Australian State income taxes during the interwar years – Implications of economic integration for financing social services

ABSTRACT

Increasing economic integration heightens the difficulties of maintaining income tax system integrity. Contrasting with the key revenue raising role of VAT for northern European welfare states, the growth of Australia's income taxation was the main source of funding for expansion of social protection measures since World War II.

Tax reforms during World War II fundamentally changed the character of the Commonwealth's income taxation, and underpinned its post-war transition to a 'mass tax'. However, the Uniform Income Tax of 1942 was not based on a clean slate. Rather it was an income tax template based on the country's state income taxes during the interwar period. It also relied on institutional and inbuilt mechanisms to redistribute national revenues across Australia's economically diverse states.

This paper will

- describe key trends and features of Australian States' income taxes during the period 1915 to 1942, within the context of evolving Federal/State financial arrangements, and

- show how these State tax policies were intrinsically linked to Commonwealth income tax design and social protection measures introduced in the post 1942 Uniform Income Tax era.

- consider the parallels for current income taxation and federal financial arrangements.

It illustrates that Uniform Taxation in 1942 was not wartime political opportunism, or an ideological response to protecting low wage earners from income taxation. Nor was it a response to the need for fiscal and constitutional powers for macroeconomic management. The paper identifies economic disparities between the States and Federal/State finance arrangements, tax competition, and revenue declines during the Depression, as important economic and institutional constraints on Australian governments' responses to the fiscal problems of this period. Uniform Taxation, along with the establishment of the Commonwealth Grants Commission (Smith 2002), is shown to be a solution to those difficulties for implementing effective income tax policy to fund social protection in the federal system. It is concluded that as globalization and economic integration increases taxpayer mobility and cross-jurisdictional tax competition, there are comparable issues for current national income tax policy in an international context (Smith 2004 (1993)).

Introduction

As shown elsewhere (Smith 2002), wartime tax reforms fundamentally changed the character of the Commonwealth income tax, making it less steeply progressive in incidence and providing the basis for its post-war transition to a 'mass tax'. The Uniform Tax Plan of May 1942 replaced all existing State income taxes, and taxes on lower income earners were substantially increased the following year (Laffer 1942)(Carslaw 1980 [1941-47]). The expansion of Commonwealth income tax revenues after World War II effectively financed Australia's post-war welfare state.

It is common to assume, in line with experience in the United Kingdom (Peacock and Wiseman 1967), that such changes to taxation and social security originated in the crisis of World War II. For example, Butlin *et al.* (Butlin, Barnard et al. 1982) and Watts (Watts 1987) emphasise the Commonwealth's wartime taxation policy reforms in the transition to mass income taxation. The conventional interpretation of tax unification in 1942 is that it arose from the need of the Commonwealth Government to finance war expenditures and was a natural outcome of the negotiations over the 'maddening maze' of State taxes (Bailey 1980 [1944], p. 309); and sharing of income tax powers from 1916 to 1941 (Laffer 1980 [1942]). Maddock (1982) has argued that, because the Uniform Tax Plan did not immediately increase the income tax burdens of lower income earners, tax unification reflected the ideological disposition of the Curtin Labor Government. A similar interpretation of uniform taxation as wartime political opportunism by the Commonwealth is drawn in Levi (1988). An alternative view put by Krever and Mellor is that "the most important reasons for the move involved Australia's institutional response to the emerging views worldwide about the importance of economic management at the national government level, and the establishment of sufficient fiscal and constitutional powers at that level to be able to carry out that role" (Krever and Mellor 2014).

However, such interpretations of a 'war crisis' or macroeconomic management origin for the transition to mass income taxation focus excessively on specific events or political parties and ideologies. They ignore the significance of pre-existing State income taxation and the economic, social and institutional forces shaping it over a considerably longer period of time.

For example, on the eve of World War II, State income taxes accounted for nearly half of national tax revenues and three-quarters of all income taxation in Australia. During the 1920s and 1930s, increased government spending was driven by the need for higher social expenditures; it was the expansion of State income taxation that financed this. The growth in the States' income taxation occurred amidst almost continuous Commonwealth–State negotiations on taxation, as the open-ended financial provisions of the Constitution were interpreted and given practical effect from 1901. Within the bounds set by the Constitution, State income taxation had also been responding to the growing integration of the Australian economy and the massive economic shock of the 1929–32 Depression. The former made the States' taxation of higher incomes administratively complex and difficult to enforce: the latter meant the State treasurers had to reconcile these intractable economic constraints with the strong political imperatives to fund social relief through higher taxation.

Most importantly, when the Commonwealth Uniform Tax Plan was implemented in 1942, it was not based on a clean slate but on an income tax template designed by the State treasurers over the previous two or more decades. The 1942 Commonwealth income tax not only aimed to replicate the revenues of existing State taxes for that year, it also sought to do so with as little change as possible to the existing patterns of income taxation (Carslaw 1980 [1942–47]). As a result, Commonwealth income taxation from 1942 was significantly shaped by the design and incidence of the State income taxes that it incorporated.

Thus an exploration of State income taxation and its redistributional role is essential for understanding Commonwealth income tax policy in the period 1939–42 and its implications for the post-war expansion of social services. The character of pre-1942 State income taxation, and the timing of changes in their progressivity, also has a bearing on the debate on how the move to uniform taxation should be interpreted, and on the relevance of 'war crisis' theories of the growth of taxation to Australia.

The purpose of this paper is to assess the constraints, trends and other features of State income taxation in the interwar period, and to explore the relationship between these State policies and Commonwealth income taxation and the 1944 National Welfare Fund from World War II.

Firstly, it identifies some important institutional and economic constraints shaping interwar State income tax policies, while the second section outlines the main features and trends of the States' ordinary income taxes between the early 1920s and 1942 and attempts to statistically evaluate overall State income tax progressivity during the interwar period. The following section examines the special earmarked income and wage taxes introduced during the Depression. The significant tax administration issues raised by taxing wage earners are then considered and the implications for the Commonwealth's post-war income taxation explored.

Constraints on States' income taxation during the interwar period

At Federation in 1901 only 6 per cent of Australian tax revenues came from income taxes (Table 4.1). By 1939–40 income taxes were 34 per cent of national taxation and about three-quarters of this was levied at the State government level. The substantial expansion of State income tax revenues more than offset a Commonwealth Government policy of reducing its income taxation from 1922 (Barnard 1986a).

As the Commonwealth income tax levied higher and middle incomes relatively heavily, its declining role in Australian income taxation during this period indicates that aggregate income tax progressivity was diminishing *pari passu* with the expansion of States' taxation.

