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Australia needs higher taxes, not spending cuts

The Federal budget balance is expected to deteriorate. The reasons are numerous, but, in a lengthy statement, the government sums it up in terms of "two key factors", namely (a) the softer economic outlook, and (b) unsolved issues inherited from the former government.

The economy is going through a transition process, with a decline in resources investment to be replaced by a recovery in the non-resources sector. It seems that the resources investment decline may be sharper than previously forecast while the recovery in the non-resources sector may be more gradual.

Thus, with real GDP growing at a slower rate, (hence "a softer economic outlook") revenue from taxation will also be less. The result is a higher budget deficit.

The previous Labor government can apparently be blamed for many "legacy" items, but one is rather curious. Our central bank, the Reserve Bank of Australia, has to receive $A 8.8 billion to compensate for losses occurred to the Australian foreign currency reserves during the period when the Australian dollar appreciated.

The choices faced by the government

Given the deficit prospect, the government faces three choices (1) Run a bigger deficit, (2) raise taxes, or (3) cut government spending. The government has already embraced choice (3) – cut spending. With regard to (2) it abolished the carbon tax and the minerals resource rent tax, and thus went in the wrong direction.

Perhaps the government will cut public spending further in directions that it finds attractive. After cutting the CSIRO, the ABC and the SBS, the staff of the Federal public service, and funds available to the states for health, education and transport, not to speak of the universities, there are surely more possibilities.

Incidentally, over 20 non-statutory bodies have been abolished or rationalised. The underlying (or even explicit) philosophy is to reduce the size and responsibilities of the government –this is in tune with United States conservative attitudes.

What the government should consider is raising taxes rather than further spending cuts. This is a very serious proposal. Yet, compared with the US approach, it may be more in tune with traditional Australian attitudes, which expect a great deal from governments.

Why the federal government should raise taxes

To understand the argument behind the need to raise taxes, it is important to understand what can be described as *Howard's Gift.*

Under the Howard government period, beginning around 2003, there was a boom in the form of rising export prices of iron ore and coal. As a result revenue from corporation tax increased sharply.

This led the Howard government to cut personal income taxes on no less than five occasions. Also, superannuation concessions were extended. The details can be found in John Edwards' *Beyond the Boom*, pages 49 to 52.

This was John Howard's Gift to the taxpaying middle and upper classes. It was clearly a response – perhaps understandable – to the export boom.

The trouble was that it had the effect of increasing budget deficits in later years when tax revenues declined. In particular, budget deficits in the Labor (Gillard) years were increased by *Howard's Gift*. Even now it has an adverse effect on the government's budget balance.

However, as the mineral export boom in the Howard years turned out to be temporary, the income tax cuts that were motivated by the boom should also be temporary. In other words, they should now be reversed! Personal income tax rates should be increased to where they were before the boom.

Usually opposition parties oppose tax increases. Prime Minister Tony Abbot's ran a very effective campaign against the carbon tax when in opposition. So this proposed tax increase needs to have bipartisan support. If Labor gets into government later they will be glad to have a decent revenue base for their budgets.

At the same time some other improvements should be made to the income tax system. These ideas all come from the famous *Henry Report* on the Australian tax system.

The aim would be to simplify the system and, above all, to remove special concessions and deductions that principally benefit the better-off. These are the favourable concessions that affect superannuation earnings of people on high incomes.

All remuneration should be measured as wages. Capital gains tax rate concessions, and various concessions available to primary producers should also be removed.

In addition to increasing income tax rates to their earlier levels more revenue needs to be obtained from the GST. This tax has to rise if necessary funds are to be generated for the States' vital functions.

There is no doubt that the GST is a relatively efficient tax, but it would be more efficient and easier to collect if goods and services of all kinds faced the same GST rate. Exemptions should be avoided and, probably, the rate increased closer to levels of comparable international rates.

However, the real problem with broadening the GST or raising the rate has to do with equity. This tax is a bigger burden for persons with low incomes than for the well-off. But equity within society is more effectively achieved with a progressive income tax and social security system than through exemptions from the GST. This means that some of the GST revenue gain should be returned to households in the form of increases in social security payments and a more progressive personal income tax schedule.

To summarise, I suggest that the GST should be expanded so as to raise more revenue and simplify it, while the income tax and social security systems would be adjusted to compensate for adverse effects on people with low incomes.

It is clear that Australia's taxation system as a whole needs major improvements. This is clearly shown in the *Henry Report*, which is a valuable guide for reform.

No doubt these matters will be discussed in the government's prospective White Paper on taxation. The government needs to raise more revenue while making limited improvements to income tax and the GST. The basic aim, above all, should be to avoid further damaging government spending cuts.

And what about a recession?

The government believes that there is a "softer economic outlook", which means we might face a recession. It is impossible to predict at this time whether this will happen. However, if there is any possibility of a recession, then it is not the time to cut government spending nor to raise taxes.

However, the government does need to implement long-term structural reform of the tax system and expand its revenue base. In face of a recession the Reserve Bank of Australia will need to lower interest rates and stimulate the economy, and also depreciate the Australian dollar. Such stimulus would, as a by-product, partly reduce the budget deficit.