Mixed Fortunes

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I am pleased to have the opportunity to be here with you this evening to launch Paul Tilley's new book, *Mixed Fortunes, A History of Tax Reform in Australia*, published by Melbourne University Press.

This is an instructive book. Well written. Highly readable. A valuable resource for those motivated to wonder what it might take to secure a decent, sustainable society on this land, in the 21st century. I am going to assume that that includes all of you. I am also going to assume that you consider yourself somebody who has some understanding of tax policy; that you are, in some sense, a tax policy practitioner.

Like many of you in the audience, I have a lived experience of most of the 50 or so years of tax policy discussion that got underway with the commissioning of the Asprey Review in 1972. I must admit, though, that, until reading this book, I was unaware of many of the seminal events that preceded it.

Reviewing the history since Asprey does not fill me with optimism.

As I was reading Paul's account, I found myself wondering how, knowing as much as we do about the principles of good tax system design, we have managed to achieve so little, and how one might explain why today's tax system falls so far short of what is needed to secure prosperity for future generations of Australians.

As I was reflecting on these things, I was finding parallels in the history of our extraordinary destruction of Australia's natural capital. I came to the not very surprising realisation that if we are to have any hope of securing prosperity for future generations, we had better have a more honest appreciation of the values of the present generation.

I have noted on a few occasions recently that Australia is confronting an intergenerational tragedy of our making.

We have proved ourselves incapable of meeting the challenge posed by the *Intergenerational Report* published in 2002. Relative to GDP, the cyclically adjusted level of government spending is increasing at almost precisely the rate projected in that report.

The burden of funding the prospective lift in public spending will have to be shouldered by a declining proportion of the population – principally young workers; the same people who have been priced out of the housing market; the same people who are going to have to adapt to the interrelated impacts of climate change and biodiversity loss that are accelerating at a faster pace than most informed people considered probable as recently as a decade ago.

So, I have been asking myself what sort of people could produce that tragedy, and why. What do they believe? What do they value?

One thing many of them appear to believe is that our national income is derived exclusively from, or at least underwritten by, what we export. This truly mad mercantilist notion has been around for a long time. And it's not unique to Australians. You can read Adam Smith's explanation of its stupidity in *The Wealth of Nations*, published in 1776.

The people who celebrate exports also celebrate plunder. They tend to see progress as something that humans extract from the planet's stores of natural capital; stores that, for centuries, were considered infinite but are now known to be close to exhaustion.

These people also celebrate dumb luck. They respect the moral principle of 'finders keepers'.

But they are fearful of foreigners, and that includes those foreigners who might be interested in investing in this country's future.

Their engagement with economic policy issues is conditioned by a profound mistrust of politicians and a resentment of 'experts'.

They are concerned, principally, with immediate self-interest. They want to know what is in it for them. How much cash will they get; how much will they lose? Is somebody going to get a bigger cut?

They have no appetite for the retrospective application of any policy change, unless it delivers them a cash bonus. And they are opposed to any new tax.

This is the Australian electorate.

Tax policy practitioners, people like you and me, speak a different language. Asprey's framing of tax policy design as a concern with revenue adequacy, economic efficiency, equity and simplicity, impresses many of us in this room, but it has no resonance in the general community.

Consider the arguments among policy people about the relative merits of income and consumption taxes. Some in this room would see an indirect consumption tax as offending vertical equity for two reasons: first, a flat consumption tax rate with no threshold lacks progressivity; and second, because it doesn't tax saving, it benefits those with higher incomes and a lower propensity to consume. Others, including Asprey, see difficulty in assessing the relative equity attributes of a broad-based consumption tax and an income tax that is full of holes that overwhelmingly favour the wealthy.

These theoretical arguments have entertained policy people and commentators for years. They are far removed from the inter-temporal efficiency arguments favouring consumption, or expenditure, as a tax base; that is, the stuff that I had some familiarity with before joining the Treasury.

I came to the Treasury late in 1984, as a young academic immersed in neoclassical international trade theory, neoclassical growth theory and general equilibrium tax incidence analysis, including general equilibrium analysis of housing policy, on which I wrote my PhD.