Table 4.1
Income Tax Share of Taxation 1901–1945

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

Source: Derived from Barnard 1985.

Contemporary observers attributed the strong interwar expansion of State income taxation to the States' heavy burden of post-war reconstruction and development and their diminishing share of customs and excise revenues (Murphy 1980 [1928]).[1] Thus, with the Constitution barring States from imposing their own 'excise' taxes, it was mainly a £23 million expansion of their annual income tax revenues (Barnard 1986a) that financed the £43 million annual expansion of Australian social expenditures during the interwar period. Although the

[1] By the mid 1920s, post-war inflation had severely eroded the real value of the per capita payments to States agreed to in 1910 (May 1971). While Commonwealth customs and excise revenues rose from £17 million to £48 million between 1919 and 1938, Commonwealth payments to or for the States rose by only £9 million over the same period (Barnard 1987).

Commonwealth's annual spending on social programs rose by around £12 million between the world wars (1919–1938), most of the increase (£31 million) was by the States (Table 4.3). While higher direct taxation funded the States' new social spending, that of the Commonwealth was in effect funded from increased indirect (customs, excise and sales) taxation.[2] Meanwhile, taxation as a percentage of gross domestic product rose from around 8 to 15 per cent during this period (Barnard 1987).

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

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

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

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

The substantial expansion of State income taxation between the two world wars occurred in the context of two significant, and related, constraints.

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[2] The Commonwealth reduced its annual land and income taxes by £3 million between 1922 and 1938. See Smith (2002) for a discussion of the redistributional role of its indirect taxation, drawing on the case of sales taxation since 1930.

Firstly, the Commonwealth's income tax, introduced in 1915, constrained the States' taxation of middle and high income earners (Murphy 1980 [1928]). The problem arose from the distribution of taxing powers under the Commonwealth Constitution (Bailey 1980 [1944]). Since 1915 there had been complicated and difficult negotiations over how the direct tax field should be shared.[3] Despite the desire of the Commonwealth Treasurer to withdraw from taxing incomes,[4] the Commonwealth Government could not afford a complete retreat from the wartime tax regime because of the heavy cost of war debts and related obligations (Copland 1980). It was also increasingly evident by the mid 1920s that the Commonwealth needed to make some provision in its own finances for the deteriorating financial position of some States (see Gilbert 1973; May 1971). The Commonwealth had, therefore, tried to get the States to tax the lower end of the personal income range while it taxed higher personal and corporate incomes exceeding £2000 a year, but this was contentious (Gilbert 1973). While making sense in economic terms, it was politically favourable only to the Commonwealth. It meant that the States forewent the advantage of taxing companies and higher personal incomes, which were relatively constant and predictable in their political alignments as well as lucrative sources of revenue. On the other hand, most of the electorate would be subject to State taxation. That is, Commonwealth and the States each preferred to occupy the popular taxation fields and leave the most unpopular to the other. In 1926, tax negotiations were abandoned in favour of a Commonwealth take-over of the States' debts under the 1927 Financial Agreement. However, the key issues of direct tax assignment and the varying tax capacities of the States remained unresolved and the pressing problem of double taxation was untouched (Prest and Mathews 1980). As a leading economic commentator on taxation, Professor R.S. Mills, pointed out at the time, the agreement resulted in 'a certain maladjustment of financial means to political ends' (Mills 1980 [1928], p. 73). The Commonwealth Treasurer was frequently able to announce reductions in its income tax rates during the 1920s: 'State Treasurers have been forced to increase rates of taxation and have even explored new and unconstitutional avenues such as the petrol tax of South Australia and the newspaper tax of New South Wales' (Mills 1980 [1928], p. 73).

A second and growing difficulty for States was growing inter-State trade and investment, which implied stronger competitive pressures to reduce taxes. Already in the early 1920s, the growth of internal trade in Australia was seen as making State taxation of shareholder and company incomes increasingly complex and inequitable (Australia, Royal Commission into Taxation 1922) and led the Kerr Royal Commission to its recommendation that income taxation become the exclusive preserve of the Commonwealth. This recommendation was supported by leading economists (for example, Copland 1925, 1980a [1924], 1980b [1927], and Mills 1980 [1928], who noted that the States' income taxation had an inherently lower yield. This was partly because aggregating incomes which were derived from more than one State produced significant revenue benefits under the strongly progressive Commonwealth income tax, but it was also because the yield of the separate State income taxes was increasingly constrained by tax avoidance and tax competition as the volume of inter-State trade rose.

Such economic pressures on tax policy are apparent in converging State income tax rates over this period. As interstate mobility increased, the States would have been drawn into more intense 'tax competition', either regarding the tax base or through competition on rates of tax.[5] Tax competition between the States could have been expected to be most intense regarding rates on mobile 'property' incomes and on higher income individuals.

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3 See Australia, Royal Commission on Taxation (1934a, pp. 51–5) for a chronology, and Copland (1980 [1924]) and Mills (1980 [1928])for contemporary commentary and analysis of these negotiations.

4 The 1921–23 Royal Commission into Taxation recommended centralising income tax (Australia, Royal Commission into Taxation 1922). However, influenced by conservative fiscal ideologies and a rural and commercial political constituency that was antagonistic to direct taxes, Treasurer Earle Page reduced Commonwealth land and income taxes. He envisaged that creating room for the States to expand their income taxation would enable the Commonwealth to end the per capita payments to the States. See Smith (2004) regarding Commonwealth–State financial relations during this period.

5 Competition through rates may have been intensified during the 1920s by the cuts to Commonwealth income tax rates, which would increase the effective progression of the State schedules (Scott and Triest 1996). The

Tables 4.3 and 4.4 present data on the States' highest marginal tax rates on income from personal exertion and from property for selected years during the 1920s and 1930s and estimate the coefficient of variation for each of those years.

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

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

Source: Barnard 1987.

recommendations for more uniform tax bases by the Fergusson Royal Commission on Taxation in 1932–34 may also have discouraged further competition through the tax base during the 1930s.

Table 4.4
State Income Taxes, Highest Marginal Rates

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

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

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

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

Sources: See Table 4.4.

It is evident from the declining coefficient of variation in both Tables 4.4 and 4.5 that differences in income tax rates on higher income earners did narrow, presumably encouraged by economic integration and State tax competition. It is also apparent in Table 4.5 that rates of taxation on property incomes, while slightly higher than on personal exertion income, were somewhat less variable between States than rates on personal exertion income. Furthermore, differences between the States converged more rapidly between 1921 and 1937 for rates on property incomes than on personal exertion incomes.

