation., pp.2-4

⁵ 'humans are hard-wired not for logic but for detecting injustice. Trust, and the detection and punishment of injustice, lie at the heart of human society.' Carr, G. (2005). The proper study of mankind - A survey of human evolution. The Economist. 377., p.11

The comparative history of income taxation is an important part of the role that state credibility played in divergence.

I History of Income Taxation

Income taxation has often proven to be a difficult fiscal institution to introduce. Britain was the first to achieve a significant income tax in 1799; taking advantage of the opportunity provided by war and national danger in 1796-99. This would become permanent by the mid nineteenth century. England previously introduced a temporary income tax in 1660 to pay for war against France, which was preceded by income tax in the northern-Italian communes during the Renaissance.⁶ Prior to 1799 attempts at explicitly progressive taxation in Britain had been strongly resisted despite proclamations of progressive intent by informed and politically important contemporary opinion.⁷ Income taxation quickly became important, and was the basis for Britain becoming the first 'fiscal state' in the early nineteenth century.⁸ This achievement likely played a significant role in Britain's exceptional early success in development. From the early nineteenth century Britain was a leader in income taxation, sustaining a fiscal state, and development. These processes were very likely interconnected. Britain's income tax was so successful that it generated a movement for income taxation in other states by the last quarter of the nineteenth century, and many nations began to adopt income tax from the early 1890s.⁹ The history of income taxation is short, and begins in Argentina and Australia in the late nineteenth and early twentieth centuries.

⁶ Webber, C. and A. B. Wildavsky (1986). A history of taxation and expenditure in the Western world. New York, Simon and Schuster., p.337

⁷ O'Brien, P. K. (1988). "The Political Economy of British Taxation, 1660-1815." The Economic History Review 41(1): 1-32., p.12-13, 17-22

⁸ A fiscal state is one capable of combining its tax flows with long-term borrowing. See: Daunton, M. J. (2001). Trusting Leviathan : the politics of taxation in Britain, 1799-1914. Cambridge, UK ; New York, NY, Cambridge University Press., p.4-5

⁹ Some nations also began to develop income taxation from an early date: Holland in 1797, Austria in 1799, the duchy of Baden in 1808, and Russia in 1812; but the British income tax was the leading exemplar of success. Webber, C. and A. B. Wildavsky (1986). A history of taxation and expenditure in the Western world. New York, Simon and Schuster., pp.310, 337, 343

Argentina

There was early support for income taxation in Argentina, from at least the late nineteenth century. In line with contemporary international thought, it was increasingly seen as an essential fiscal reform. In 1894 a book was published on how Argentine federal fiscal institutions needed to be reformed, which finds that the contemporary fiscal trend was away from indirect to more progressive direct taxation. It concludes that income taxation should become the foundation of Argentine fiscal institutions.¹⁰ This was followed by another call for more progressive Argentine fiscal institutions in 1909, when Nicanor Sarmiento finds that ‘the state cannot demand from its citizens a sacrifice that they do not have’ and should tax those better able to pay. This would ‘respect the economic and personal integrity of individuals’. The only way of satisfying such ‘justice is with a *progressive tax over property and income*.’¹¹ In 1914 the Socialist deputy Alfredo Palacios also called for the reform of Argentine fiscal institutions. He finds Argentine fiscal institutions to be unscientific, regressive, responsive only to immediate revenue needs, and inconsiderate of individual circumstances.¹² He highlights the regressive nature of Argentine fiscal institutions in their reliance upon workers, as landowners went relatively untaxed. He also calls for more just and progressive fiscal institutions.¹³ In 1918 Ernesto Hueyo, an important Argentine banker, called for an income tax, noting that the ‘better organised nations’ had already introduced it. He argues that income taxation is more in accord with democracy, more progressive, more socially just, and more elastic.¹⁴ In the early twentieth century there were various calls for more progressive and direct taxation in Argentina, especially an income tax that could be more socially just and befitting of democracy. Support for a socially just and progressive income tax has long historical roots in Argentina.

¹⁰ Quesada, E. (1894). Reorganización del Sistema Rentístico Federal - El Impuesto sobre la Renta. Reorganización del Sistema Rentístico Federal - El Impuesto sobre la Renta, Los salones del Ateneo, Arnoldo Moen., pp.26,31

¹¹ The translation is mine, but the italics are from the original. Sarmiento, N. (1909). "El Impuesto Progresivo - Sobre la Propiedad y la Renta como base del Sistema Tributario." Anales de la Sociedad Científica Argentina LXVII(Primer semestre de 1909)., p.134

¹² Palacios, A. L. (1915). Presupuesto y Sistema Impositivo - Discurso que pronuncio Alfredo L Palacios, el 21 de Noviembre de 1914 en la Cámara de Diputados, al discutirse en general el presupuesto de la nación para 1915. Buenos Aires., pp.12-15

¹³ Ibid., p.23-27

¹⁴ Hueyo, E. (1918). "El Impuesto a la Renta." Revista de Economía Argentina Tomo I, p.331-333

The need for an income tax as part of an overall reform of fiscal institutions was clear and obvious by the early 1920s. By this time income taxation was the single most important tax in France, Germany, Sweden, Great Britain, and the US.¹⁵ Finance Minister Molina and President Alvear made an important attempt to introduce it as part of wider fiscal reform in 1924. Just previously, in 1923, an important conference was held in Buenos Aires on Argentine public finances by Gaston Jèze, which was openly attended by both Molina and Alvear. Jèze argues that a principal cause of Argentina's constant budget deficits was the insufficient ability to raise revenue. Furthermore Argentine fiscal institutions were: 1) inelastic in their almost exclusive dependence upon consumption taxes; 2) unjust for a democracy, if not 'antidemocratic' due to their highly regressive nature; 3) incoherent, disorganised, and unplanned.¹⁶ He calls for a complete 'recasting' of Argentine fiscal institutions to be based upon three principles: 'democratic social justice' (seen as essential in all modern democracies to avoid political breakdown), productivity, and elasticity (to address chronic deficits).¹⁷ Jèze argues that introducing an income tax is the single largest necessary reform in Argentina (alongside an inheritance tax), and would neatly address all three principles. The influence of Jèze's 1923 conference upon Molina's 1924 attempt to introduce an income tax was likely large. Molina saw income taxation as part of a larger fiscal reform that would address 'the deficiency of our taxation system, which has changed little since colonial times.'¹⁸ He saw Argentine fiscal institutions as 'incompatible with the normal development of our country' due to their reliance upon indirect customs taxation.¹⁹ For Molina, as for Jèze, income taxation promised to be socially just (attenuating social conflict and enabling greater state social action), productive, and elastic (balancing the national budget).²⁰ Income taxation was to be a just tax that strengthened both democracy and public finances.

¹⁵ Webber, C. and A. B. Wildavsky (1986). A history of taxation and expenditure in the Western world. New York, Simon and Schuster., pp.451-452

¹⁶ Jèze, G. (1923). Las Finanzas Públicas de la Republica Argentina, La Facultad de Ciencias Económicas de la Universidad de Buenos Aires y en el Instituto Popular de Conferencias de "La Prensa" bajo los auspicios del Instituto de la Universidad de París en Buenos Aires., p.80-83

¹⁷ *Ibid.*, pp.83-85

¹⁸ Molina, V. M. M. d. H. d. I. N. and M. T. P. Alvear (1924). Mensajes y Proyectos de Legislación Impositiva y Bancaria, Ministerio de Hacienda de la Nación, Remitidos por el P E al H Congreso de la Nación, Para ser considerados en el periodo de 1924. Buenos Aires, G Kraft., p.13

¹⁹ *Ibid.*, p.13

²⁰ *Ibid.*, p.15-16

The 1920s was a difficult trial period for Argentine democratic institutions, ending in a long period of failure from 1930 to 1983. During the 1920s the budget was an object of contention between the less democratically successful Conservatives and the more successful Radicals (the Radical party dominated the federal state from 1916-30). The Conservatives and their allies increasingly saw the Radicals as fiscally irresponsible, which was a major reason for the 1930 military coup. From 1923 to 1927 it became impossible to agree upon a new budget, which meant a continual extension of the previous year's budget. The strained relationship between the Executive and the Legislature in the 1920s meant that the 1923 budget remained the standard, with only slight modifications, until 1931.²¹ This made fiscal reform such as income taxation much harder to achieve, as reforms were attached to the annual budget law to be presented by the President on May 1. This was never achieved in the 1920s. The lack of an annually elaborated budget meant the Executive evaded Legislative control, permitting an increase in public expenditure.²² The deadlock of the 1920s not only prevented democratic fiscal reform, but also led many Argentines to perceive their state institutions (and perhaps democracy) as relatively backward. For example: 'In the most advanced nations, the budget is the primary concern of governments and parliaments, constituting the most serious political and economic act.'²³ As Argentina clearly failed on this account, it was by inference a less advanced nation. It also helped establish the cause against democracy in Argentina, making the pre-democratic past appear more golden, a time when public finances appeared better managed. When the Argentine income tax finally came into being in 1932, it was observed that Argentina was following in the footsteps of more progressive, just and humane countries such as New Zealand.²⁴ Ironically, it was only able to do so once its democratic institutions were subjugated.

It would have been preferable for Argentine state credibility and democracy to introduce income taxation via a democratic process, such as Molina's 1924 attempt.

²¹ Sánchez Román, J. A. (2004). "Chapter 2: Economic Elites, Regional Cleavages, and the Introduction of the Income Tax in Argentina." Unpublished., p.6-8

²² Ibid., p.9

²³ Avellaneda, N. A. s. o. P. N. A., 1874-80) (1928). Discurso de Presentación por el Académico Doctor Pedro Olaechea y Alcorta. Conferencia de Nuevo Académico Doctor Nicolas A Avellaneda en el acto de su recepción, Buenos Aires, Academia Nacional de Ciencias Económicas., p.19-20

²⁴ Bottini, E. B. (1931). Distribución del Impuesto. Conferencia de Extensión Universitaria, Pronunciada el 6 de Agosto de 1930 en la Sociedad "Luz", bajo el patrocinio de la Facultad de Ciencias Económicas, Buenos Aires., p.4

By not doing so, income tax and its justice were more open to question. Why then did Molina's democratic attempt to introduce income taxation fail? Was it due to elite opposition, typically the reason for difficulties elsewhere? Its failure appears to have been largely due to Molina's overzealous and somewhat arrogant reform package. Molina mistakenly coupled the introduction of income taxation to a sweeping reform of fiscal-federalism. His proposal tied the introduction of income taxation to the elimination of provincial taxes on production and trade in order to further unify the national market.²⁵ These provincial taxes were forbidden in the Constitution, but had been re-introduced in the wake of the 1890s depression when the interior provinces faced financial difficulties.²⁶ It was unwise to couple the introduction of income taxation to the more contentious issue of fiscal federalism. Had income taxation alone been attempted, it could well have been successful. For instance some provinces had no choice but to oppose Molina's reform due to their dependence on internal taxation.²⁷ Not only that, but the federal government was controlled by the Radicals while the Interior provinces were controlled by the Conservatives. Molina's reform would have increased the power of the federal government, and thereby the Radicals, which guaranteed the opposition of the Conservatives. The main obstacle to the 1924 income taxation proposal was not the various elites, but the active opposition of the Interior provinces to the reform of fiscal federalism.²⁸ In fact landowners were potentially in favour of it, as it could have reduced the larger threat of land taxation.²⁹ Industrialists were more concerned with protectionism and social policies than income taxation. Molina's 1924 reform also antagonised potential supporters. For example Hueyo, previously an open supporter of income taxation in 1918, openly opposed Molina's proposal.³⁰ The introduction of income taxation was likely needlessly delayed by tying it to a reform of fiscal-federalism; at a time when its revenues could have greatly improved public finances and thereby the credibility of the new democracy. Poor public finances were seen as democracy's greatest fault. Failure meant that the state's fiscal institutions continued on the unsteady course begun in

²⁵ Sánchez Román, J. A. (2004). "Chapter 2: Economic Elites, Regional Cleavages, and the Introduction of the Income Tax in Argentina." Unpublished., p.11

²⁶ Ibid., pp.18-21

²⁷ Internal taxation comprised almost 90% of Mendoza's revenues, and almost 40% of Tucuman's revenues. Ibid., p.22

²⁸ Ibid., p.2

²⁹ Ibid., pp.14-16

³⁰ Hueyo, E. (1925). "Impuesto a la Renta - Critica al Proyecto del Ministro Molina." Revista de Economía Argentina **Tomo 14**(No. 79-80), p.43-44,49

WWI, which was largely due to a lack of revenue and not excessive expenditure. A 1927 US government study of 'Latin American Budgets' found that Argentine public expenditure was 'not excessive', and that its chronic budget deficits were due to a failure to address the budget.³¹ Had income taxation been introduced in 1924, it might have ameliorated the poor public finances that were a major reason behind the 1930 military coup.