With those interests, I was dismayed, early in 1985, to have Ted Evans and David Morgan explain to me that, on their reading of discussions between the government and the ACTU leadership, all that was going to matter in the analysis of tax reform options were static – that is, single period, or even 'overnight' – 'cash gain' estimates for different types of households. Revenue adequacy was important, so our reform options had to be revenue neutral, but academic concerns about inter-temporal economic efficiency and tax system simplicity were irrelevant. All anybody would want to know is what was in it for them; how many dollars they were going to get. And that's also all the newspapers would want to know. That's what they would be printing on their front pages.

Well, if what was required was static distributional analysis that ignored the future, then that was what was going to be delivered.

So I sat down with Jim Wright to develop the price input-output model called TAXIO, and then spent a couple of weeks in the ABS working with Bruce Bacon, creating a unit record file for the Household Expenditure Survey. We put those bits together with some software code that Neil Warren, then working at EPAC, had developed for another purpose, and a small group of Treasury people became overnight experts in static microsimulation modelling.

Looking back from this distance, it is easy to understand why we did what we did. But I can't escape the sense that, in developing the tools that facilitated squabbles over the distribution of gains and losses among the households of Australia in 1985, we were participating in a conspiracy against future Australian households.

When Treasurer John Kerin, in 1991, instructed then Treasury Secretary Tony Cole to develop a modelling capability to analyse the distributional implications of any change to the tax and transfer systems, we went through it all again, but with much enhanced modelling ambition, bringing in Ann Harding who, between 1985 and 1991, had independently developed considerable expertise in microsimulation modelling. As Paul documents, that's where PRISMOD came from. PRISMOD was, by any measure, the world's most detailed, most sophisticated, static microsimulation model for the analysis of tax and transfer system changes. But that's all it was.

As Paul records, PRISMOD was used to devastating effect by Paul Keating, after he became Prime Minister in December 1991, in his full-frontal assault on the impressive *Fightback!* package developed by then Opposition Leader John Hewson. *Fightback!* spoke our language. It was an attempt to break out of the static cash gains framing that had bedevilled Paul Keating's Option C; instead, seeking to make the case for reform on economic arguments. But it couldn't break out of that static distributional framing.

And then, toward the end of the '90s, PRISMOD was pulled off the shelf to produce the distributional analysis of the Howard-Costello tax reform proposals, with a GST as its centrepiece.

All PRISMOD ever did was churn out static cash gain numbers, permitting political leaders to state, with exaggerated precision, what was in it for households of any type, with any mix of income and wealth.

Of course, we had commentators arguing amongst themselves about implications for vertical equity, economic efficiency, and tax system simplicity – but the fact is that all that ever really mattered politically were the static cash gain estimates. The reason fresh food is not subject to GST, for example, is that during negotiations in the Senate the Australian Democrats were concerned that the estimated cash gains for aged pensioners were too slim.

I've spent a bit of time on that set of episodes for two reasons. First, to illustrate just how hard it is to secure genuine tax reform in this country. And second, to emphasise that the language we tax policy people use to discuss reform options, and the things that matter to us, have no resonance with those who vote. A corollary of that second proposition is that the things that matter to us have, thus far, been of little interest to our political leaders. And a corollary of the first is that tax reform is much easier to secure if it is revenue negative; that is, if it passes the cost onto future generations.

The tax review commissioned by the Rudd Government, early in 2008, started out with the premise that we had billions of dollars to spend in 'over compensation'. We had the opportunity to design a big bang reform package in which everybody would be a winner.

But when the budget was mugged by the GFC, only 6 months into our review, we reset. Instead of designing a package to impress the electorate, we asked ourselves how the tax and transfers systems might best evolve, over some years, to meet several daunting challenges of the 21st century, and to underwrite future prosperity. We identified challenges associated with strong population growth and population ageing; the implications of the Asian century; climate change and widespread environmental destruction; and developments in digital communications and commerce. We called out worsening housing affordability as a matter much in need of policy attention.