That tax competition constrained the States' income taxation of higher income earners is suggested also by the increased tax imposed on higher property incomes by the Commonwealth's revenue-neutral Uniform Tax Plan in 1942 (Bailey 1980 [1944]). Most States left considerable taxable capacity among higher income earners untouched, although the heavy taxation in

Queensland prevented the Commonwealth from taxing this field more heavily until 1942 (Carslaw 1980 [1942–47]).

Thus it is apparent, that while economic and political constraints did not prevent expansion of the States' income tax revenues during the interwar period, they did shape its extent, its design and its incidence. State income taxation during the interwar period is discussed in more detail in the following two sections, the first of which looks at the States' use of ordinary income taxes to supplement their depleted revenues in the late 1920s, and the second examines the special Depression income and wage taxes — the States' preferred alternative to increasing income taxes on middle and high income earners.

The States' ordinary income taxes

There was little economic or political impetus for drastic changes to the incidence of State income taxes until the mid 1920s. Economic conditions were relatively stable, prices and income growth moderate, and the levels and structures of income taxes were largely unaltered by the legislatures.

Key features of State income taxes early in the 1920s are illustrated in Figure 4.1, which is reproduced from the 1922 report of the Royal Commission into Taxation. This supplement the information presented in Tables 4.4 and 4.5 showing the considerable diversity of State income tax policies during the early interwar period.

Despite the massive increase in the Commonwealth's income taxation after 1915, the States were again collecting more income tax than the Commonwealth by 1924–25. As the Commonwealth reduced its income taxation from the early 1920s, the States increased theirs. Table 4.6 shows the per capita income tax burden from the mid 1920s to World War II, with the rise in the severity of State income taxation clearly apparent.

Until the 1920s, State income taxation was broadly progressive, with a gradual convergence towards graduated rate structures after Federation. In keeping with the contemporary thinking on income tax design,[6] all States taxed property incomes more heavily than 'personal exertion' incomes.

However, later in the 1920s, differences in State income tax systems and policies multiplied (Murphy 1980 [1928]; Laffer 1980 [1942]; Groenewegen 1988). Those States with the least taxable capacity faced particularly serious financial difficulties, which were magnified by the Depression from 1929 (Giblin 1928, 1929, 1980a [1930]). The Depression also reopened tax conflict between the Commonwealth and the States.[7]

In Queensland until the mid 1920s, the statutory exemption was £250 (Queensland, Government Statistician's Office, *ABC of Australian and Queensland Statistics*, various years; *Queensland Year Book*, various years).[8] This was lowered to £150 p.a. during the Depression. At that time tax rates were increased sharply.[9]

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6 See Smith (1993b) for an overview of the historical development of Australia's progressive taxes, Van den Driesen and Fayle (1987) for the early history of State income taxes, Murphy (1980 [1928]) and Groenewegen (1988) for analysis of key features and origins of Australian income tax design, and Shehab (1953) for a detailed analysis of how the progressive income tax principle evolved in the United Kingdom.

7 As incomes fell dramatically, the Commonwealth sought to offset declining revenues by raising its income tax on the lower range of incomes already taxed by States. Although the States tried to boost declining revenues through taxing company and property incomes more fully, this worsened the problems of double taxation between the various income taxing authorities.

8 Income taxation was comparatively heavy in Queensland, although the very highest incomes were quite lightly taxed.

9 Rates on incomes up to £8000 were doubled to 6d in the pound, and rates also increased on higher incomes. A super tax of 20 per cent applied to those with net incomes above £438. 'Additional tax', with rates ranging from 15–27.5 per cent, applied to taxable incomes above £779 from 1930–31.

South Australia, one of the poorer Australian States, began applying ordinary income taxes to annual incomes as low as £150 from 1917 (Office of the Government Statist, various years). The State also raised its rates of income tax from the mid 1920s.[10] From 1927–28, under severe financial stress (May 1971), the State began taxing all incomes above £100 p.a.

The more affluent States, on the other hand, expanded revenues during the 1920s mainly by imposing higher rates on existing taxpayers. This move was concentrated on single taxpayers earning more than £200 p.a. For example, from 1925–26 New South Wales increased the statutory deduction from £250 to £300 p.a. (New South Wales, Office of the Government Statistician, various years). Income tax rates were also briefly reduced[11] but were then raised again in the late 1920s, particularly on incomes above £500. In Victoria, the taxable income threshold remained at £200 p.a. throughout the 1920s, with revenues bolstered by increasing income tax rates (Victoria, Office of the Government Statistician, various years).[12]

This brief chronology of State income tax changes shows that the transition to 'mass' income taxation began in Australia in the mid 1920s when less prosperous States like Queensland and South Australia extended income taxation to low income earners, and as States increased ordinary income tax rates to expand revenue.