Income taxation was successfully introduced in 1932, unattached to a greater reform of fiscal-federalism. Argentina was a relatively late starter in income taxation as many developed states had introduced it during WWI. Even within Latin America, Brazil and Mexico introduced income taxation in 1924 and 1925 respectively, despite their much greater potential for elite opposition.³² The 1932 income tax overcame the constitutional obstacle of article 67, which stated that direct taxation was a provincial power and could not be levied by the federal state unless it was temporary and due to an emergency.³³ Congress avoided the need for considering constitutional reform by simply introducing income taxation as an emergency temporary device valid for five years.³⁴ It nonetheless became permanent, if now pervasively evaded.³⁵ The reform of fiscal-federalism, a separate issue, was later achieved in 1935 when the Provinces renounced internal taxation in exchange for the federal state's assumption of their debts.³⁶

The introduction of income taxation in 1932 was not advocated on the grounds of social justice, but to increase federal revenue and shore up public finances. Enrique Uriburu, Minister of Finance in 1932, often declared that the income tax was a necessity. Roberto Ortiz, Minister of Finance in 1936, also stated that the main reason for its introduction was to raise much needed revenue, as the state found itself unable

³¹ Corliss, J. C. (1927). *Latin American Budgets, Part 1: Argentina, Uruguay, Paraguay, and Brazil. Trade Information Bulletin No. 497*, Bureau of Foreign and Domestic Commerce, United States Department of Commerce., p.1-2

³² Sánchez Román, J. A. (2004). "Chapter 2: Economic Elites, Regional Cleavages, and the Introduction of the Income Tax in Argentina." *Unpublished.*, p.1

³³ *Ibid.*, p.21

³⁴ *Ibid.*, pp.35-37

³⁵ Britain overcame a similar obstacle as it has to renew income taxation annually, and has done so continuously from 1842.

³⁶ Sánchez Román, J. A. (2004). "Chapter 2: Economic Elites, Regional Cleavages, and the Introduction of the Income Tax in Argentina." *Unpublished.*, pp.38-39

to reduce expenditure as quickly as revenue declined.³⁷ It was much less progressive than the income tax envisaged by Molina.³⁸ Nonetheless its progressive brackets meant social justice was at least an implicit goal. It did not fit into an explicit goal of social democratic justice, which would have been self-contradictory in the absence of democracy. A 1932 observation of its introduction finds that:

‘It is the little pleasing work of our present government to have to re-establish the equilibrium of public finances and our national economy, a very difficult job ... We must recognise that an unbalanced budget is the worst evil that can afflict public finances. ... In order to achieve a balanced budget, the provisional government has implemented the income tax, that is the tax that has most contributed to the organisation of public finances.’³⁹

This strongly implies that the previous profligacy of Radical democracy was to blame for poor public finances and the need to introduce income taxation. Likewise, a 1935 Ministry of Finance publication explains that in the early 1930s ‘The most important thing was to clean up the public finances. ... The new taxes were undoubtedly heavy. But unfortunately they were necessary.’⁴⁰ The final introduction of income taxation had nothing immediately to do with ideas of social justice, but was painted as a necessary revenue raising exercise, one made implicitly necessary by the former profligacy of democracy.

A more positive justification for the new income tax was the increased role of the state. The new income tax was also justified by a large program of new public works, and increased attention to the agricultural sector.⁴¹ This broadly concurs with the general theory of this thesis, that the state needs to be accountable to its citizens/taxpayers if it is to achieve the common good necessary for development. Unfortunately the 1930s were undemocratic. The potential lack of fit at this time between desired public goods (expressed democratically) and those actually delivered may be evident in the state’s focus upon the traditional agricultural sector rather than

³⁷ Ortiz, R. M. M. o. F., Argentina) (1936). Determined Policy of Sound Finance. The Daily Telegraph. London., p.4

³⁸ Sánchez Román, J. A. (2004). "Chapter 2: Economic Elites, Regional Cleavages, and the Introduction of the Income Tax in Argentina." Unpublished., pp.34-36, 39

³⁹ Ramm Doman, R. A. (1932). "El Impuesto a la Renta - Su Forma y Su Aplicación." Revista De Economía Argentina Tomo 29(No 172)., p.202-203

⁴⁰ Nación, M. d. H. d. I. (1935). La Rebaja de Impuestos. Buenos Aires., p.8

⁴¹ Ibid., p.13

the increasingly important cities. A democratic polity would more likely have focussed upon urban public goods, as Argentina was highly urbanised. Peron's later attack upon the agricultural elites, widely perceived as the power behind the 1930s regime (the *decada infame*), could be interpreted as resentful democratic retribution. Nonetheless the 1930s regime at least perceived the need to provide a return on taxation through the provision of public goods:

'The Executive Power believes that after demanding such an extraordinary sacrifice from the nation's citizens [i.e. income taxation], it is equitable and fitting to return to the private economy, to whatever degree possible, the resources that are no longer indispensable to the nation.'⁴²

The 1930s regime was driven by a strong desire to make the Argentine state more credible, but the rural focus of its public goods suggests that the lack of democracy allowed it to be out of touch. A rural focus worked well in the late nineteenth century, but was outdated by the 1930s, as the burgeoning urban and industrial expansion begun in the 1920s required a shift in emphasis. This occurred in Australia during the interwar period, when there was a switch from rural to urban public goods driven by democracy.⁴³ The 1930s regime thereby fomented later social conflict when democracy returned under Peron. Nonetheless the role of the state increased substantially at this time, successfully fostering much development.⁴⁴

The Peronist regime began in 1946 and greatly increased the historical level of state expenditure.⁴⁵ Total state expenditure increased by 70% in 1946 alone. State revenues hardly increased, which meant the budget deficit increased enormously. This was concealed by indirect financing, i.e. seigniorage. Peron's regime also began the discreditable habit of booking a large amount of expenditure outside the formal budget, amounting at times to around 50% of total expenditure.⁴⁶ The bulk of this outside expenditure supported a policy of import substitution, being spent on IAPI (Argentine Institute of Trade Promotion), the Banco Hipotecario Nacional (National Mortgage

⁴² Ibid., p.14

⁴³ This is explored in more depth elsewhere in the thesis upon which this paper is based.

⁴⁴ Rodríguez, C. J. (1940). "La Experiencia Financiera Argentina - El Crecimiento de los Gastos Públicos." *Revista de Economía Argentina* **Tomo 39**(N° 262-3), p.155

⁴⁵ Reutz, T. (1991). "Ilusiones Fiscales, dimensión y método de financiamiento del déficit fiscal del gobierno, 1928-1972." *Ciclos (año 1) - Instituto de Investigaciones de Historia Económica y Social, Facultad de Ciencias Económicas, Universidad de Buenos Aires* **1**(1), p.120

⁴⁶ Ibid., p.120

Bank), and the state rail system. The Peronist regime largely reversed the 1930s achievements in public finance. Public accounting was widely reorganised from 1933-38 to ensure that all state expenditure was within a single budget, and to eliminate unconsolidated (floating) debt.⁴⁷ As the quality of public finances declined from 1946 onwards, so did the justice of taxation, as public expenditure moved outside society's control.

The Peronist regime did mark the return of democracy, which meant the role of income taxation shifted sharply back to its earlier aim of social justice. It became an explicit tool for income redistribution alongside its then proven role of raising revenue. In 1950 the Ministry of Finance declared that taxation was no longer simply to collect revenue but also to actively redistribute income.⁴⁸ The income tax had always been a passive means for redistributing income, as it was only paid by the wealthy, but this was no longer deemed sufficient. The income tax became more progressive, and new income taxes on extra profits and extraordinary profits were introduced. This was thought to be necessary in order to 'destroy' the situation of economic privilege that had governed the country.⁴⁹ Peron converted income taxation into an aggressive tool for income redistribution, which defied the wealthy few that actually paid it. The harsh language of the Ministry of Finance, seeking to 'destroy' the privileged classes that paid income taxation, likely undermined its perceived justice; just as increasingly shaky public finances undermined the state's overall credibility. As income taxation began to falter, the irony was that fiscal institutions became more regressive. Already by 1956, Prebisch observes that Argentine fiscal institutions had become more regressive than progressive, in stark contrast to both other developed countries and to earlier Argentine experience.⁵⁰ Incompetent management of public finance appears to have played a large role in this. Seigniorage was the chosen instrument of the Peronist regime to fund an increase in social justice, but it undermined the objective in the process.

‘The excessive and disorderly intervention of the State has seriously disturbed the economy in detriment to its efficiency and, together with inflation, has

⁴⁷ Ibid., p.121

⁴⁸ Nación, M. d. H. d. I. (1950). La Coordinación Económica, Financiera y Administrativa como fundamento de la Prosperidad Nacional., p.21

⁴⁹ Ibid., pp.29-30

⁵⁰ Prebisch, R. (1956). Desarrollo Económico y Política Social. Mesa Redonda en la Universidad de Córdoba, Buenos Aires, Secretaría de Prensa de la Presidencia de la Nación., pp.19,51

generated sources of extraordinary benefits that contrast with desired social policy. The intervention of the State is certainly indispensable to accelerate the rhythm of development and promote its social meaning.’⁵¹

There was nothing necessarily wrong with increased state intervention according to Prebisch, except in how it was financed. Instead of unjustly forcing contributions via inflation tax, the Argentine state needed to foster credibility and consent with taxpayers to finance desired expenditure.

A massive decline in Argentine fiscal institutions occurred during the Peronist regime of 1946-55. In 1956 Federico Pinedo (an important former Minister of Finance) pointed out a considerable increase in tax evasion in this period. One indicator was business, which declared a net income of 69% of total net income in 1942. This declined suspiciously to a mere 41% by 1955.⁵² Either relative business income declined massively as a proportion of the economy in this period, and/or tax evasion increased enormously. Pinedo warned that income taxation needed to shift from a tax on the wealthy few to a mass tax, and that further attempts to increase the burden upon the wealthy would not increase revenue. Increased revenues could only come from the taxation of middle and small income earners. This had occurred unintentionally via inflation (i.e. bracket creep) that pushed constant real wages into higher nominal brackets over time. This was also credited as the primary reason for the intense increase in tax evasion that began in the 1950s.⁵³ By 1960 it was estimated that half of all income tax was evaded.⁵⁴ This was also largely attributed to the bracket creep of the 1950s.⁵⁵ Another reason cited for the extraordinary increase in tax evasion was the political war against the economy from 1946-55.⁵⁶ After Peron the state floundered in an undemocratic setting to normalise and re-establish taxation through ‘blanqueos’, incentives to reincorporate capital back into the legal fiscal system beginning in 1956. These efforts were undermined by their repeated use, acting to increase evasion by entrenching expectations of future blanqueos. In 1958

⁵¹ Ibid., p.33-34

⁵² Pinedo, F. (1956). *El Fatal Estatismo*. Buenos Aires, Guillermo Kraft Ltda., p.88

⁵³ (1963). "Sistema Impositivo y la Presion Tributaria." *Boletin TECHINT* 134: 13-56., p.47-53

⁵⁴ Secretaria del Consejo Nacional de Desarrollo, S. P. E. N. (1967). *Estudios de Política Fiscal en la Argentina (Versión Preliminar)*, Republica Argentina, Presidencia de la Nación., Vol. 5, p.19

⁵⁵ Ibid., Vol. 1, p.10-13

⁵⁶ López, A. T. (1957). "Las sistemas fiscales como generadores de deshonestidad." *Revista de Ciencias Económicas* 62., p.54

the Secretary of Finance revealed that 70% of taxpayers inspected were found to be evading tax.⁵⁷ In 1959 income tax evasion was estimated as being larger than the fiscal deficit.⁵⁸ Another indication of how extensive tax evasion became was the breakdown in the parallel logic between GDP (an expression of the sum of individual incomes) and income taxation in 1952.⁵⁹ Tax evasion was part of a notable change in the overall moral climate, attributed to the dissatisfaction with inflation.⁶⁰ The Argentine experience of tax evasion at this time was unusual. In the early 1960s income tax evasion was not a major problem in other high-income countries.⁶¹ Even the tool of collecting income tax at its source, a means of reducing evasion elsewhere, was apparently a means for tax evasion in Argentina.⁶² In sum the decrease in income tax justice in the early postwar period quickly found collective expression in widespread and severe tax evasion.