Our review identified the several potential sources of tax revenue: labour income; the normal return on capital; transactions; land; consumption; wealth; natural resources; windfall capital gains; economic rents; environmental externalities, including carbon emissions; and user charges.

We noted that placing reliance upon the first three – labour income, the normal return on capital, and transactions – put at risk the living standards of future generations by retarding productivity growth and workforce participation, the principal drivers of GDP per capita. We argued the case for reducing reliance on these sources and placing much greater emphasis on all others.

But understanding these things and convincing others of them are very different exercises. A nation that celebrates plunder and dumb luck, and respects 'finders keepers' will not easily see a case for extracting more revenue from natural resources, windfall capital gains, economic rents or environmental externalities. A nation that has no tolerance of new taxes will not easily support land taxes, taxes on wealth or extensions to the GST.

There is a reason why some will tell you that an old tax is a good tax. But, of course, our old taxes are not good taxes.

We have to get rid of transactions taxes.

We have to avoid the budget's lazy reliance upon fiscal drag in the personal income tax system.

We have to reduce the rates of tax applying to the normal return on capital and apply more equal taxation across the various sources of capital income.

Much more than this remains to be done. I have spoken at length about many of these on other occasions and don't have the time to reprise those things this evening.

But I do think I should spend a couple of minutes on the strategic approach that might be taken to achieving reform.

As Paul notes, in the past 50 years, there have been only two successful tax reforms in Australia.

The first emerged out of the June 1985 Tax Summit. It rolled across the income tax landscape for all the second half of the 1980s, delivering Fringe Benefits Tax, substantiation of work-related expenses, capital gains tax, denial of entertainment as a tax deduction, taxation of superannuation, taxation of foreign source income, dividend imputation and a great deal more.

The second was the Howard-Costello tax reform package developed in 1997 and 1998 that delivered the GST, abolished the Wholesales Tax, Bank Accounts Debit Tax, and numerous state level stamp duties, completely overhauled the family payments system, and a great deal more.

Taken together, these two episodes implemented most of what Asprey recommended. And it only took 25 years!

There has been no tax reform since.

Many of you would be wondering whether, given the passage of 14 years since the release of our tax review, there is a case for another *foundational review*, to borrow the terminology used in Paul's book. As far as the tax and transfers systems are concerned, it is true that things have moved on since our review was published, but only in directions that strengthen the case for the recommendations we made then. The damage done to the integrity of the process that determines the GST revenue carve-up among the states, by the special deal for Western Australia, provide a graphic illustration.

The stronger case for a new foundational review, though, is that we also need a review of the allocation of spending responsibilities across the federation, a need illustrated graphically in the federation's response to the COVID-19 crisis.

A foundational review of spending responsibilities would start with an exploration of trends, and risks, in spending pressures at all levels of government. It would consider, collectively, which of these can be trimmed and, in all areas, which level of government should have responsibility for policy design and program delivery.

And then it would determine the allocation of taxing powers. There are constitutional issues to be acknowledged here, but that's no excuse for avoiding this project.

Of course, this is a lot of work. But we know it can be done, because we have taken on much bigger projects in the past. The 2008-09 tax review, the parallel review of federal financial relations, and the multiple Commonwealth-State reform processes led by senior ministers in the Rudd Government, covering all key policy areas, was much more challenging. And that work was being undertaken at the same time as we were dealing with the global financial crisis.

I have noted on other occasions that today's tax reformers do not enjoy the political luxury available to previous governments to craft a revenue-negative reform package. The package needed now must be revenue positive. And it must be a Commonwealth-State undertaking, which adds considerable complexity.

Most importantly, it won't be successful without a compelling narrative that resonates with those who don't speak our language. A narrative that makes the case for this generation not merely asking what is in it for them, but instead, doing what they can do to secure prosperity for future generations of Australians.

This is going to be more than usually hard. But what is at stake here should not be underestimated. The intergenerational tragedy confronting Australia is of our own making. And it is of a magnitude that threatens the social compact.

Somebody has to grab this thing and get on with it.