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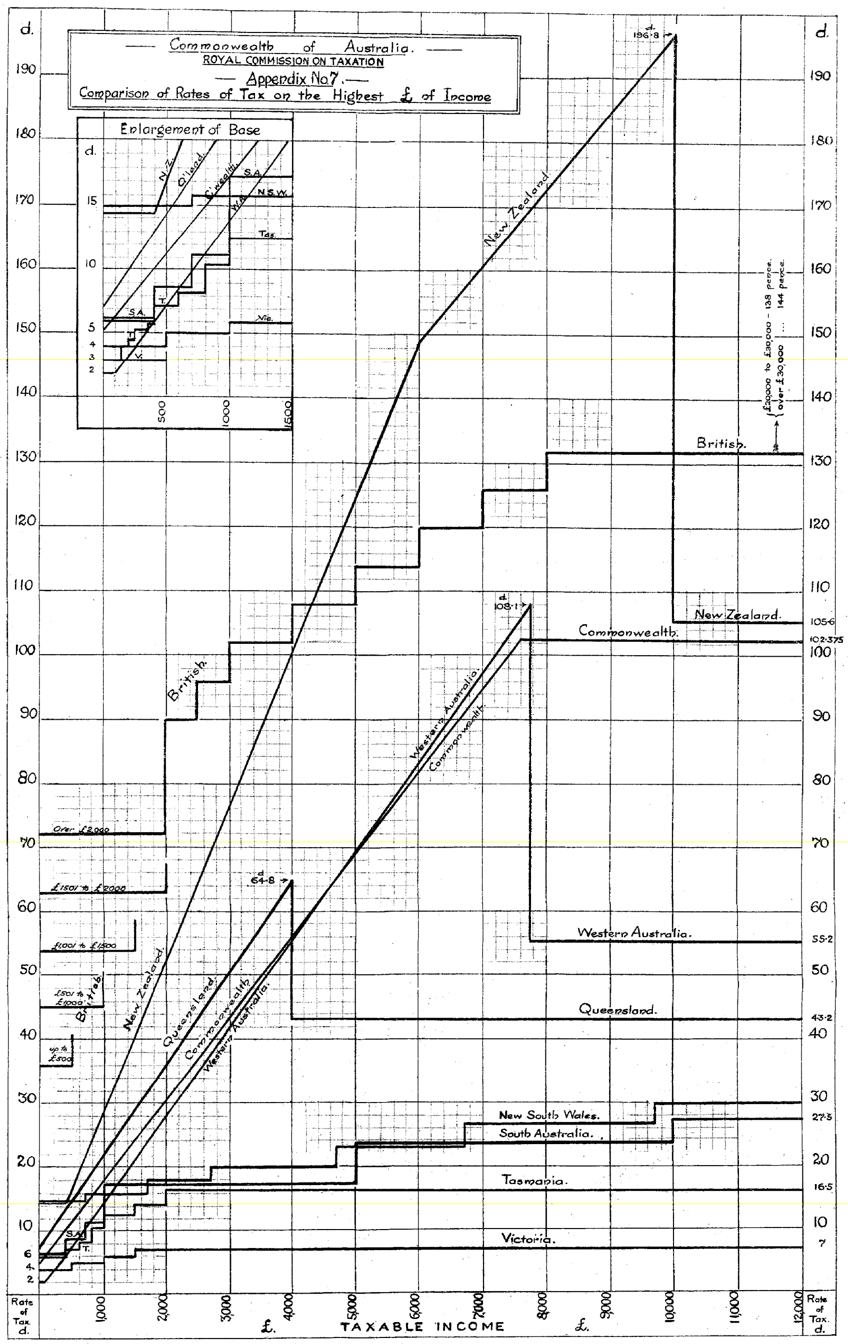
[10] From 1917–18 to 1925–26, rates of 5d in the pound applied to taxable incomes between £1 and £400, 7d applied to incomes from £401 to £700, and a rate of 1s 10d applied on incomes exceeding £10,000. Higher rates applied to property incomes. From 1916–17, 'bachelors' also paid a fixed tax of £1, while a super tax of between 6d and one 6d applied to incomes above £1000. The super tax became a surcharge of 25 per cent of the total amount of income tax from 1917–18. In 1925–26, tax rates were increased to commence at 5½d for the first pound of taxable income, increasing by ½d for each pounds up to £4400, and then a flat rate of 2s 3d in the pound. Higher rates applied to property income, which commenced at 11½d for the first pound of taxable income.

[11] The State traditionally taxed incomes relatively heavily, although with a generous statutory deduction and concessional allowances.

[12] Tax rates were increased by ½d for each of the 1924–25 and 1926–27 income years, again for 1928–29, and by 1d for 1930–31. A super tax on individuals' incomes also applied to incomes above £800 from 1923–24. For 1929–30, a further additional tax of 7½ per cent of total tax was imposed on all taxpayers. This was in addition to the former super-tax, which ranged between 10 per cent and 25 per cent for individuals with incomes above £800. However, the effects of increased rates of taxation were partly offset for the many taxpayers with dependents by expanded concessional deductions.

Figure 4.1
State Income Taxes, Highest Rate of Taxation



Source: Royal Commission into Taxation 1922, Appendix 7

Data on the distribution of State personal income taxation also permit some systematic analysis of income tax progressivity during the interwar period by enabling the calculation of global indices of tax progressivity. Such data are available more or less continuously during the interwar period for Victoria, South Australia, and Queensland. In 1922–23, these States accounted for 29 per cent, 10 per cent and 8 per cent of Commonwealth taxable incomes respectively. Data are also available for 1920–21 in New South Wales, which accounted for 36 per cent. Patterns evident in these States are thus likely to be reasonably representative of aggregate patterns and trends for the States as a whole. Together with consideration of the special Depression taxes in the following section, these estimates provide some indication of how the redistributional role of State income taxation changed during the 1920s and 1930s. They also provide an incomplete but suggestive comparison with Commonwealth income tax progressivity in this period (see Smith (2002)).[13]

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

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

Note: [a] Includes Family Endowment Tax.

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

Table 4.7 shows that the comparatively light Victorian income tax played only a minor redistributional role.[14] By contrast, the tax progressivity index for a single year, 1922–23, suggests New South Wales' income tax was about as progressive as the Commonwealth tax at the beginning of the 1920s (Table 4.8). This reflects both the high average tax rate in New South Wales and its progressive structure (as reflected in the S and K indices). Indices for Queensland (Table 4.9) likewise reveal a strongly progressive tax; rising S and K indices and a stable M–T index suggest that a steepening of progression in the tax burden offset a declining average income tax yield over time.[15]

Tax indices for South Australia (Table 4.10) also show a relatively stable income tax scheme throughout the 1920s. The decline in progressivity after 1930 reflects the regressive effect of the fixed tax introduced that year: the poll tax of £2 10s per taxpayer, which raised an

[13] Global tax indices have been used extensively since the 1970s to compare different tax systems or changes over time in the progressivity of taxation. Commonly used indices include the M–T index, known as the 'coefficient of tax progression' (Musgrave and Thin 1986 [1948]), the K index (Kakwani 1977a, b), and the S index (Suits 1977b). The properties of these progressivity indices and issues in interpretation are discussed in Smith (2001).

[14] However, this tax is not directly comparable with that of New South Wales, for example, because although around 15–20 per cent of income earners were taxpayers under the Victorian levy, around 50 per cent appear to have been subject to New South Wales income taxation.

[15] The sharp increase in progressivity in 1941–42 reflects uniform income taxation. This is because statistics reported for this year include both Commonwealth and Queensland income taxes. This indicates the overall progressivity of national income taxation before the structure and levels of Australia's income taxes were drastically altered by wartime tax increases and before the heavier Commonwealth taxation of lower incomes from 1943.

additional £300,000 in revenue in 1930–31, made the South Australian income tax effectively proportional in incidence. Over the period 1930–35, around 43 per cent of personal income taxation in South Australia was paid by those earning less than £200, compared with 25 per cent in 1924–25 (South Australia, Office of the Government Statist, various years).

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

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

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

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

Year ending June	*M-T*	*S*	*K*	*Average tax rate per cent*
1921	1.03	0.43	0.23	6

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

In States other than South Australia, the myriad of special taxes introduced during the Depression complicates the systematic comparison of States' income tax policies. Because South Australia raised all its additional income taxes through the ordinary tax, rather than by separate new taxes, trends in its ordinary income tax, therefore, provide the best indication of the extent to which State governments' responses to the financial crisis reduced the progressivity of their income taxes.[16]

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

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

Note: [a]Taxable income in 1924, 1938 and 1939; net income in 1933, 1935, 1936 and 1937; gross income in 1927 and 1932.