Argentine income tax evasion was attributed by one government source in the 1960s to three causes: 1) the lack of sufficient means to efficiently police evasion; 2) instead of evaders being punished, they were awarded with various opportunities for amnesty in the numerous “blanqueos”, which led to expectations of non-punishment; and 3) the inefficiency of state expenditure in some sectors served as a widely publicised justification for tax evasion.⁶³ Of these three reasons, the last is the most fundamental and convincing, dealing with the underlying issue of state credibility. Poor public expenditure is a clear, just and obvious reason to evade taxation. As for the first two reasons, there can never be sufficient means to efficiently police evasion, and the blanqueos were a symptom not a cause of evasion (even if they helped to entrench it). Yet the last reason was barely studied in the report. The opening quotations of this chapter are from a slightly earlier source that more explicitly attributes the primary cause of tax evasion to something akin to low state credibility.⁶⁴ The ‘taxpayer and

⁵⁷ Peire, J. J. (1959). Evasión Impositiva. Buenos Aires, Talleres Gráficos "Fanetti", p.11

⁵⁸ Secretaria del Consejo Nacional de Desarrollo, S. P. E. N. (1967). Estudios de Política Fiscal en la Argentina (Versión Preliminar), Republica Argentina, Presidencia de la Nación., Vol. 1, p.13-14

⁵⁹ Peire, J. J. (1959). Evasión Impositiva. Buenos Aires, Talleres Gráficos "Fanetti", p.13

⁶⁰ López, A. T. (1957). "Las sistemas fiscales como generadores de deshonestidad." Revista de Ciencias Económicas **62.**, p.47-48

⁶¹ Secretaria del Consejo Nacional de Desarrollo, S. P. E. N. (1967). Estudios de Política Fiscal en la Argentina (Versión Preliminar), Republica Argentina, Presidencia de la Nación., Vol. 5, p.8

⁶² *Ibid.*, Vol. 5, p.15

⁶³ *Ibid.*, Vol. 5, pp.15-16

⁶⁴ See opening quotes of this paper. Peire, J. J. (1959). Evasión Impositiva. Buenos Aires, Talleres Gráficos "Fanetti".

the treasury' were at odds, the former spending what the other would not volunteer, with the deficit between these two being settled in seigniorage. By the mid 1950s the Argentine experience already demonstrated that more complex fiscal institutions such as progressive income taxation required cooperation stemming from state credibility. Some understood the essence of the problem, but they were paid little heed. Public finances continued to be grossly mismanaged, as did the unwillingness of taxpayers to fund them.

Australia

The origins of Australian income taxation extend back to the gold boom of the mid nineteenth century. The surge in migration caused by the gold boom almost immediately coincided with increasing popular demands for more progressive taxation, including new taxes on land, income, and wealth.⁶⁵ Taxation became a popular and contentious issue, as evidenced by riots against the gold license fee paid by prospectors that eventually led to its repeal. The immediate pressures of greater population due to the gold rushes meant an increased need for revenues, which in the short run was obtained via further regressive indirect taxation. The first direct taxes, death duties, were introduced in 1851, but were relatively insignificant in terms of revenue.⁶⁶ The push for greater democracy begun with the gold rushes meant that established ideas about taxation and the state's role were challenged from the mid nineteenth century onwards. By federation in 1901, this had led to the introduction of progressive direct taxes on income and land in most colonies.⁶⁷ This mirrored a similar movement in England, where accumulated wealth became an obvious target for taxation as democracy broadened. In the late nineteenth century most Australian colonies progressively discriminated against property income (versus income from 'personal exertion') with higher taxation rates, and some also adopted varying tax rates on incomes, land or estates. Progressive and direct taxation was introduced in the Australian colonies in the latter half of the nineteenth century as a result of the broadening of democracy begun with the gold rushes.

⁶⁵ Smith, J. (1993). Taxing Popularity - The Story of Taxation in Australia. Canberra, Federalism Research Centre, The Australian National University., p.7-9

⁶⁶ These were abolished by the early 1980s. Ibid., pp.16-17, 78

⁶⁷ Ibid., p.14-15

The obvious economic, and inequitably distributed, resource in nineteenth century Australia was land, which led to the promotion of land taxation from as early as the 1840s. Land taxation could be considered a rough form of income taxation within the nineteenth century Australian context, as land ownership clearly correlated with the ability to produce wealth. Yet ineffective land policies allowed highly concentrated land tenure to continue for much of the nineteenth century, and most of the best public land had passed to private freehold by the 1870s.⁶⁸ The pastoral monopoly that dominated land tenure became a major barrier to closer settlement, impeding agricultural expansion that was potentially more productive. The pastoralists' inequitably large land holdings also caused great public unrest. Land taxation was very popular, and was seen as a way to redress inequities. It was amongst the first taxation put forward by the popularly elected assemblies from the 1870s. All the Australian colonies (States after 1901) introduced land taxation between 1877 and 1915. This was driven by democracy but also by the need for greater revenues, as revenues from land sales and customs taxation were declining.⁶⁹ Yet the original aim of colonial land taxes was development, not revenue, as taxation was meant to 'unlock the land' for agricultural development by the smallholder. They were also specially designed not to discourage wealth creation and accumulation, levying taxation only upon the original unimproved values of the land rather than their current capital values. The new federal state also introduced a land tax in 1910, which was the first to tax the extensive pastoral and grazing lands held by crown leases in western NSW, Queensland, the Northern Territory and northern Western Australia.⁷⁰ The federal land tax successfully encouraged subdivision and more intensive production, but may not have redistributed wealth (one of its intentions). It also raised much revenue, but was abolished in 1952 to compensate the states for their loss of income taxation in 1942. As the Australian economy developed over the twentieth century, with new prosperities in industry and mining as well as from land, Australian wealth increasingly took the form of assets other than land.⁷¹ By the 1970s land taxes had clearly become partial and discriminatory wealth taxes, and were long superseded by income taxation.

⁶⁸ Ibid., p.18-19

⁶⁹ Ibid., p.19-20

⁷⁰ Ibid., p.43-44

⁷¹ Ibid., pp.76-78

Australia's first income taxes were introduced by the individual colonies in response to financial and budgetary crises. Tasmania and South Australia introduced income taxation in 1880 and 1884 respectively, followed by most of the other colonies during the 1890s depression. This was in line with international norms, as income taxation became increasingly widely adopted from the early 1890s.⁷² In order to overcome the objections of local elites, the budgetary threat had to be substantial (usually around 6-7% of output) before it was possible to introduce income taxation.⁷³ By 1907 all the Australian colonies/States had introduced it. Only the relatively less developed colonies, such as Queensland and Western Australia, were able to maintain a traditional dependence upon indirect taxation until after federation. New South Wales managed to delay introducing direct taxation until 1895 by selling its crown lands. Victoria originally found itself unable to introduce income taxation due to the strong opposition of its pastoralists, turning instead to heavy excise taxes. These were sold to the popular masses as protectionism, popularly seen as an employment policy by the early labour movement.⁷⁴ Yet their primary purpose was to raise revenue. By 1895 Victoria also had to resort to income taxation. Income taxation was established in the key Australian colonies by the late nineteenth century.

A federal income tax was introduced in 1915 and soon came to monopolise income taxation. Its introduction was widely accepted by the general public due to the heavy financial pressures of WWI, in contrast to the earlier reactions against the federal land and estate taxes.⁷⁵ Despite the Treasurer's claims to the contrary, the federal income tax was designed not only to raise revenue, but also to be progressive and redistribute income. It was the first Australian income tax to have continuously rising marginal rates and, initially, only taxed the wealthy. It taxed property income at a higher rate than personal exertion income (ended in 1953), using all available means to be progressive. The Prime-Minister, William Hughes, who was to shortly introduce the federal income tax, stated in 1914 that progressive taxation was 'the basis of true civic government'.⁷⁶ Another MP, Mr. Finlayson, remarked in 1916 that the federal income

⁷² Webber, C. and A. B. Wildavsky (1986). A history of taxation and expenditure in the Western world. New York, Simon and Schuster., p.310

⁷³ Smith, J. (1993). Taxing Popularity - The Story of Taxation in Australia. Canberra, Federalism Research Centre, The Australian National University., pp.24-25

⁷⁴ *Ibid.*, p.9-10

⁷⁵ *Ibid.*, p.45

⁷⁶ Hansard Australian Parliamentary Debates, Parliament of Australia., 11/12/1914, p.1639, Vol. 75

tax was ‘a fair, reasonable, and proper method of taxation ... incomes are, after all, the surest index to what people are able to pay by way of taxation.’⁷⁷ Ideological support for progressive taxation appears to have been widely accepted when the federal income tax was introduced. Opposition to it emerged, but it was unsuccessful in checking its progressive intent. Dr. Earle Page, federal Treasurer and founder of the Australian Country Party, saw the federal income tax in 1924 as merely a war-time tax for revenue purposes, one that needed to be discarded as soon as possible.⁷⁸ Despite his position as Treasurer, he was unsuccessful in this regard due to the continuing financial pressures of the interwar period. His comments suggest that there was a significant minority, likely within the wealthy elites, that were at least mildly antagonistic towards income taxation. Income taxation quickly proved desirable for its elasticity, as the experience of WWI showed the danger of dependence upon indirect customs taxation in the absence of trade. This strengthened the movement towards direct taxation. As one MP, Mr. Anstey, put it ‘The Government is existing precariously upon revenue derived from Customs. It is living in a house of cards that may collapse at any moment.’⁷⁹ From 1915 onwards the balance turned increasingly against indirect taxation and towards direct taxation.⁸⁰

The federal income tax did not begin to tax ordinary wage and salary earners until the late 1920s.⁸¹ In 1928 only incomes above £250 were subject to income tax, when the living wage was below £52.⁸² Wage taxation was introduced in the 1930s Depression to fund the public cost of unemployment, and by the late 1930s wage and salary earners had become used to paying such income taxation. World War II further entrenched the taxation of lower incomes, as income taxation moved from an elite to a mass tax. The war meant that the federal state needed much more revenue, and an attempt was made to formalise the taxation of low incomes in 1940 by lowering the exemption to £150, much nearer the living wage. This was strongly opposed and

⁷⁷ Ibid., 8/12/1916, p.9627, Vol. 80

⁷⁸ ‘The federal income tax was imposed to meet war necessities. ... The Government is anxious that this form of direct taxation be alleviated, and the field of income tax should be evacuated by the Commonwealth at the earliest possible moment.’ Ibid., 31/7/1924, p.2722, Vol. 107

⁷⁹ Ibid., 6/8/1924, p.2858, Vol. 108

⁸⁰ Smith, J. (1993). *Taxing Popularity - The Story of Taxation in Australia*. Canberra, Federalism Research Centre, The Australian National University., p.16

⁸¹ Ibid., p.52-53

⁸² The living wage was defined in the 1907 Harvester judgement as a wage that guaranteed workers a standard of living that was reasonable for “a human being in a civilised community”.

eventually led to a compromise where the exemption was lowered to £200.⁸³ Such were the financial pressures of war that the exemption soon dropped to £105 by 1943, when the living wage was about £60. From 1942 income taxation became virtually universal at substantial rates for all income levels.⁸⁴ The 1930s Depression and WWII were the opportunities whereby income taxation was transformed from a tax on the wealthy into a mass tax. The Liberal Treasurer in 1940, Mr. Spender, found that income taxation:

‘was originally designed to produce a moderate revenue by taxing higher incomes with considerable severity while falling lightly on middle incomes and exempting lower incomes altogether. It is unfortunately necessary now to widen the field so as to obtain a substantial contribution from middle incomes. ... All that it [Australia] asks is that burdens imposed shall be equably shared, according to its democratic ideals.’⁸⁵

Income taxation came to be supported by all political parties, as long as it was ‘equably shared’, i.e. became a mass tax. This was sold as being part of ‘democratic ideals’. It was also an opportunity to change its administration and begin collecting it at its source, which made it more easily enforceable on the much larger population on lower incomes:

‘To make the [federal income] tax an efficient and equitable war-time instrument it is clear the field must be broadened into incomes under £400, which account for 70 per cent of the total personal incomes in Australia. ... In the case of wage and salary earners arrangements will be made for taxes to be collected at the source since regular periodical contributions avoid the hardship of lump sum payments.’⁸⁶

The new tax collection system was called pay-as-you-earn (PAYE) and facilitated the move to a mass tax, beginning to withhold income tax on wage and salary incomes in 1944.⁸⁷

⁸³ Smith, J. (1993). Taxing Popularity - The Story of Taxation in Australia. Canberra, Federalism Research Centre, The Australian National University., p.53-54

⁸⁴ Butlin, N. G., A. Barnard, et al. (1982). Government and capitalism : public and private choice in twentieth century Australia. Sydney ; Boston, Allen & Unwin., p.338

⁸⁵ Hansard Australian Parliamentary Debates, Parliament of Australia., 2/5/1940, p.479-81, Vol. 163

⁸⁶ *Ibid.*, 21/11/1940, p.86-8, Vol.165

⁸⁷ A number of States had previously run similar systems for their own income taxes. Taxation, C. o. (1915-60). Annual Report of the Commissioner of Taxation, Parliament of the Commonwealth of Australia., 23rd Annual Report, 1942, p.12

World War II provided an opportunity not only for moving income tax from an elite to a mass tax, but also for much needed fiscal-federal reform. The introduction of a federal income tax on top of already existing State income taxes complicated Australian fiscal institutions from a fiscal-federal perspective. A maze of income taxation (upon dividend, company, and personal incomes) emerged in Australia from 1915, with all levels of government taxing incomes.⁸⁸ By 1942 Australia had 26 separate income taxes. These varied to a large degree in principles, and burdened taxpayers unequally.⁸⁹ Some rationalisation of Australian fiscal-federal relations was necessary, but it was not until WWII that change became possible. Attempts at synchronising income taxation in the fiscal-federal sphere began shortly after federal income tax was introduced, with many attempts between 1916 and 1942.⁹⁰ The most significant attempt at tax synchronization previous to WWII was the Uniform Income Tax Act in 1937, but was unsuccessful⁹¹ The federal state clearly expressed its desire to monopolise income taxation as early as 1923.⁹² It successfully seized the opportunity of WWII to monopolise income taxation on the tenuous constitutional grounds of defence and grants powers.⁹³

