Why Reform is Beyond the Government's Grasp

17 March 2014

Poor financial management and policymaking as political patronage have led us to our current budget dilemma, as Ken Henry confirmed last week writes Ian McAuley.

Treasurer Joe Hockey is right — Australia has a fiscal problem. The Federal Government's Mid Year Economic and Fiscal Outlook (MYEFO), released last December, showed that without policy change, budget deficits would continue for at least 10 years. Stripped of spin, that's a simple statement of arithmetic, based on Treasury projections of Commonwealth revenues and expenses.

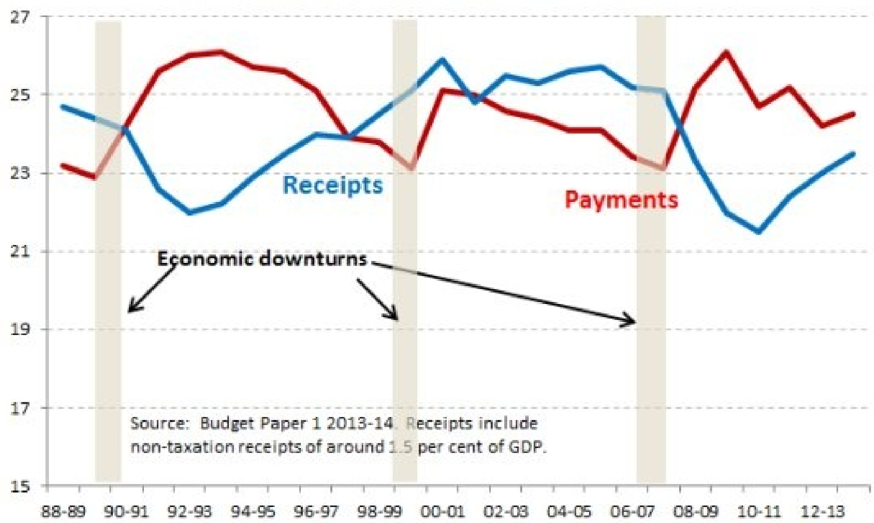
It is in this context that Ken Henry, now free of the constraints he faced as a public servant, made his strong statements on the ABC's 730 Report last week. His basic point was that there is a gap between what we want as public services and the taxes we are paying.

Before analysing Henry's comments, it's worth looking at how we got here.

The political spin from the Abbott Government and the Murdoch media is that the problem lies in six years of Labor profligacy, capped off by big-spending promises, particularly the National Disability Scheme and the Gonski school reforms.

The reality is that the Rudd-Gillard Government was hardly a big spender by world or Australian standards. Rather, in line with economic orthodoxy, it was increasing spending during economic downturns and reducing spending as the economy recovered. Figure 1, below, shows Commonwealth payments (red line) and receipts (blue line), from 1988-89 to 2013-14.

Figure 1: Commonwealth receipts and payments as percentage of GDP - 1988-89 to 2013-14



If partisan comparisons are to be made, it is correct that the Rudd-Gillard Government was spending more than the Howard Government which preceded it. Spending in the Howard Government's 12 budgets averaged 24.1 per cent of GDP, and averaged 25.0 per cent of GDP over the Rudd-Gillard Government's six budgets.

But there claims about profligacy should end, for the Howard Government came to office as Australia was pulling out of a recession, and, apart from a minor downturn at the turn of the century (the "tech wreck"), was in office during the longest recorded boom in global business conditions and a re-awakening of the Chinese economy, stimulating a huge investment in our mineral resources. Labor took office on the eve of the worst global downturn since 1929.

That is not to exonerate Labor, however. It presided over a collapse in revenue, as shown in the graph above, and that fall in revenue, rather than any blow-out in spending, is the source of the deficit. In fact the MYEFO projections are for revenue to grow even more slowly than expected at the time of the 2013-14 Budget.

An easy excuse for Labor is to say that the taxation base had been weakened by the Howard Government. Indeed, all but the most partisan economists recognise that Howard squandered the proceeds of the boom by giving tax cuts and generous tax breaks for middle class welfare.