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

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

Year ending June	*M–T*	*S*	*K*	*Average tax rate, per cent*
1926	1.01	0.29	0.16	4
1927	1.01	0.25	0.14	4

[16] A difficulty in comparing trends in such indices over time or between States is that they are distorted by variation in the coverage of the income earners in tax statistics. Different policies on the threshold at which incomes became taxable can bias measures of tax progressivity. In the absence of reliable State data on these excluded incomes, some assessment can be made of the effects by using the incomes data from the 1915 War Census to approximately adjust the indices. For example, while the Commonwealth income tax covered around 15 per cent of Victorian income earners during the early 1920s, the State tax covered 20 per cent. In New South Wales, State income tax covered around 50 per cent of income earners; the proportion of State taxpaying income earners was probably at least as high in South Australia. Adjusting approximately for the different coverage of income tax in New South Wales, Victoria and the Commonwealth does not alter tax progressivity rankings in the 1920s, showing that the Commonwealth tax was slightly more progressive overall by all measures than the New South Wales tax. The Victorian tax, levied at low average rates and having a relatively flat rate scale, was the least progressive in structure and had little effect in altering the post-tax distribution of incomes.

1928	1.01	0.23	0.14	4
1929	1.01	0.23	0.14	4
1920	1.01	0.22	0.13	5
1935	1.00	0.03	0.00	9
1940	1.01	0.07	0.04	8

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

The special Depression taxes of the other States are examined in more detail below in order to show the generally regressive character and the complexity of these taxes and the policy behind them.

The Depression taxes

With the disruption to public finances by the Depression from 1929, most States introduced various special taxes on incomes and wages. The average burden of these taxes per capita exceeded that of the States' ordinary income taxes in every year from 1931–32 to 1935–36 (Table 4.6).

These levies had quite a different incidence from the ordinary State income taxes, because they were typically designed to tax the previously untouched broad mass of wage earners and were fixed amount or proportional rate taxes. Furthermore, many were assessed on weekly earnings. As many workers could find only irregular employment, this increased the effective burden and raised the yield compared to equivalent rates of tax assessed on annual incomes.

While governments also increased tax on high income earners, the major contribution to revenue came from expanding tax coverage to the lower ranges of income. The high yielding but regressive taxes were typically earmarked to fund unemployment relief and social services (Bland 1976 [1934]). As such, they represented a substantial contribution from the wage-earning classes to the financing of growth in social welfare expenditures during the 1930s.

The Depression taxes are summarised in the *ABC of Australian and Queensland Statistics* and the *Queensland Year Book*. New South Wales, for example, imposed an 'Unemployment Relief Tax' in 1931 on weekly wages and incomes earned in 1930–31.[17] This was replaced from December 1933 by the 'Special Income Tax' and 'Wages Tax'. The revenues were used to fund unemployment relief, child endowment and other social services (Commonwealth Bureau of Census and Statistics, *Labour Report*, 1940; New South Wales, Office of the Government Statistician 1940). From 1939, these were superceded by the 'Unemployment Relief Tax' and 'Social Services Tax' (Sawkins 1933).

Likewise from the 1929–30 income year, the burden of income taxation was extended to the lower incomes in Victoria through the 'Unemployment Relief Tax', and, from 1931–32, by a 'Special Tax'. The 'Unemployment Relief Tax' was for the purpose of providing employment on relief works and sustenance for unemployed workers and their dependents; and in 1932–33 it applied at a rate of 10s per £100 for incomes up to £104, rising to a maximum rate of 118s 6d on incomes exceeding £3000. The minimum taxable income was £52 p.a. The Victorian 'Special Tax' applied to income earned by any person, with the minimum taxable income being £101. Rates ranged to 12s 6d where the taxable income exceeded £2500. The deductions allowed for ordinary income tax were not allowable for calculating taxable income for these taxes. Because of the large number of income earners subject to tax, the revenues mounted quickly.

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[17] After mid 1932, in accordance with the *Finances Adjustment Act*, the revenues were paid into consolidated revenue rather than administered off-Budget by the Unemployment Relief Council.

Around 55 per cent of the ‘Unemployment Relief Tax’ came from those earning £500 p.a. or less, compared to 23 per cent of ordinary income tax assessed. While in 1924–25, those earning less than £200 p.a. paid 15 per cent of income taxes in Victoria, by 1932–33 they contributed 22 per cent of both the ordinary income tax and the new ‘Unemployment Relief Tax’.

In Queensland the Depression was met by an ‘Unemployment Relief Tax’ in 1930, which was revamped from 1939 as the ‘State Development Tax’. This flat tax started at 1d for every 6s 8d of earnings applied on all incomes between £104 and £208 p.a. It rose to 4d on each 6s 8d of earnings on incomes above £499 p.a.[18] Other low income groups which were previously exempt from income taxation were also brought into the tax field with a levy of 3d in the pound for incomes above £104 p.a. and 5½d on incomes above £104 p.a.

In Western Australia, a ‘Hospital Tax’ was imposed from early 1931 on all incomes except those less than £1 per week, and a ‘Financial Emergency Tax’ applied from the beginning of 1933. Tasmania supplemented State income tax revenues by its ‘Special Income Tax’ on non-employment incomes above £104 p.a. and a ‘Wages Tax’ on all weekly earnings above £3 10s.

With their low taxable thresholds and flat or proportional tax rates, and narrow tax base, the Depression income and wage taxes were clearly less progressive than the ordinary income taxes levied up to the late 1920s. Such taxes rapidly replaced ordinary income taxes as the major source of income tax revenues. In 1932–33, these special Depression taxes accounted for 65 per cent of all State revenues from taxing incomes.

These levies remained in place long after the Depression and were partly incorporated in the States’ ordinary income taxes during the 1930s (Bland 1976 [1934]; Laffer 1980 [1942]). Their regressivity thus remained a feature of the States’ income taxation until 1942 when the State taxes were incorporated into the Commonwealth income tax structure.

As seen in Table 4.2 some £13 million of the £18 million increase in State income taxation from the mid 1920s to the end of the 1930s, can be attributed directly to the regressive Depression taxes (Table 4.2). The Depression taxes can thus be said to have substantially contributed to funding the £23 million expansion of social services expenditures by States during the interwar period.