The federal state determined that it would require a large increase in revenues due to WWII, and that much of this would have to come from income taxation, but the ability to do so was seriously limited by the states' income taxes. The federal state felt obliged to limit its income tax to the highest rate imposed by any State, which meant a large proportion of incomes were inaccessible to federal income tax.⁹⁴ As a result the federal state imposed itself as the sole income taxation authority in 1942, ending the

⁸⁸ Smith, J. (1993). Taxing Popularity - The Story of Taxation in Australia. Canberra, Federalism Research Centre, The Australian National University., p.28, 44

⁸⁹ Taxation, C. o. (1915-60). Annual Report of the Commissioner of Taxation, Parliament of the Commonwealth of Australia., 23rd Annual Report, 1942, p.10

⁹⁰ Parliament of the Commonwealth of Australia, Second Report of the Royal Commission on Taxation, 1934, p.51

⁹¹ Smith, J. (1993). Taxing Popularity - The Story of Taxation in Australia. Canberra, Federalism Research Centre, The Australian National University., p.49

⁹² Prime Minister Bruce in 1923 said: 'the simplest is that the Commonwealth should take over the whole work of collecting income taxation and that the Commonwealth Act should be the only taxation Act. The objection to that proposal is that we cannot do it under the Constitution, and the States would never agree to it in any circumstances.', Parliament of the Commonwealth of Australia, Second Report of the Royal Commission on Taxation, 1934, p.53

⁹³ Smith, J. "Progressivity of the Commonwealth Personal Income Tax, 1917-1997." The Australian Economic Review 34(3): 263-278., p.264

⁹⁴ Taxation, C. o. (1915-60). Annual Report of the Commissioner of Taxation, Parliament of the Commonwealth of Australia., 23rd Annual Report, 1942, p.10

states' ability to levy income taxation. The states challenged this upon constitutional grounds but were ultimately unsuccessful in the High Court.⁹⁵ This defeat quickly led to the states' acquiescence as there was widespread support for tax simplification. The legislation became permanent despite being originally limited to the length of the war plus one financial year.⁹⁶ The move to exclusive federal income taxation also marked a move to increased progressivity. In addition it represented a huge reform of fiscal-federal relations, and is an example of the slow but successful evolutionary character of Australian democracy. Federal income taxation originally complicated fiscal-federal relations, but eventually led to fiscal-federal reform in the federal state's favour. In the meantime federal income taxation stabilised federal fiscal institutions with significant and stable new revenue.

Income tax was increased in 1943, but as the war came to an end in 1945 the increase was renamed as a 'Social Services Contribution, in anticipation of postwar pressure to reduce income taxation. At the end of WWII there was widespread discontent among working people with income taxation.⁹⁷ Yet the federal state chose to maintain high expenditure in order to pay for postwar reconstruction and welfare spending, rather than reduce taxation. The public's distaste for income taxation's transition from an elite to a mass tax was compensated by the provision of many desired public goods in the postwar period. For example a quarter of income taxation was allocated to a new National Welfare Fund for future expenditure on social welfare.⁹⁸ This funded widows' pensions (introduced in 1942), unemployment benefits (introduced in 1944), and child endowments. These should have increased the justice of income taxation by providing widely desired public goods, easing the transition to a mass tax. By the early 1960s the principle of mass taxation was well accepted, and the separated social services contribution was reincorporated back into the income tax. The burden of income tax on low and middle-income earners was not severe in the 1960s, and was generally seen as a fair price to pay for benefits received.

⁹⁵ Ibid., 23rd Annual Report, 1942, p.12

⁹⁶ Ibid., 23rd Annual Report, 1942, p.11

⁹⁷ Smith, J. (1993). Taxing Popularity - The Story of Taxation in Australia. Canberra, Federalism Research Centre, The Australian National University., pp.54-55

⁹⁸ Ibid., pp.54-55

The redistributive role of income taxation slowly evolved in the postwar period. Its original progressive structure in the 1950s slowly diminished as its ability to earn revenue slowly increased with bracket creep. This bracket creep was driven by low and persistent inflation in combination with a lack of adjustment in income tax brackets. This greatly helped to entrench income taxation in the postwar period as a mass tax, as opposed to its pre-1942 identity as a 'class tax'.⁹⁹ Most industrialized nations followed a similar postwar trajectory.¹⁰⁰ As bracket creep operated slowly, it was fairly imperceptible. Australian income tax brackets were not adjusted from 1950-51 until the latter 1970s.¹⁰¹ This meant the income tax became much less progressive as its revenues greatly increased. The effects of bracket creep were openly acknowledged in the 1970s when tax brackets were revised. The 29 brackets from 1950-51 were reduced to 14 in 1974-75, to 7 in 1975-76, and to 3 in 1978-79.¹⁰² Bracket creep had been so extensive by the 1970s that many people had been pushed into much higher nominal brackets than their real incomes justified. This was largely due to a great increase in inflation from the late 1960s, which pushed up income taxation's real burden and coincided with increasing unemployment.¹⁰³ Predictably such injustice led to a great increase in tax evasion, as it had previously done in Argentina, which reduced progressivity even further. Tax evasion became increasingly common, especially amongst higher income earners, from as early as the late 1950s.¹⁰⁴ It combined with income tax concessions to compromise income taxation as a means for redistribution. By the 1980s the Australian taxation system was widely perceived as economically destructive in its effects on production, consumption, saving and investment decisions.¹⁰⁵ Postwar Australian income taxation policy was one of neglect in the face of bracket creep, which substantially reduced its progressivity and eventually its acceptability. Inflation led to a similar, if less

⁹⁹ Smith, J. "Progressivity of the Commonwealth Personal Income Tax, 1917-1997." The Australian Economic Review 34(3): 263-278., p.273

¹⁰⁰ Webber, C. and A. B. Wildavsky (1986). A history of taxation and expenditure in the Western world. New York, Simon and Schuster.

¹⁰¹ Although the maximum tax rate was reduced, declining from 75% to 70% in 1950-51, and again in 1953-54 to 66.7%.

¹⁰² Alchin, T. M. (1983). "Intertemporal Comparisons of Tax Progressivity: 1950-51 to 1979-80." Australian Economic Papers 22(40)., p.97

¹⁰³ Smith, J. (1993). Taxing Popularity - The Story of Taxation in Australia. Canberra, Federalism Research Centre, The Australian National University., p.55

¹⁰⁴ Smith, J. "Progressivity of the Commonwealth Personal Income Tax, 1917-1997." The Australian Economic Review 34(3): 263-278., pp.273-275

¹⁰⁵ Smith, J. (1993). Taxing Popularity - The Story of Taxation in Australia. Canberra, Federalism Research Centre, The Australian National University., p.97

disastrous, process as that which occurred in Argentina, by reducing income taxation justice. As Australian income taxation was more entrenched as a mass tax, it was more resilient. The Australian federal state came to realise its injustice and implement significant reform that corrected the situation.

The justice of Australian income taxation greatly declined during the 1970s as tax evasion became increasingly normal. Inflation eroded tax morale and promoted evasion. This coincided with the emergence of a more socially conflictive political environment during the Whitlam government of 1972-75. This was the first postwar Labor government to win a federal election, and it launched a large and long awaited program of extensive social reform. The social conflict that it generated was so extensive that the Governor-General sacked the Prime Minister and his Labor government in 1975, despite his probable lack of constitutional power to do so. Tax avoidance began to threaten the Australian income tax in the 1960s. It was facilitated by incentives to stimulate investment or support particular industries, and especially by court interpretations that created large gaps in company taxation. This greatly increased in the 1970s, when inflation combined with the ambitious social reforms of the Whitlam Government and rising tax burdens.¹⁰⁶ As inflation pushed average wages into the top marginal tax brackets, tax avoidance became very widespread. An attempt was made to index income taxation to inflation in 1976, but it quickly proved unsustainable. A Royal Commission in the late 1970s found that tax avoidance schemes had spread to the most respected members of society. New legislation in 1980 began to close the most obvious tax loopholes, but the income tax base continued to decline.¹⁰⁷ Income tax began to make a recovery from 1985 when the 'National Taxation Summit' was held. This led to extensive reforms, including the introduction of capital gains and fringe benefits tax; an increase in the rate of company taxation to the top personal tax rate; a decrease in personal income tax rates; and the end of various industry concessions.¹⁰⁸ These reforms were strongly opposed by the business community but appear to have reversed the considerable damage to income tax that occurred from the 1960s to the early 1980s.

¹⁰⁶ Ibid., pp.99-102

¹⁰⁷ Ibid., p.109-110

¹⁰⁸ Ibid., p.111-114

Inflation seriously damaged Australian income taxation, its most important fiscal institution, from the late 1960s to the mid 1980s. Unlike Argentina, Australia repaired its income tax through significant reform and by ending high inflation. Ingenious ways of evading taxation are no longer a popular dinner party topic as they once were. More exact evidence for income taxation's recovery is found in a study of Australian tax morale, which compares tax morale in 1981 and 1995. In 1981 Australian tax morale was well below the OECD average, but by 1995 it was slightly above it (the OECD average remained roughly the same).¹⁰⁹ The Australian state managed to dodge the bullet that eventually sank the fiscal viability of the Argentine state, but the obstacles to doing so were lower. Social conflict was much lower in Australia than in Argentina (no military coups have ever occurred in Australia), and the onset of inflation, while destructive, was after a long period of success that saw income tax entrenched as a mass tax. This long period of success meant that income tax was more difficult to dislodge and that Australian fiscal institutions were more clearly dependent upon it. It was clear that income taxation could not be allowed to die, and that its death would parallel that of the (beneficial) state. Another large and important difference is that Australia avoided using seigniorage as a major source for revenue, and at least some of the high inflation of the 1960s and 1970s was due to external events. It managed to avoid opting for a negative path dependency centred on seigniorage, as Argentina did in the postwar period. The contrasting experiences of income taxation highlight the role that justice and credibility plays in its viability.

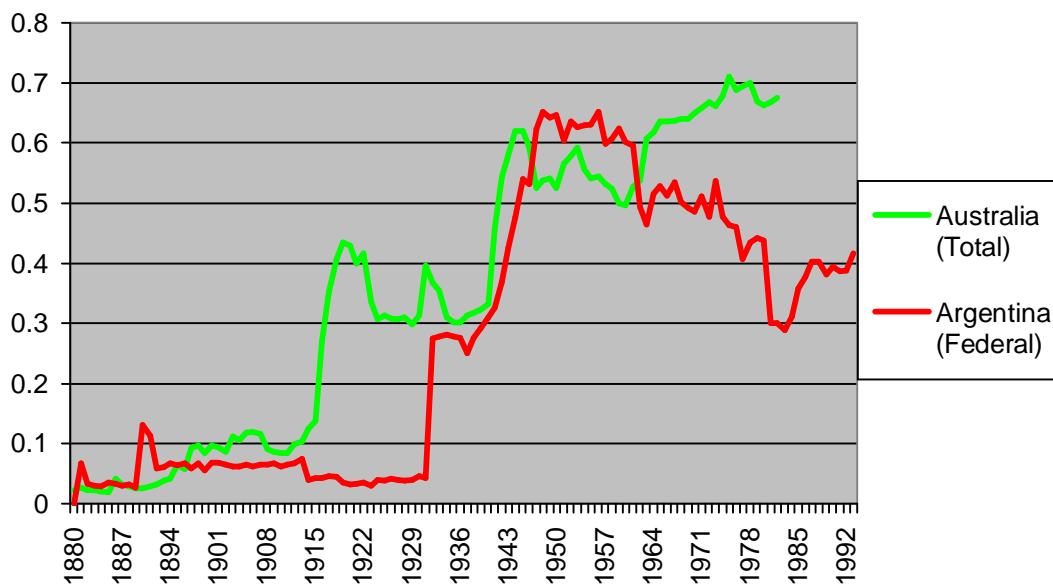
II Comparisons of the Income Tax Experience

Indirect taxation tended to decline in importance as a source of revenue in both Argentina and Australia until the mid twentieth century, as both sought more equitable, stable and substantial sources of revenue from direct taxation in order to finance their states' ability to play a significant and sustainable economic role. This was part of a global movement in developed countries. For instance in the 1920s indirect taxation provided about 35% of tax revenue in Britain, 50-60% in France and

¹⁰⁹ Torgler, B. and K. Murphy (2004). "Tax Morale in Australia: What Factors Shape it and has it Changed over Time?" Manuscript re-submitted to Journal of Australian Taxation., p.18-21

Germany, and 70% in Sweden (similar to nineteenth century fiscal norms).¹¹⁰ Direct taxation is much more difficult to collect than indirect taxation due to its inherent reliance upon cooperation. In contrast, a state does not have to be very effective in establishing its authority to collect indirect taxation.¹¹¹ Hobson observes that a state's ability to collect direct taxation (especially income taxation) relative to indirect taxation is a good indicator of state strength.¹¹² This idea can easily be expanded to incorporate state credibility, where a state's ability to collect direct taxation indicates state strength because it reflects the underlying faith of society in it. A society that has faith in its state should cooperate with direct taxation, whereas a society that does not is unlikely to. Less credible states should be more dependent upon indirect taxation, such as trade and customs taxation, than on direct taxation, such as on income and profits. Weak states still rely primarily upon indirect trade taxation for much of their revenue.¹¹³ The proportion of direct taxation to revenue should be a broad measure of state credibility.