But Labor continued with tax cuts, including "compensation" for its levying a price on carbon, as if a difficult and necessary industry transformation could be implemented without imposing any pain on "working families". If we could now be collecting taxes at the same rate as in the last few years of the Howard Government the Commonwealth would have another $50 billion a year of revenue and there would be no deficit.

It could be said that Labor had no political leeway to increase taxes during a downturn, but that's a weak excuse. It could have repaired the base so that, as economic conditions improved, tax collections would recover. Indeed, it tried to do this in its last few months of office, when it proposed to increase taxes on high incomes of so-called "self-funded" retirees and to close rorts in employer-provided motor vehicles, but these were too late to be implemented in legislation.

In fact, the Rudd-Gillard Government could be criticised for spending too little in response to the GFC. It could have provided the same fiscal stimulus by increasing spending without cutting taxes. When the time comes to withdraw stimulus it's politically easier to cut spending than to reverse tax cuts.

Its lost opportunity in relation to tax was its rejection of most of the recommendations of the "Australia's Future Tax System Review", headed by Treasury Secretary Ken Henry. Most seriously, in response to the Review's recommendation for a minerals resource rent tax, it caved in to bullying by the mining industry — a cave-in which sent the message to the electorate that it was too fearful to protect the community interest and sent the message to rent-seekers that a little publicity was all that was needed to gain a privilege at the public expense.

On 7.30, in relation to taxes, Henry said:

> "It is clear in retrospect that the tax cuts and increases in family payments that were provided in the early part of this century, particularly in those years 2004 to 2007-08 ... have put very considerable pressure on the budget."

The ABC's Sarah Ferguson tried to get Henry to make specific suggestions about taxes — raising the GST for example — but Henry's argument was more general. Tax reform has to be seen as a package, integrating with other reforms. A well-designed package may have regressive elements while the package as a whole is progressive.

Henry's interview was not the only sharp criticism of the economics of the Howard years last week. The Productivity Commission released its Draft Report on Public Infrastructure, which pointed out the huge fall in public infrastructure spending during the later years of the Howard Government – years when revenue which should have been spent on roads, public transport, railroads, and water supply was diverted to tax cuts and to middle class welfare. It also pointed out the limits of privatisation, making the easily forgotten finding:

> "Where project selection decisions are consistent with recommendations in this report, there is additional capacity for the Australian State and Territory Governments to finance public infrastructure from their own balance sheets through the issue of sovereign debt and/or through tax."

The government's response to the report was to have someone on the public payroll trawl through the 600 page document looking for criticisms of the previous government to help ministers make some puerile statements on the National Broadband Network. When asked about the document's suggestions on road user charging, for example, Tony Abbott said the government was not considering it, suggesting it was too "novel by Australian standards".

Perhaps he was projecting his own discomfort with technology onto the Australian community. It's more probable, however, that just as he rejects a market-based approach to climate change he doesn't want the impersonal operation of markets to displace his government's ability to use road funding as an instrument of political patronage.

So politically, even though there are voices of economic good sense, on taxation we remain at an economic dead end. The Abbott Government refuses to face up to the shortcomings of the Howard Government, and, instead of criticising the Rudd-Gillard Government for dropping the ball on tax reform, is creating the impression that it was a wasteful and profligate administration without presenting supporting evidence — because there isn't such a case to be made.

Labor, for its part, is still unwilling to admit that in its time in office it missed many opportunities to strengthen our revenue base — rejecting the hard parts of the Henry Review, surrendering the public interest to the mining lobby, and failing to explain carbon pricing. It seems to be incapable of delivering the simple message that if we are to have decent public services we need a tax base to support them.

As a consequence we have governments, state and federal, incapable of (and in some cases unenthusiastic about) providing the public goods and services needed in an advanced economy, and as Ken Henry said, which "lack the policy capability to execute major reform".

In some areas, such as better public schools and public transport, we will just go without, and in other areas we will rely on expensive and wasteful mechanisms such as private health insurance to provide what could better be provided through taxation. And major structural reforms, such as reducing our dependence on mining and forestry, building our knowledge-based industries, and phasing out the thermal coal industry, are put on hold.