Taxing wage earners — ways and means

Closely associated with these changes in the nature of income tax from the early 1930s was the introduction of a new tax collection mechanism — ’group schemes’ — for collecting income tax on wages at source. This evolved into the Commonwealth’s ‘Pay as You Earn’ (PAYE) system, introduced in 1944. The advent of the group schemes responded to the tax administration problems presented by the special Depression taxes.

Conventional wisdom and practice in regard to taxation policy in the early twentieth century, based on the benefit tradition in public finance, was that wage earners should bear tax because fiscal exemption bred political irresponsibility. For example, in 1910, liberal social reformer Lord Asquith told the United Kingdom Parliament that ‘if we are to have social reform we must be ready to pay for it and when I say we, I mean the whole nation, the working and consuming classes as well as the wealthier class of direct taxpayers’ (quoted in Sabine (1966, p 146) . Such themes were also evident in Australian debates on progressive income taxation (Groenewegen 1988).

However, others were arguing that most working-class people already paid excessively through indirect taxation (Sabine 1966). Labour scrutiny of the early twentieth-century tax

[18] Employers with ten or more employees were required to deduct and forward the tax deducted from employee wages.

system in Australia emphasised the heavy burden of indirect taxation on the wage earner (Groenewegen 1988). Furthermore, until the early decades of the twentieth century, direct taxation of wages was seen as inappropriate (Sabine 1966). Commodity taxation of these lower incomes was considered preferable, as it allowed those of limited means to choose their level of tax contribution by directing consumption to untaxed necessities.[19]

At that time in the UK, the low average rates of income taxation meant it was not cost-effective to tax lower income earners. According to Gladstone,

> there was a certain point in the progress down the scale of direct taxation beyond which it was not advisable to pass. The sums to be levied, for instance, might be so small that they would not pay the cost of collection, or if they were collected, the vexation attending it would be such that it would not be expedient to attempt it (quoted in Sabine 1966, p. 95).

Income taxation at source had originated in Pitt's English income tax of 1803, which nearly doubled revenue collections compared to the 1801–02 income tax (Australia.Royal Commission into Taxation 1922). The first tax withholding schemes were limited to the British Civil Service, and the Royal Household from the 1850s (Australia.Royal Commission into Taxation 1922; Shehab 1953)(Australia, Royal Commission into Taxation 1922; Shehab 1953). Adverse court decisions discouraged experiments in widening the scope of tax withholding to other wage and salary incomes (Sabine 1966, pp. 96–7).

Despite the arguments of proponents in favour of the benefits for revenue flows, reduced evasion, and convenience to taxpayers, and a dissenting minority report favourable to extending 'taxation at source', the 1921–23 Kerr Royal Commission into Taxation in Australia had recommended against wider application of taxation at source (Australia, Royal Commission into Taxation 1922). Its second report argued that a withholding system, along the lines of that in the United Kingdom, would produce unacceptable inequities and complexities because of the steep graduation in rates under the Commonwealth income tax.

> There are at least two general objections to the system of taxation at the source. First it involves the collection by the Crown of large amounts of money which in some cases it is not entitled to retain, and which in other cases are in excess of what it is entitled to retain, thus depriving a considerable body of taxpayers of the use of their money for varying periods; and, second, some revenue gain (it is difficult to estimate how much) will be due to the failure of taxpayers, either through ignorance or neglect, to make and establish their claims for refund or credit (Australia, Royal Commission into Taxation 1922, p. 84).

They considered the system should be only narrowly applied, if at all, 'lest some day public complacency may permit revenue gain to outweigh every other consideration, even that of an equitable distribution of the burdens of taxation' (Australia, Royal Commission into Taxation 1922, p. 84).

The Commissioner of Taxation submitted that taxation of wage earners at source was probably not cost-effective because of the need for end-of-year-tax adjustments arising from the progressive Commonwealth income tax structure. Hence the system 'would not pay unless the present minimum rates of Income Tax were considerably increased' (Australia, Royal Commission into Taxation 1922, p. 83).

> The only remedy [to evasion] lies in legislation which would provide that the tax at a flat rate should be deducted from wages as they are paid. It would be

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[19] Concern over the regressive burden of indirect taxation was an important element in the thinking of the Commonwealth Labor Party, including for example, Attorney-General W. M Hughes, who had been closely involved with introducing both the Commonwealth land tax of 1910 and the 1915 income tax. However, the philosophy that the wage earner was best taxed through indirect taxes continued to have adherents in the Commonwealth Parliament throughout the 1930s and into World War II. As noted earlier, Commonwealth indirect taxation expanded considerably during the interwar period (see Smith 1999).

> necessary, however, to provide expensive machinery for adjusting the total amount of tax paid during a year, to the actual amount payable by each person so taxed. The question, therefore, to be decided is whether or not the tax collectable would be sufficient to pay for the additional adjustment machinery (Australia, Royal Commission into Taxation 1922, p. 83).

Witnesses to the inquiry also gave evidence of the strident opposition of employers to the 'deduction at source' system in the United States, because of the high costs it imposed on the businesses required to collect and forward the tax.

By the early 1930s, expenditure taxation by State governments in Australia appeared, 'for the time being', to have reached its limits (Hytten 1980 [1934], p. 284). As shown earlier in this paper, State governments turned to wage and income taxation.

In 1930, South Australia was forced, 'by the extraordinarily high rates of taxation imposed in that year', to adopt a new method of tax administration, known as 'group schemes' (Hytten 1980 [1934], p. 284). That year, the State had imposed its fixed tax of £2 /10/- per taxpayer, which included incomes as low as £101 p.a. A periodic withholding scheme was an essential practical requirement for collecting the tax from low wage earners, as many taxpayers had found it impossible to meet their liabilities in a lump sum. The group schemes involved employees in an establishment periodically remitting installments of their income tax through a representative. After the success of the initial schemes in government offices and in a number of large private businesses, the South Australia Government introduced more comprehensive arrangements. Employers were required to deduct 5 per cent from cash payments to employees in excess of 10s and to issue tax stamps to the employee corresponding to the value of deductions.

The success of the South Australian scheme was judged in terms of the regular flow of revenue, with 85 per cent of estimated yield of the tax being collected, compared to 67 per cent at the same time in the previous year (Hytten 1980 [1934]). It also unexpectedly disclosed a great deal of evasion, with a number of cases identified where returns for previous years had not been lodged. There were some additional costs of collection, which were impossible to estimate but were believed to be trivial compared to the additional revenue collected. In 1932, Hytten wrote that:

> The general feeling in South Australia is one of satisfaction, on the part of both the government and the taxpayers. It suits the great majority of taxpayers, who find a difficulty in paying the heavy tax in one lump sum at 30 days notice, which, owing to the frailty of human nature, always seems far too short. To put it briefly, the method had given our most important direct tax the feature that has always made indirect taxes so dear to the hearts of financiers: the feature of causing the minimum 'feeling of hurt' to the victim (Hytten 1980 [1932], p. 286).