Direct Taxation, 1880-1993



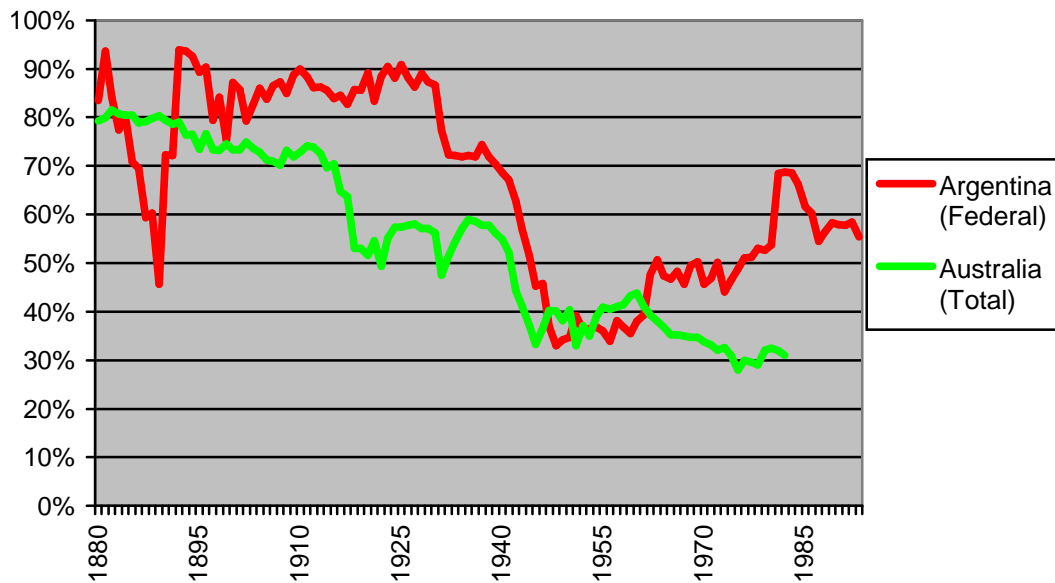
¹¹⁰ Webber, C. and A. B. Wildavsky (1986). A history of taxation and expenditure in the Western world. New York, Simon and Schuster., p.452

¹¹¹ Snider, L. M. (1987). "Identifying the Elements of State Power - Where Do We Begin?" Comparative Political Studies 20(3): 314-356., p.326-7

¹¹² Hobson, J. M. (1997). The wealth of states : a comparative sociology of international economic and political change. Cambridge ; New York, Cambridge University Press., p.234

¹¹³ *Ibid.*, p.19

Indirect Taxation, 1880-1993



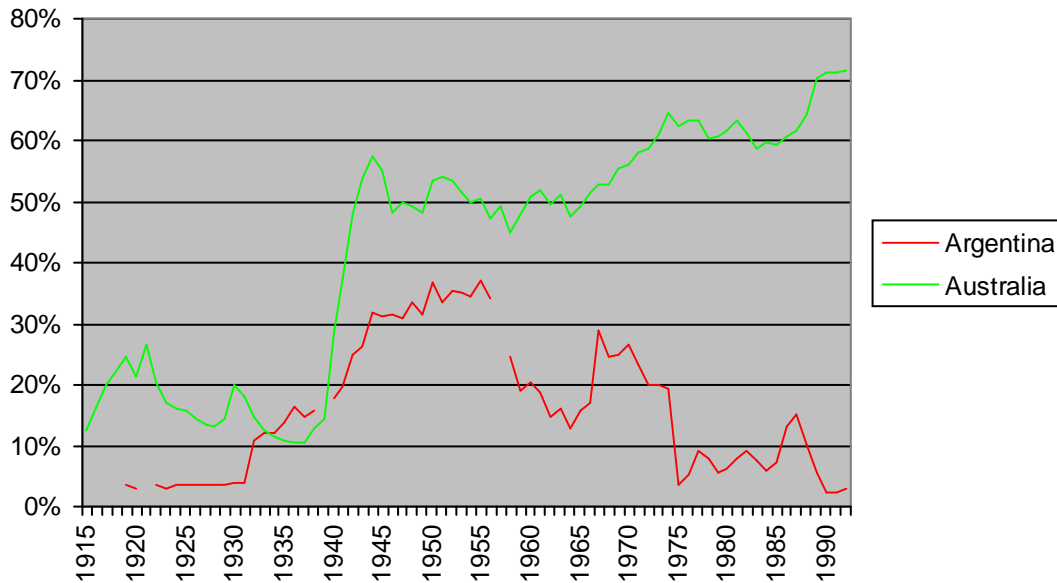
Argentina: (Cortés Conde 1989); (Della Paolera 1988); (Vazquez-Prasedo 1971); (Veganzones and Winograd 1997); (Della Paolera and Taylor 2003); Australia: (Barnard 1985); (Vamplew 1987)

Until WWI, both Argentina and Australia were remarkably similar in their dependence upon indirect taxation. As of WWI, Australia was able to greatly increase its direct taxation. It made further dramatic increases in WWII and again in the early 1960s. Argentine direct taxation remained well behind Australia from WWI until the early 1930s when it finally introduced income taxation. Argentina then made very rapid and sudden increases in direct taxation, exceeding Australian direct taxation as a proportion of revenue from 1947 until 1961. Unfortunately this proved unsustainable, as considerable tax evasion began to emerge in the 1950s. Argentine direct taxation then began an impressive and rapid decline that appears to have reached its nadir in 1983 at the end of the last military dictatorship. This fits with expectations of state credibility, democracy, and direct taxation explored elsewhere in the thesis. If direct taxation is an indicator of state credibility, the Australian state greatly solidified and/or increased its credibility during WWI, WWII and the postwar period. Argentina in contrast did not develop sufficient state credibility to support its impressive shift from indirect to direct taxation, and its credibility began to fail from the 1950s. The sudden and dramatic initial increases in Argentine direct taxation suggest that it may

not have had sufficient time to embed direct taxation within a greater context of social consensus before inflation greatly increased evasion. The conflictive stop and go nature of Argentine democracy at this time also supports such a view. In contrast the Australian growth in direct taxation was more evenly paced, taking time to consolidate after each large increase, and occurring within widely accepted ideological contexts of war and national emergency.

The single most important direct tax has been income taxation. Narrowing the focus from direct taxation as a whole to income taxation in particular, it can be seen that similar trajectories were followed. Income taxation was rapidly successful in both Argentina and Australia, and its later failure in Argentina was almost as equally rapid. Its period of success in Argentina, as a proportion of federal state revenue, lasted at least twenty years, from its introduction in 1932 until the mid 1950s. Despite its late start, the Argentine federal income tax rapidly converged to similar levels in terms of revenue as the Australian federal income tax. In the mid 1950s the Argentine income tax made its first serious decline, but it remained a significant source of revenue until the 1970s when it more or less permanently collapsed to less than 10% of revenue. Both the 1950s and the 1970s were periods of surging inflation, which appears to have been the key opportunity for decline. Argentine income taxation has now long been an insignificant fiscal institution. In contrast the Australian federal income tax has always been an important source of revenue. The graph below clearly shows the different trajectories and success of federal income taxation in each as a proportion of federal state revenue.

Income Taxation, 1915-92



Argentina: (Mitchell 2003); Australia: (Mitchell 2003)

Income taxation requires a high degree of cooperation from taxpayers and should therefore reflect their faith in the state, especially their belief that a satisfactory level of public goods will be returned to them. The proportion of income taxation to revenue should thus be positively correlated with state credibility. The comparison between Argentina and Australia shows remarkable convergence in income taxation as a proportion of federal revenue until 1955, with striking divergence thereafter. In fact there is a brief period in the mid-1930s when Argentina's federal fiscal base is more dependent upon income taxation than Australia's. This was shortly after the Argentine government of Uriburu (1930-32), which dramatically increased income and wealth taxes, but was also the first military dictatorship.¹¹⁴ It employed a broad range of aggressive tax programs to increase revenue and diversify the revenue base. The wealthy who paid income taxation in Argentina may have felt more comfortable paying under a dictatorship than under a democracy, as they may have felt a better access to power. If true, this augured badly for income taxation under democracy. Despite not participating in WWII, Argentina was able to significantly increase its

¹¹⁴ Della Paolera, G. and A. M. Taylor (2001). Straining at the anchor : the Argentine Currency Board and the search for macroeconomic stability, 1880-1935. Chicago, University of Chicago Press., p.195

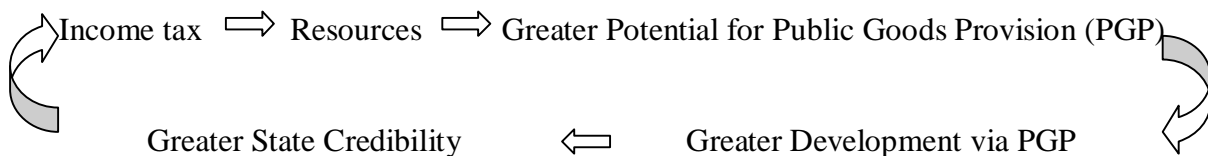
income taxation at this time. This was a considerable achievement considering that the state lacked the nationalistic rallying cry of war to credibly demand a greater sacrifice in terms of taxation. With Peron's overthrow income taxation begins its evident decline in terms of proportion to revenue, but as will be seen its decline began under Peron's administration from 1945-55. The World Wars were the pivotal events for Australian income taxation, enabling its introduction in WWI and its dramatic increase in WWII. Australian federal income taxation most clearly came into its own during WWII, when the federal state gained control over income taxation and transformed it into a mass tax. Australia continued to sustain this path from 1955 onwards, whereas Argentina slowly returned to a dependence upon regressive indirect taxation.

Using income taxation as an indicator of state credibility, Australian federal state credibility grew substantially from WWI onwards. In Argentina the initial success of income taxation reflected a fairly high achievement of state credibility (at least amongst the wealthy elite paying income tax), despite a dearth of democracy. By the mid 1940s Argentine income taxation largely reached its peak of success in terms of revenue, and began to openly fail from the mid 1950s. If the foregoing discussion on state credibility and income taxation holds, the failure of Argentine income taxation from the mid 1950s was caused and likely preceded by a failure in state credibility. This observation can be repeated for the final failure of Argentine income taxation in the mid 1970s. The opportunity for collective change and evasion in both instances was inflation. A change to a negative path dependency should have been preceded by a decline in state credibility, followed by an opportunity for change in collective action. The opportunity in the late 1940s/early 1950s was an aggressive increase in income tax rates that combined with inflation, and in the mid 1970s due to a very large increase in inflation. These opportunities greatly and rapidly increased the opportunities and justifications for income tax evasion. The timing suggests that a major failing in state credibility occurred sometime between the mid 1940s and the mid 1950s.

III Entrenching Income Tax as a Mass Tax

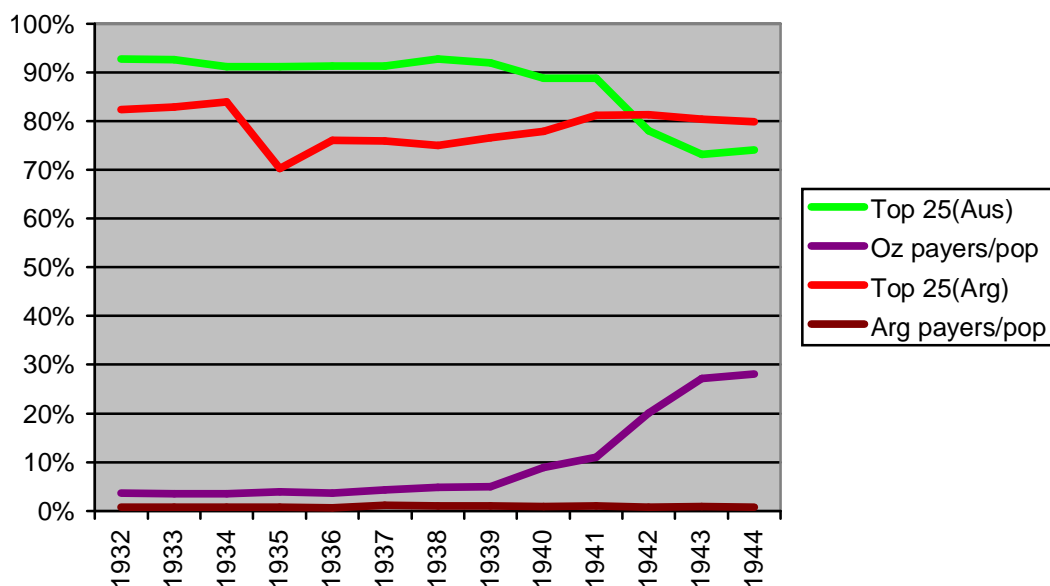
An important idea illustrated elsewhere in the thesis is that the expansion of democracy should promote a shift in the weight of taxation from indirect taxation (paid by a poorer majority) to direct taxation (paid initially by a wealthier minority). Income taxation has been a popular means for achieving such a shift. If the wealthier minority is reasonably willing to pay the initial income tax, the increased resources of the state should provide an opportunity to provide more public goods. If the state seizes this opportunity to provide greater public goods that promote development, and thereby state credibility, it will reinforce the process. Development will increase the overall wealth of society, enabling a greater proportion of people to afford income taxation. This process could transform income taxation from an elite tax on the wealthy few into a mass tax, one paid by a wealthier average, which would also entrench income taxation. Income taxation would move from being a relatively fragile institution paid by a few into a more permanent one paid by many. As an increasing proportion of society pays income taxation, it becomes more difficult to coordinate collective action against it. The successful introduction of income taxation will typically depend upon its acceptance by a wealthier minority, and if its increased resources foster greater development, income taxation should slowly become more widespread and less progressive. This scenario is confused by excessive inflation and can easily be frustrated, for instance if the state provides poor quality public goods that hinder and/or fail to foster development.¹¹⁵

The ideogram below outlines the potential for income taxation to encourage a positive path dependency of credibility & development:



¹¹⁵ A detailed analysis of public goods provision is provided elsewhere in the thesis.

Wealthier minority vs. Poorer majority?, 1932-44



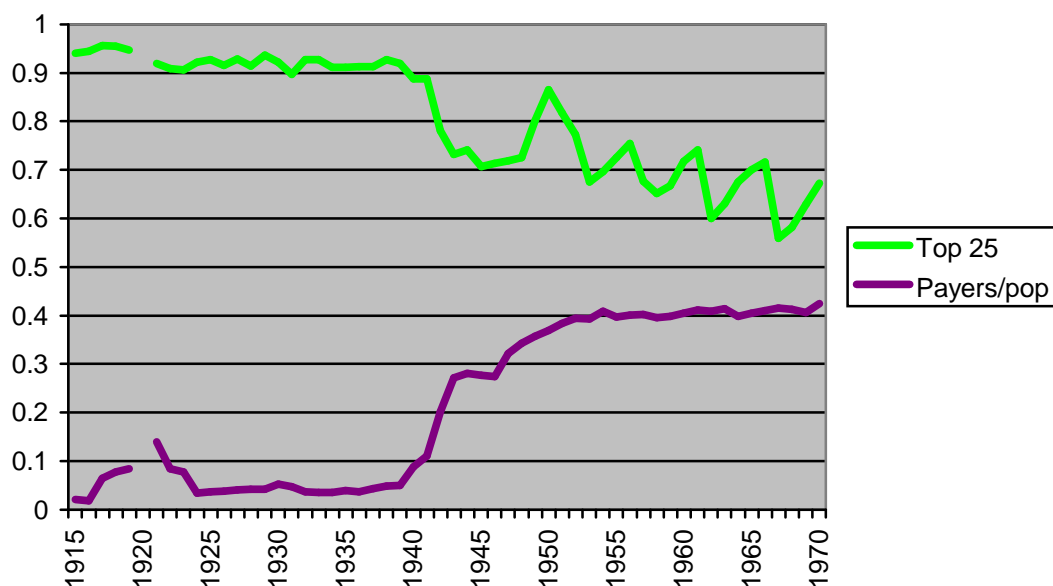
Argentina: (Nacion 1935-1945); (Maddison 2003) Australia: (Taxation 1915-60); (Statistics 1960-71); (Maddison 2003)

The chart above compares the Argentine and Australian experiences of income taxation from 1932-44, a key period. It looks at the proportion of income tax paid by the highest earning quarter of income taxpayers (as a proportion of the income taxpayer population). The period is highly significant as it was when the Argentine income tax became most successful and when the Australian income tax began to transit from an elite to a mass tax. What is striking from the comparison is the high dependence of income taxation upon a wealthy minority in both countries. Both Australian and Argentine income taxation was elite taxation for much of this period, as the top earning quarter of the income taxpayer population paid the vast majority of income tax. Australia's greater dependence is lessened somewhat by the slightly larger proportion of the population that paid income taxation. The average Argentine proportion of the population that paid income tax was only 0.85% from 1932-44. This compares to an Australian average of 4.05% prior to WWII (from 1932-39). Few people were paying income taxation in both Argentina and Australia prior to WWII, and of those few, an elite quarter were paying the vast bulk (70-90%) of it. Income taxation appears to have been a fragile institution in both Argentina and Australia at

this time, dependent upon a small group of wealthy people, despite the increasing dependence upon it as a fiscal institution.

The other striking feature of the comparison is that the Argentine graph is relatively static, while the Australian graph evidences the beginning of dramatic change. With the commencement of WWII Australian income taxation began a permanent shift from an elite to a mass tax. This change occurred too quickly to be due to greater development alone, enabled by a larger state capacity for public goods provision. Rather the state used WWII as an opportunity, via nationalism and national emergency, to demand a greater sacrifice in taxation. The external threat of war to the masses enabled their greater cooperation with the state for the benefit of greater security. There was an impressive leap in the participation of income taxpayers as a proportion of the total population, from less than 5% before the war to almost a third of the population near the war's end. This shift proved to be permanent. The move to mass income taxation was later solidified by greater public goods provision and development. The great increase in the income taxpayer population was mirrored in a relative decline in the burden upon the wealthy elite, presumably because it was already paying much of what it was willing to bear. The important development in Australian income taxation in the postwar period was its successful consolidation as a mass tax, evident in the longer run graph below. In contrast Argentine income taxation remained a fragile elite tax, never entrenching itself as a mass tax.

Elite to Mass Income Taxation - Australia 1915-70

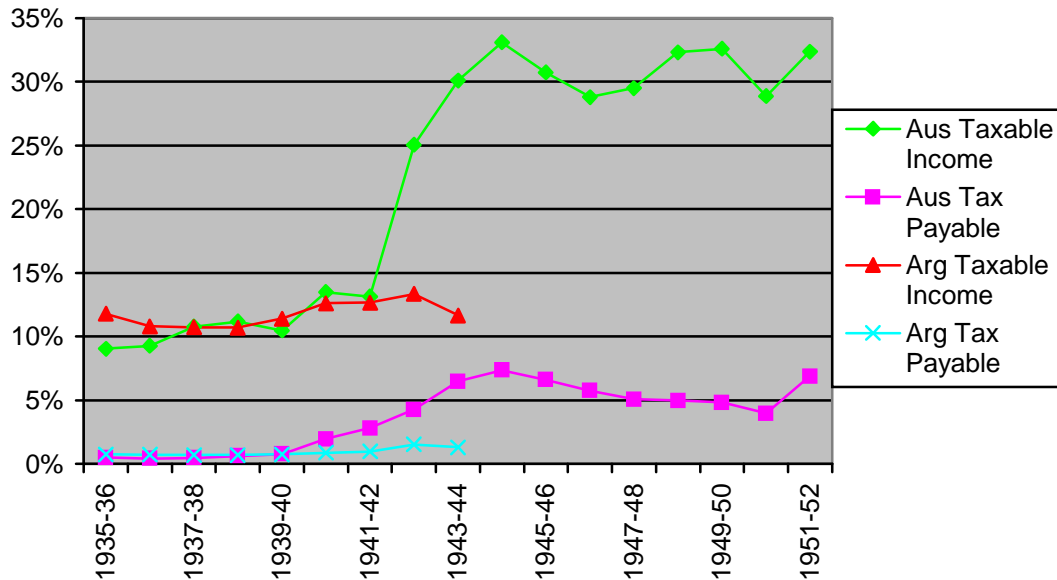


(Taxation 1915-60); (Statistics 1960-71); (Maddison 2003)

The chart above expands the Australian data from 1932-44 to 1915-70. It confirms that the shift to mass taxation began in WWII and was consolidated in the postwar period. The proportion of Australian income taxpayers continued to gradually increase, stabilising at about 40% of the postwar population from the mid 1950s. The trend in the burden of income taxation also continually shifted away from the elite top earning quarter of the population. This trend continued even after the proportion of income taxpayers to total population stabilised. Australian income taxation thus successfully transited from an elite to a mass tax, becoming less progressive over time. This should be seen as an indication of its success, at least prior to the emergence of rapid bracket creep and increasing tax evasion in the 1970s. Mass taxation meant that income taxation became entrenched, i.e. more difficult to counter collectively, as well as becoming Australia's fiscal institution par excellence. The Australian state became utterly dependent upon it. In order for income taxation to be continually successful, the Australian state must have used the opportunity presented by its increased fiscal revenues reasonably well. This would have maintained the justice of income taxation. The delivery of postwar development (or at least the ability

of the state to not impede it) lifted all real Australian incomes substantially over the postwar period, reinforcing the ability of the mass to pay income taxation.

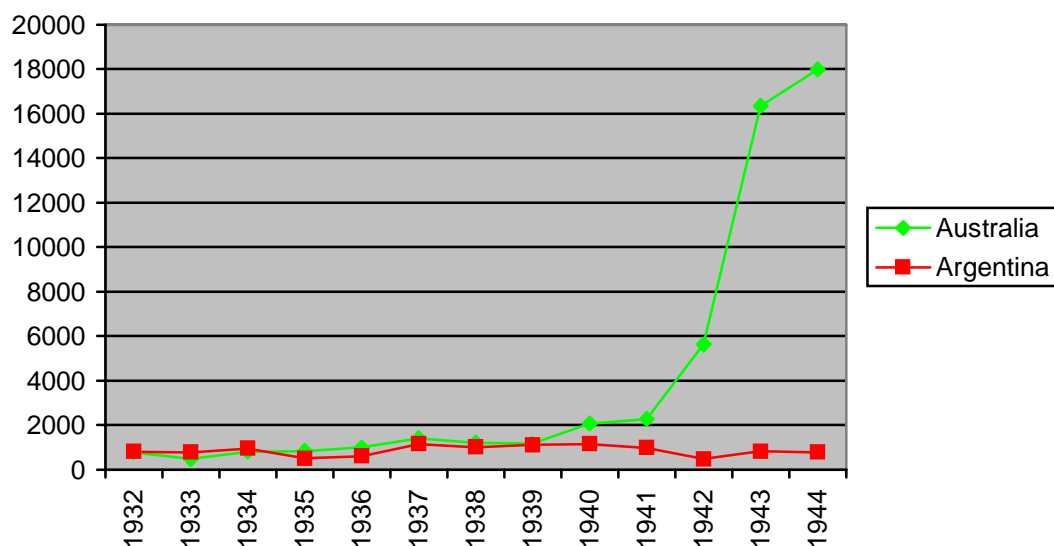
Elite to Mass Tax measured by GDP, 1935-52



Argentina: (OXLAD), (Nacion 1935-1945); Australia: (Taxation 1915-60), (Mitchell 2003)

The chart above compares Australian and Argentine income taxation from the perspective of GDP. This also shows the similarity in Argentine and Australian income taxation prior to WWII, as well as capturing the shift in Australian income taxation from an elite to a mass tax. Australia and Argentina were remarkably similar in the amount of income that was subject to income tax relative to GDP prior to WWII, at around 10-13%. They were also similar in the amount of income taxation that was paid as a proportion of GDP, at around 1%. World War II resulted in a large, dramatic and sustained divergence, when Australia increased both the amount of income that was subject to income taxation relative to GDP, and the amount of income taxation that was paid relative to GDP. The War led to dramatic and sustained changes in both, reflecting the shift from an elite to a mass tax that occurred in the early 1940s. This further substantiates the story.

How few? - Low Barriers to Collective Action - Dependence upon Elites (#s adjusted to Australia)



Argentina: (Nacion 1935-1945),(Maddison 2003); Australia: (Taxation 1915-60), (Maddison 2003)

The chart above looks at how low the barriers to collective action were amongst the elites paying the bulk of income taxation. It compares the actual number of elite individuals upon whom income taxation depended (i.e. the top quarter of the income taxpayer population). This shows just how fragile Argentine and Australian income taxations were prior to WWII, dependent upon the cooperation of surprisingly few individuals. After adjusting Argentine figures to Australia's relative population size, the graph shows that the number of elite individuals was roughly similar in terms of total population prior to WWII. Unlike Australia, Argentine income taxation retained its dependence upon the cooperation of a wealthy few. The average number of elite individuals was only 1694 from 1932-44, and the majority of them lived in the city of Buenos Aires and likely socialised together.¹¹⁶ The only region of Argentina to ever pay a significant share of income taxation was the federal capital, the city of Buenos Aires.¹¹⁷ The boundaries to the collective action of the Argentine elite in regards to income taxation were not high. If there was a reduction in the perceived justice of

¹¹⁶ This is the actual, not the adjusted number.