'Deduction at source' also commenced in Victoria in November 1932, as a component of the new 'Unemployment Relief Tax'. The scheme had as its object 'the assisting of taxpayers in the payment of their taxes' (Victoria. Office of the Government Statistician 1937, p. 289). Regular deductions were to be made 'from the salaries and wages of those constituting the majority of taxpayers and were the classes most requiring assistance of this character'.[20]

A number of States experimented with various arrangements for collecting the special wage taxes. In the early 1930s, the Fergusson Royal Commission on Taxation considered the experience of the various States, and commented favourably on the method adopted in South Australia and Victoria, compared to the weekly wage taxes in some other States.

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[20] As in South Australia, the employer making the deduction provided the employee with tax installment stamps to the value of the tax deducted. The employee produced these stamps, which provided credit towards the tax liability after receiving the tax assessment. If the value of stamps exceeded the tax liability, a refund was made. The general public apart from salary and wage earners could also participate in the system.

> Although certain difficulties were experienced at its inception, these appear to have been overcome. The system is giving general satisfaction in those States, and is extremely popular with those whose tax is so assessed (Australia, Royal Commission on Taxation 1934b, p. 136).

The operation and equitable impact of the 'group schemes' in Australia had been facilitated by the rise in steady employment, including in the formal manufacturing sector during the 1930s, and by the general rise in incomes after the Depression.

The Fergusson Royal Commission found the following distinct advantages of collecting the tax on wages and salaries at source;

- regular flow of revenue
- tax could be collected from those who have hitherto evaded their obligation
- the taxpayer who was able to pay tax by small regular installments instead of being asked to make an inconveniently large single payment was thereby assisted.

However, the Commissioners were reluctant to recommend such a scheme for the Commonwealth income tax. This again reflected an attachment to the principle of progression:

> The taxation systems of Great Britain and Australia are fundamentally different. Taxation by deduction at the source lies at the very root of the British system. It is based upon a flat rate of tax which is deducted by the payer, as, for example, by a company on dividends paid to its shareholders. Incomes not exceeding a certain amount are taxable at half the standard rate, and hence in such cases, and in others where the recipient is not taxable, refunds and adjustments have to be made. But because the deductions are always made at a flat rate such adjustments are easy to make. Australian tax systems, however, are all based upon a graduated rate of tax, commencing from the lowest point. If, therefore, an attempt were made to apply taxation at the source to Australian conditions, would be necessary to repeal all the Commonwealth and State Acts relating to Income Tax, and completely alter existing methods of administration (Australia.Royal Commission on Taxation 1934b, p. 136).

Like their predecessors in 1922, the Commissioners saw 'deduction at source' as unfair for the casual worker who received wages at a fairly high rate for a few weeks, and then suffered a long period of idleness (Australia, Royal Commission on Taxation 1934b, p. 136). Deduction at source was also considered inequitable because it imposed the same tax on a given amount 'whether the recipient is a single man without responsibilities, or a married man with a family' (p. 137). The Report observed that many employees would be exempt from Commonwealth tax owing to the statutory exemption and the concessional deductions to which they are entitled.

> The [married man with a family] is not likely to be satisfied with the explanation that the rate is calculated at an average applicable to all workers, for he can reasonably maintain that his domestic responsibilities entitle him to greater consideration than the taxpayer without any (Australia, Royal Commission on Taxation 1934b, p. 137).

For such reasons it rejected the scheme put forward by the Taxpayers' Association of Victoria for a 'graduated stamp tax' at a rate equal to half the personal exertion rate on all salary and wages below £400 p.a. The Taxpayers' Association, a group representing mainly high income business professionals and property owners, had proposed a 'final' withholding tax. This was to be deducted without assessment or end-of-year adjustment, and without a statutory exemption or concessional deductions such as allowed for wife and children, life insurance, medical expenses, under the ordinary income tax. According to the Royal Commission: 'Simplicity is not the only consideration, and we are not prepared to recommend any method of collecting tax on wages at the source that does not provide for an eventual adjustment of over or under payments' (Australia, Royal Commission on Taxation 1934b, p. 137).

Deduction of tax at a flat rate was said to run counter to the principle of progression, because whatever withholding rate was adopted would be too high for some taxpayers and too low for others. As numerous adjustments would be required and an elaborate refund department necessary, procedures would not be simplified nor the cost of administration reduced. The Royal Commission, therefore, concluded that taxation at the source as applied in Great Britain could not be generally adapted to Australian conditions (Australia, Royal Commission on Taxation 1934b*,* p. 136).

In 1944, the Commonwealth introduced a 'Pay As You Earn' (PAYE) scheme, which first applied for the 1944–45 income year (Carslaw 1980 [1942–47]).[21] The introduction of 'collection at source' was associated with heavy Commonwealth income tax increases including on low and middle income earners. All incomes above £104 p.a. (formerly £156 p.a. were now taxed. PAYE, along with heavier taxation of wage earners, was directly linked to the establishment of the National Welfare Fund to finance new social security measures (Carslaw 1980 [1941-47])(Butlin and Schedvin 1977).[22] The National Welfare Fund was to provide for national child endowment, the new widows' pension and unemployment benefits.[23]

Meanwhile under the Uniform Income Tax Plan, the States' loss of their income tax powers effectively pegged their expansion of social services expenditures at the pre-war level (Laffer 1980 [1942]; Bailey 1980 [1944]). The principle of reducing income tax compensation where States were relieved from the cost of providing such services was endorsed by the Committee on Uniform Taxation (Australia. Committee on Uniform Taxation 1942) and implemented by the Government (Butlin and Schedvin 1977), but, in the longer term, the basis for distributing grants to the States created pressures for the Commonwealth to expand social services to achieve uniform standards across the country (Bailey 1980 [1944]).

The new PAYE system was significant because it facilitated an enhanced revenue raising function of the Commonwealth income tax. Most importantly, as Hytten (1980 [1934]) had observed in regard to the earlier State schemes, it introduced the feature of political invisibility to the income taxation of low and middle income earners — reducing the 'feeling of hurt' of the victim.