¹¹⁷ The city of Buenos Aires was the source of 69-79% of income taxation from 1934-40. Calculated from Memoria 1940, Nacion, M. d. H. d. I. (1935-1945). "Memorias, Direccion General del Impuesto a los Reditos.", p.23

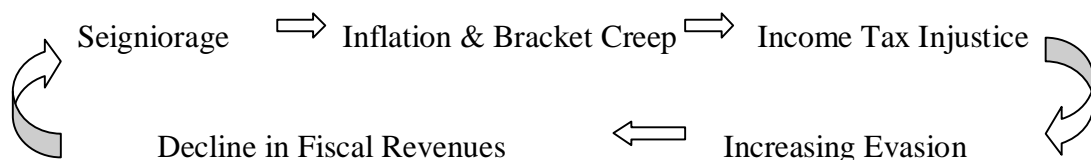
income taxation, it should not have been difficult for a change in path dependency to occur. Low barriers to collective action amongst the elite ceased to be true in Australia from WWII, as the bulk of the income tax burden spread to a much larger number of individuals coupled with greater administrative powers by collecting at source (i.e. PAYE). Such a large number of disparate individuals was much more difficult to coordinate. The move to a mass tax greatly increased the barriers to concerting collective action amongst income taxpayers, entrenching income taxation and allowing path dependency to take a stronger hold. In contrast Argentine income taxation remained a fragile institution based upon the cooperation of a wealthy few individuals. The aggressively anti-elite and socially conflictive democratic populism of Peron from 1945-55 may have destroyed their willingness to pay income taxation, engendering a silent but eventually powerful rebellion against the state. It is not difficult to imagine this silent rebellion emanating from the country clubs of Buenos Aires.

IV Delivery of Development and Entrenchment of Income Taxation

Did income taxation allow the state to deliver greater development, or at least get out of its way? There are indications that income taxation was an important variable in a positive cycle of economic growth and development. To truly entrench income taxation as a fiscal institution and sustain a shift to mass taxation, there should also be some delivery of development. This will not only increase its perception as a just tax, encouraging the necessary cooperation, but it will also allow more people to afford income tax. Increased development, especially if it is spurred by the state's provision of desired public goods, should increase tax morale and state credibility. The best way of increasing the proportion of income taxpayers must surely be to slowly expand the income tax base by raising incomes per capita as a result of development. If this is the case, a low level of inflation could be useful to slowly spread income tax via 'bracket creep'. Bracket creep has been a means for expanding the income tax base, as income tax brackets are adjusted more slowly than inflation. People are slowly pushed into higher income tax brackets as their nominal wages increase. This is fine as long as inflation is largely or partly driven by increasing demand due to development, which would mean that increasing nominal wages partly reflect increasing real wages. Bracket creep thus removes the need for constant political settlements to increase

income taxation rates, but it is by no means unproblematic. It can either help the process of entrenching income taxation or, if it occurs too quickly and/or with little development, destroy income taxation by spawning widespread evasion. Inflation due to discreditable seigniorage can drive rapid bracket creep that should undermine the justice of income taxation and encourage non-cooperation. This is a major threat to income taxation, as it can push people very quickly into higher income tax brackets, the injustice of which would be obvious, confronting, and widespread. Rapid bracket creep without a concurrent adjustment in income tax brackets could easily increase income taxation beyond the ability of people to pay. This would facilitate the coordination of collective action to evade it; a process that could open a vicious path dependency of lower fiscal revenues driving increased seigniorage. Collective action to evade income taxation could lead to income taxation's demise, depriving the state of a significant fiscal resource, one that has long been fundamental to most developed states. Rapid inflation due to seigniorage can thus be an opportunity for switching path dependencies. Bracket creep helped entrench income taxation in Australia until the 1970s when it became problematic. In Argentina it destroyed income taxation in two blows, one with the inflation of Peronism in 1946-55, and the other in the 1970s.

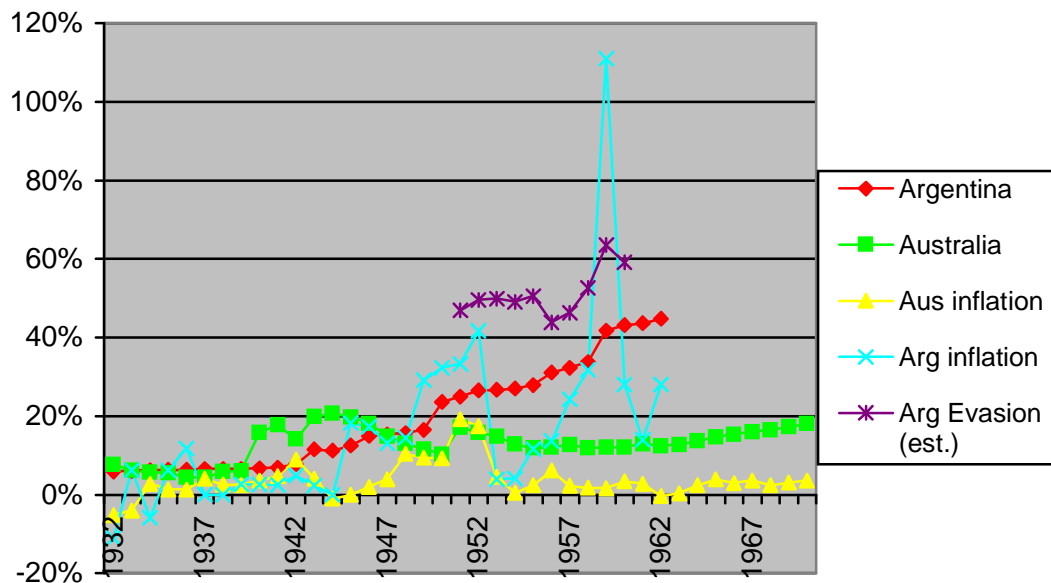
Encouragement of a vicious path dependency via seigniorage:



Bracket creep is ultimately limited in its ability to raise income tax revenues by the rate of the highest income tax bracket. Once inflation has pushed everyone into that bracket, it can provide no further benefit. In fact if such a point is reached, inflation can then result in declining income tax revenue due to the 'Tanzi effect'. This reduces real income tax revenues via the delay between assessment and collection, as the real value of money declines so rapidly during periods of high and hyperinflation. Income taxation typically has the longest lags between assessment and payment. Taxpayers rationally choose to delay payment as long as possible, as their assessed payments are fixed in nominal terms while their real values constantly decline. The Tanzi effect came into effect in Argentina during the very high inflation of the 1970s, accelerating income taxation's final demise. Inflation can thus act to reduce the justice of income

taxation due to overly rapid bracket creep, encouraging evasion, and finally undermining its capacity to collect revenue when inflation becomes very high.

Average Income Tax Rates, 1932-70

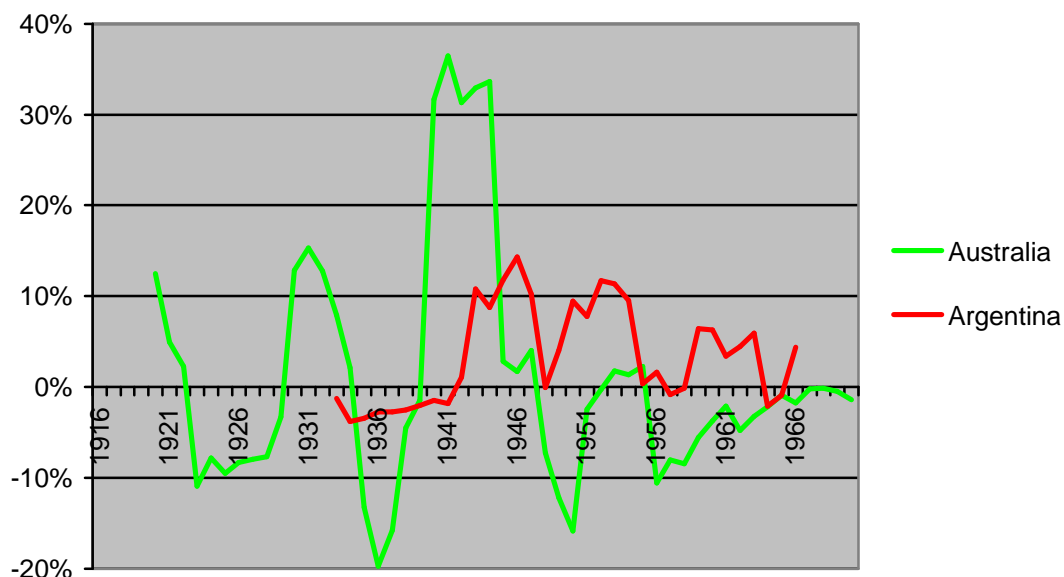


Argentina: (Nacion 1935-1945), (1963), (Secretaria del Consejo Nacional de Desarrollo 1967), (OXLAD); Australia: ((ABS) 2005), (Taxation 1915-60), (Statistics 1960-71)

The effects of bracket creep upon average income tax rates and evasion can be seen above. The average income tax rate (the proportion of total income tax to total taxable income) is one indication of bracket creep. As people are pushed into higher income tax brackets the total average income tax rate increases. This can also occur via legislative changes that raise income tax rates. The graph actually underestimates the average Argentine income tax rate from 1945 onwards (by using an unweighted average of tax rates according to each bracket rather than total income tax/total taxable income). Nonetheless it shows that prior to the war, average Argentine and Australian rates were similar. With the war, Australian average income tax rates increased dramatically to around 20%, and then declined somewhat in the postwar period while maintaining a substantial part of the previous gain. This was not due to bracket creep but to democratically endorsed legislation. After a slow decline, there was persistent but slow growth in average Australian income tax rates from the 1960s onwards with bracket creep. The large changes in the average Australian income tax

rate were due to legislation in this period, except perhaps in the late 1940s/ early 1950s when relatively high inflation corresponded with an increase in the average income tax rate. These democratic origins of increases in Australian income taxation suggest credibility, being enacted by elected representatives. Argentina serves as a dramatic contrast, where average income tax and inflation rates increased dramatically during the Peronist government of 1946-55, surpassing the Australian average at least as early as 1947 and continuing to increase thereafter. The rapid rise in the average Argentine income taxation rate was largely driven by inflation (i.e. seigniorage), which should have undermined the justice of income taxation. By the 1950s income tax evasion (estimated as a percentage of total income tax in the graph above) was quite high, increasing even further with the surge of inflation in the late 1950s. This estimate corresponds to the contemporary literature that describes a recent and massive increase in tax evasion and fraud.¹¹⁸ Argentine income taxation entered a negative path dependency of increasing non-cooperation and declining state credibility early in the postwar period.

Balance between average Income Tax and GDP growth rates, 5 year moving averages, 1916-70



¹¹⁸ Pinedo, F. (1956). *El Fatal Estatismo*. Buenos Aires, Guillermo Kraft Ltda., p.88; López, A. T. (1957). "Las sistemas fiscales como generadores de deshonestidad." *Revista de Ciencias Económicas* **62.**, p.54; Peire, J. J. (1959). *Evasión Impositiva*. Buenos Aires, Talleres Gráficos "Fanetti"; (1963). "Sistema Impositivo y la Presion Tributaria." *Boletin TECHINT* **134:** 13-56., p.53; Secretaria del Consejo Nacional de Desarrollo, S. P. E. N. (1967). *Estudios de Política Fiscal en la Argentina (Versión Preliminar)*, Republica Argentina, Presidencia de la Nación.

The chart above begins an attempt to answer the question of this section: Did income taxation allow the state to deliver development (or at least get out of its way)? It compares the growth in average income tax rates with GDP growth. To assess whether the growth in income taxation is beneficial or destructive, account needs to be taken of how fast the real economy is growing. Real incomes can only grow as fast as the economy, and usually less so.¹¹⁹ If income tax rates are growing faster than the real economy, it is likely that they will eventually be perceived as unjust and reduce tax morale. Is the burden of income taxation compensated by growth in real incomes, thus helping to entrench income taxation? A state that is successfully encouraging development should be able to offset taxation increases at least to the extent that it is able to offer growth in real individual incomes (via development). In an ideal world the efficiency gains might be such that growth in income taxation is negative when balanced against the growth in real individual incomes. The graph finds that this was largely the case in both Argentina and Australia prior to WWII, when the average growth in income taxation was less than the average growth in real GDP (asides from a brief period in the early 1930s in Australia). Making the large assumption that much of this economic growth was enabled by the increased resources available to the state from income taxation, income taxation was not only important to development but the cost/benefit calculation of income taxation was also largely in favour of income taxpayers. In Australia WWII resulted in an episode of much greater growth in income taxation rates than GDP, but this was due to legislation and was followed by an even more positive trend than previously. The Australian postwar experience is one where individual incomes may have grown faster than income taxation. In Argentina WWII marks a watershed where income taxation begins to grow persistently faster than the economy, contrasting strongly with Australia. Australian state credibility should thus have been increasing in the postwar period, as the state increased income taxation but also fostered and/or delivered growth and development to pay for it. The opposite was the case in Argentina, where state credibility should

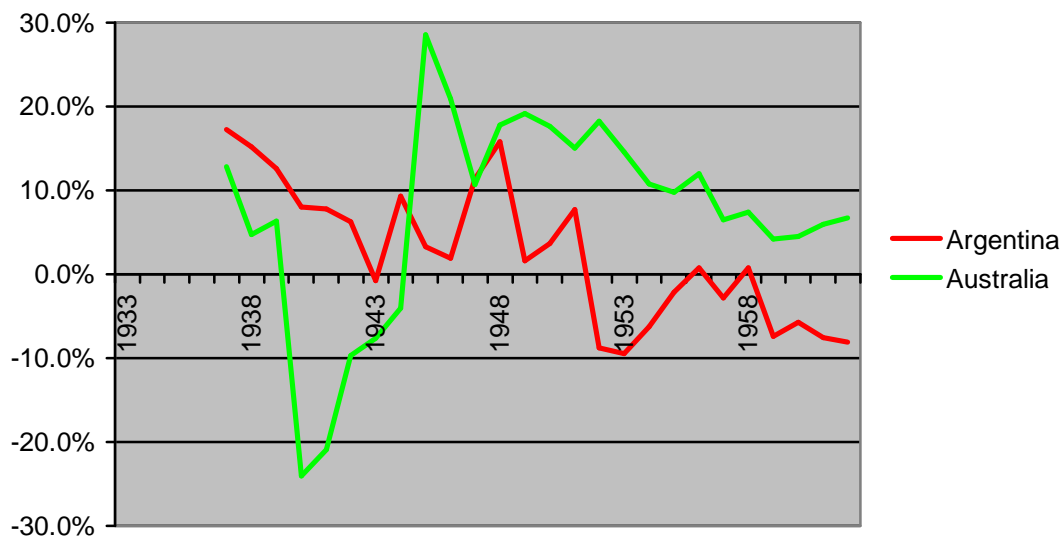
¹¹⁹ The assumption that individual incomes grew as quickly as real GDP is unlikely in reality, as there would be some lag effect and not all growth would be evenly distributed.

have been declining. The Argentine graph also implies that the fall in state credibility may have begun as early as the mid 1940s.

Or Disentrenchment and Tax Evasion?

A comparison of changes in income tax rates and revenues is made below. Legislation and bracket creep led to generally increasing rates of income tax in Argentina and Australia, averaging about 10% and 5% respectively from 1933-62. This should have led to increasing income tax revenue (all other things being equal). If it does not, it suggests tax evasion. What was the actual effect of growth in income taxation rates on income taxation revenues?

Balance between growth in Income Tax Revenue (+) and Average Rates (-), 5 year moving averages, 1933-62

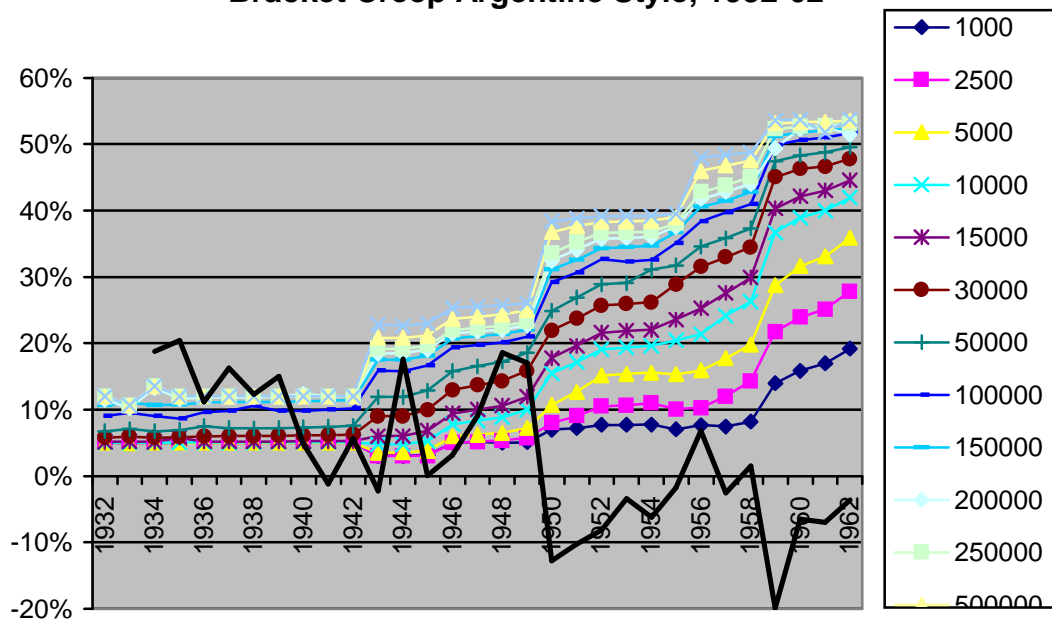


Argentina: (1963), (Nacion 1935-1945); Australia: (Taxation 1915-60), (Statistics 1960-71), (Vamplew 1987)

In a healthy fiscal environment the balance should be positive, or at least neutral. It is generally desirable that income tax revenue grows faster than income tax rates (i.e. the balance is positive), as this implies that there is increasing development reflected in individual incomes with low evasion. This is because income tax revenue is growing with the economy and/or responding well to changes in income taxation

rates. If the balance is negative, income taxation rates are growing faster than income taxation revenue. This suggests either income as a whole is declining due to recession, and/or tax evasion is increasing (more likely over time). A negative balance in spite of increasing average income tax rates due to bracket creep suggests that income taxation is becoming increasingly illegitimate. The comparison suggests that the late 1940s and early 1950s were a crucial juncture in Argentina, as income taxation became more prone to evasion thereafter. This fits very well with the foregoing, and gives a more specific timing to the turning point. In contrast Australia shows a positive balance throughout, asides from the late 1930s/ early 1940s due to legislative changes. Apart from this episode the Australian balance is positive, suggesting a healthy postwar fiscal environment and a positive path dependency with development.

Bracket Creep Argentine Style, 1932-62



(1963), (Nacion 1935-1945)

The graph above charts the Argentine experience of income taxation rates more precisely, showing how income taxation rates increased over time in constant terms compared to the Argentine balance from the previous graph. Initially income tax rates remained in a range of roughly 5-12% (as a proportion of net taxable income) from 1932-42, a period when income tax was widely accepted and became an important

Argentine fiscal institution. The story changes thereafter. Three periods then emerge: 1) from 1943-49 when rates increased dramatically at first, then slowly increased over time, ranging from 3-26%; 2) from 1950-55 when there was another dramatic increase, followed by relative stability, ranging from 7-40%; and 3) from 1956 onwards when there were further and more regular annual increases, with rates ranging from 8-54%. When combined with the previous graph of the balance between changes in income taxation rates and revenues, the crucial juncture appears to be the dramatic increase of 1950.¹²⁰ This led to a sudden and persistent rise in income tax evasion, which was only briefly reversed with Peron's fall in the mid 1950s. The dramatic increase appears to be the result of the Peronist government's intention to convert income taxation into 'the axis of the taxation system', especially as an aggressive tool for income redistribution.¹²¹ For instance:

'The point of view of the government of General Perón from 1946 has been to achieve greater justice ... for which it has been necessary to destroy the situation of economic privilege that governed the country'. (Nación 1950), p.29

As a result it not only increased income taxation rates but also added new forms of income taxation to capture previously untaxed forms of 'accidental' income, including occasional earnings and extraordinary benefits. Between 1942 and 1955, income tax rates were increased 18 times.¹²² These measures were initially successful in increasing income tax revenue, but quickly failed thereafter as evasion became widespread. Income taxation was rejected by its payers, who were often the explicitly targeted scapegoats of the Peronist government. Their rejection of more aggressive income taxation under a hostile government is hardly difficult to imagine.

Nonetheless the Australian experience shows that such mistakes are not necessarily intractable, and later governments failed to recognise the situation for what it was, and worsened it by increasing rates further. The turning point for Argentine income taxation was the late 1940s, from which it never recovered.

¹²⁰ The second graph uses a 3 year moving average rather than a 5 year moving average to more precisely date the change.

¹²¹ Nación, M. d. H. d. I. (1950). La Coordinación Económica, Financiera y Administrativa como fundamento de la Prosperidad Nacional., p.30

¹²² Sales taxes were increased 56 times during this period! Blanco, E. A. M. d. H. d. I. N. (1956). La Política Presupuestaria, La Deuda Publica y La Economía Nacional. Conferencia dictada en la Escuela Superior de Guerra., p.24

Conclusion

The different experiences of income taxation emerge as a crucial juncture in the history of Argentine and Australian fiscal institutions and development. Argentina made a brief and successful attempt to establish progressive income taxation, but this began to fail with the long period of high social conflict and inflation embarked upon from the mid twentieth century. Income taxation's final decline was completed in the mid 1970s with the resurgence of very high inflation. Its failure, from having been one of Argentina's most important fiscal institutions in the mid twentieth century, was almost total by the hyperinflation of the late 1980s. Few Argentines bothered to pay income taxation in the late twentieth century. Australia on the other hand succeeded in transforming and entrenching income taxation as a mass tax, one that the state had long been utterly dependent upon by the late twentieth century. Nonetheless the Australian income tax story was not an unqualified success, as a long and substantial period of evasion emerged from the late 1960s to the early 1980s. This was successfully reversed by the mid 1990s due to the large tax reforms of the mid 1980s.

What does the experience of income taxation tell us of divergent development? It strongly indicates the different experiences of state credibility and thereby institutional capacities to positively influence development. Looking back to the initial quotes of this chapter, a great disparity emerged in Argentina from the 1950s between those that allocated state expenditure and those that paid for it. This was largely due to a failure of state credibility. As the Argentine state greatly increased its economic role and expenditure, it found its taxpayers were unwilling to fund it. Rather than taking steps to either convince Argentine taxpayers to pay (perhaps via democratic engagement and incorporation, and more desirable public goods) or reducing expenditure, the Argentine state chose the "easy" short-term political option of seigniorage. Seigniorage forced society to fund state expenditure, but with ultimately disastrous effects. Seigniorage only makes sense in the very short-run, being politically cheap and non-confrontational. Over the long run it exacerbates the decline of state credibility by undermining its foundations, such as income taxation. No postwar Argentine government truly grasped the underlying fiscal expression of the political problem, which would have entailed considerable reform of fiscal institutions and/or adjusted state expenditure. This may have been due to a lack of

understanding of the essential problem, one that appears yet to be grasped today. It was also due to the increasing political instability that was partly a result of the negative path dependency Argentina was set upon from the mid twentieth century. As Argentine income taxation was not been transformed into a mass tax, it was much easier for it to fail when problems of credibility arose. As the fiscal institutions of the Argentine state eroded, it was unable to avoid undermining economic development via the temptation of seigniorage and insufficient public goods provision (as it monopolised their provision). Ultimately the Argentine state became an increasing impediment to development, which was driven by an inability to legitimately fund itself, by a 'lack of solidarity' between state and society. Argentine institutions failed to encourage solidarity between state and society, an important expression of which was income tax evasion. The comparison of income taxation clearly demonstrates the differing experiences of state credibility, and the importance this had upon the ability of institutions to positively influence development.

Divergence in income taxation closely parallels divergence in development in the Argentine-Australian example, from approximately 1950 onwards. The Australian state could continue to foster postwar development to some extent and/or get out of its way. The Argentine state became a major liability. As its fiscal institutions eroded, it was unable to avoid undermining development. It was slowly starved of real resources partly due to its extensive use of seigniorage as a fiscal resource. This fed into a negative path dependency of ever increasing dependence upon seigniorage that exacerbated the process. Development was undermined as high inflation slowly undermined the logic of saving and investment, wreaking havoc upon the capital markets.¹²³ A further link is to what state expenditure, expensively and inefficiently appropriated, was put towards. Expenditure upon desired public goods might have fostered sufficient development to offset the negative effects of appropriation via seigniorage. Alas, this was certainly not the case. State enterprises, to which most excess expenditure was allocated, largely represented a widespread waste of resources.¹²⁴ These enterprises were largely populist in nature and monopolist in practice, run on behalf of their workers and disparaging of their customers (i.e.

¹²³ For instance real Argentine interest rates were persistently negative in the postwar period. This is demonstrated elsewhere in the thesis.

¹²⁴ This is also investigated elsewhere in the thesis.

taxpayers). Their financing structure meant that public expenditure slowly spiralled out of the direct control of the state itself. The state also monopolised the provision of basic public goods necessary for development that it largely failed to provide. The Argentine state thus became a major impediment to postwar development. Ultimately this was driven by an inability to legitimately fund itself, by a fundamental division between the state and those it was meant to represent, expressed via silent tax revolt. The breakdown of Argentine state credibility and income taxation was incredibly expensive, and the Argentine state has yet to be reconstructed on credible fiscal bases. The failure of Argentine income taxation shows how quickly a successful fiscal institution can fail, via little more than inflation. The rapid decline of Argentine fiscal institutions and development is a warning of how quickly things can go wrong.

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