It may have also had other long-term implications for Commonwealth income tax progressivity. As the Royal Commission on Taxation had recognised in the 1920s (1922*,* pp. 81, 84), the more progressive the tax structure, the greater the tax administration and employer compliance costs of such a 'taxation at source' system. This implies that the PAYE system may have encouraged the development of an employer and business constituency for the flatter personal income tax structure that appeared to emerge more or less by default in the post-war period (see (Smith 2001)).

Conclusion

This paper has explored the changing role and character of States' income taxation during the interwar period, and the relationship between their income tax policies and the

[21] This was based on the recommendations by a Joint Parliamentary Committee of Inquiry chaired by Treasurer Chifley (Australia, Parliament, Joint Committee Appointed to Inquire into the Advisability of Basing the Liability for Income Tax for Each Financial Year on the Income of that Year 1944).

[22] Meanwhile PAYE was also introduced in the United Kingdom and the United States in 1943 (see Witte (1985, pp. 117–20) on the United States, and Sabine (1966, p. 201) and Sayers (1956, pp. 99–101) regarding the United Kingdom). In the United Kingdom, the British Chancellor argued for the introduction of PAYE partly to continue access to taxing this section of the population after World War II: 'it seemed most important that the present conditions, under which the wage earners as a whole were making a contribution to the affairs of the State through direct taxation, should be maintained' (quoted in Sayers 1956, p. 99).

[23] In 1946, this informal earmarking of the higher wartime income taxes on low incomes and wage earners was formalised through introduction of a 'Social Security Contribution'. The object was to reduce inflationary pressures and provide for the future funding of the National Welfare Fund (Kewley 1973).

Commonwealth's income taxation from 1939. It has also assessed the economic and other constraints on State income taxation during the 1920s and 1930s.

The paper has identified a significant shift in the level and character of the States' income taxation during these years and shown that this explains national trends, the States being the dominant income taxing authorities. This shift to higher and more regressive taxes reflected pressures on the States to provide expanded social services during the depression years and responded to problems created by the Constitution regarding the sharing of taxation powers between the Commonwealth and State Governments. Factor mobility was an increasing constraint on State income taxation from the 1920s, especially in taxing the higher incomes. The States' tax rates on higher income tax payers showed a tendency to converge. This study shows that State income taxes were already more regressive than those of the Commonwealth during the 1920s; this difference was amplified during the Depression as the States brought in new more, regressive income taxes to fund unemployment relief. Significantly, the first moves in the direction of taxing low income earners were made by the less affluent States of South Australia and Western Australia in the late 1920s.

Contrary to interpretations of the Uniform Tax Plan as an act of ideology or political opportunism (Maddock 1982; Levi 1988b), this study concludes that tax unification occurred at that particular time because longstanding constitutional and economic barriers to resolving the pressing problems of tax revenue, tax equity and tax complexity were removed by the wider authority acquired by the Commonwealth after the bombing of Pearl Harbour. With regulatory options for restraining inflation running out by early 1942, the arguments for increased taxes to restrain demand became compelling. For a Labor Government, the extent of the necessary increase in taxation on wage earners was acceptable only if accompanied by higher taxation of the wealthy, a move that could occur only if the Commonwealth were unconstrained by the very high income taxes levied on the wealthy in Queensland. Fundamentally, as Bailey has commented, uniform income taxation was 'an attempt by the Treasury to grapple with a problem set by the Constitution' (1980 [1944], p. 309), interacting, it might be added, with the economic problem of tax competition.

By limiting the yield of both State and Commonwealth income taxes, these barriers to tax reform had previously prevented both State and Commonwealth Governments from responding to public pressures for expanded social services during the interwar period. (The relationship between the payroll tax and child endowment is explored more fully in Chapter 5 of Smith (2002).

These findings also suggest significant connections between pre-war State income tax policies and Commonwealth income tax policy after tax unification in 1942. The regressive State income tax schedules were integrated into the Commonwealth income tax schedules in 1942 in a way that was intended to replicate the incidence of the state income tax structures that were being replaced. Significant innovations in tax administration had occurred during the Depression due to income tax policies shifting focus onto wage earners. This study shows that South Australia, pressured by severe fiscal difficulties by the mid 1920s, was the first to experiment with 'taxation at source'; this system was better suited to South Australia's flatter tax schedule than the graduated scales of other Australian income taxes. For the Commonwealth to tax low wage earners efficiently, and use income taxation for Keynesian macroeconomic management, it too needed to introduce wage withholding, which it did in 1944 through the PAYE system.

From the 1950s, PAYE was a key component of the unannounced post-war transition to less progressive 'mass taxation'. PAYE revenues enlarged the National Welfare Fund to finance the new Commonwealth unemployment benefit and most importantly, made this new income taxation less politically visible and less painful to the taxpayer. Commonwealth income tax policies and the tax-financing of social security from 1942 were thus continuous in principle with the pre-war income tax policies of State Governments and uniform income taxation in effect substituted Commonwealth for State income tax financing and provision of social services (Smith 2002).

This study further suggests that interpreting uniform taxation as ideologically motivated is overly simplistic. The past practice of linking such taxation with provision of social services meant the Commonwealth Government was expected to balance any increased taxation of low income earners with expanded social services. Legal considerations favoured a minimalist approach to changing the distribution of the income tax burden in 1942 (Butlin and Schedvin 1977). The Labor Government's reluctance to immediately exploit the capacity created by the Uniform Income Tax Plan to increase tax burdens on low income wage-earners in 1942 also reflected, in part, the substantial tax increases that had already occurred on low and middle income earners since 1939, the excessive burden of taxes already carried by wage earners through the States' income taxes and the rise that had occurred in the Commonwealth's regressive indirect taxation early during World War II (Smith 1999). Furthermore, the Commonwealth's practical capacity to impose substantial income taxation on low income earners was constrained until the introduction of PAYE in 1944 by the limited saving capacity of the wage-earning population.

This study concludes that the Australian income tax changed from a 'class tax' to a 'mass tax' during the Depression rather than during World War II and that this transition occurred at the State rather than the Commonwealth level. In addition to reducing the visibility of income taxation through the PAYE scheme, earmarking income tax revenues to expand social services would become a key strategy used by both State and Commonwealth Governments to fund social services through additional taxation during the first half of the twentieth century.

Meanwhile, a long term 'fiscal peace' regarding access by States to the nation's revenues was bought by establishing the Commonwealth Grants Commission from 1933. Because of this institutional innovation, Australian State governments no longer had a common interest in resuming income taxation after the war. By 1942, horizontal equalization was in place as the glue preventing fractures in the fiscal federation, and by the 1950s was ensuring that unification of income taxation was firmly set into Australian federal financial arrangements (Smith 2002).

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