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AUSTRALIA'S NEW GOVERNMENT SHOULD UNDERSTAND THE FOLLOWING

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As this article is being filed,[1] the federal election campaign is in full swing. Before it is published we shall know whether, over the next three years, we shall be governed by the Coalition parties, again, or by a Labor government led by Mr Kevin Rudd. This timing means that most major topical issues are, effectively, off-limits.

On immigration policy, for example, a Rudd Government will produce an even worse outcome than the Howard Government. The failed ideology of multiculturalism, which Mr Howard has lacked the ticker to confront, but from which he has glacially backed away over the years, would be fully restored. The relatively minor moves by the current Minister for Immigration and Citizenship, Mr Kevin Andrews, to clean up the mess inherited from the ineffable Senator Amanda Vanstone,[2] would be put on hold or reversed, and so on.

As we know from the intense pre-election debate about it, the same is true of industrial relations policy: a Rudd Government[3] will set back the course of economic progress there for years. Similarly for so-called "global warming": under a Rudd Government, we can expect an even more costly avalanche of United Nations-inspired nonsense than we have had over the past 18 months or so from the Howard Government (in particular, from its

1. 5th November 2007.
2. Since rewarded, for the grave damage done to Australia while Minister for Immigration and Multicultural Affairs, by appointment as our Ambassador to Italy.
3. But effectively, in this area of policy in particular, a Gillard Government.

Minister for the Environment and Water Resources, Mr Malcolm Turnbull).

While such topics will again come to the fore after the election, there is little point in writing about them now. There is however one topic about which, whatever the outcome on 24 November, it seems worthwhile to write in advance. I refer to personal income tax reform.

The Post-Election Tax Reform Opportunity

Whichever side wins on 24 November, it will inherit essentially the same federal budgetary prospect. True, the respective election campaign promises will imply a somewhat different list of future obligations. But Mr Rudd's "me too" approach has meant that even these differences, within a $250 billion budget, will be negligible.[4]

Because the Coalition and Labor will both inherit, on 25 November, virtually the same federal budgetary prospect, both will have essentially the same opportunity to undertake major change in our system of personal income taxation (and prospectively, corporate taxation also).

I have written previously on this topic, most recently in the preceding issue of this journal.[5] Since that article was written, a series of dramatic events has highlighted the truth of certain observations in it. More importantly, however, those events have revealed the sheer magnitude of the opportunity available to what, by the time this article is published, will have become our new government.

In what follows, therefore, I shall briefly recapitulate the key points made in that preceding article and recount the aforementioned series of dramatic events since it was written. I then note the policy reactions to those events, first by the Howard Government in its opening electoral campaign shot on 15 October, and then by Labor in its response on 19 October. I shall then reflect on where all this will leave us post-24 November, and challenge the winners, **whoever they may be**, to avail themselves of the unprecedented opportunity open to them.

A Preliminary Disclosure

Readers of my articles here and elsewhere will know that, while I have many criticisms of the Howard Government, I have consistently supported its return to office in every fed-

4. One caveat must be entered: at the time of filing, neither side has so far delivered its formal election policy launch.

5. John Stone, "Mr Costello's Repeated Budget Failure", *National Observer*, No.73, Winter 2007. See also John Stone, "The Future of Mr Peter Costello", *National Observer*, No.65, Winter 2005 and "Mr Costello's Wasted Opportunities", *National Observer*, No.69, Winter 2006.

eral election from 1996 onwards.[6] During the past three years my criticisms have not lessened, and in some respects (including the one to which this article is directed) they have intensified. Nevertheless, despite the many claims that a Rudd Government will constitute "an equally safe pair of hands" as the Coalition, I do not accept that complacent view. So, having in mind that elections are never about obtaining a really good government, but merely about choosing the lesser of two evils, I shall again, on 24 November, vote for Mr Howard.

Should they regard that fact as relevant, readers of this article (post-election) will give it such "weight" as they think appropriate. The fact is that the views I now express apply equally to the Coalition parties and to Labor.

A Brief Recapitulation

The key points in my last article were as follows:

• After a broadly commendable start over the years 1996-97 through 1999-2000, the annual Budgets produced by the Treasurer, Mr Peter Costello, began to fall into error.

• The years 2000-01 through 2002-03 encompassed the introduction of the Goods and Services Tax (GST). They saw the deceitful presentation of the Commonwealth's budgetary accounts, with the GST falsely described as a tax "collected on behalf of the states and territories" by the Commonwealth acting as their agent, and Mr Costello's associated perennial — and perennially false — claims to have cut our taxes.

• Commencing in 2003-04, the Budget papers began to be marked by serious errors in forecasting the outlook for non-rural commodity prices. This in turn produced seriously understated forecasts for profits, and corporation tax payments, not only by Australia's mining companies, but by all the other corporate and individual taxpayers whose prosperity has been (directly and indirectly) enhanced by the "stronger for longer" commodities boom.

• A striking feature of these forecasting errors has been that, with the minor exception of 2005-06, they have been **consistently one way** in understating the revenue outlook**.**

• As a result, year after year the Commonwealth's accounts have recorded large surpluses, far exceeding those initially forecast — despite, every year, further large spending decisions after the Budget has been brought down.

• Last May, the 2007-08 Budget forecast a decline of 1.5 per cent in our

6. In 1998, because of my strong opposition to the then proposed introduction of the Goods and Services Tax, I advocated a vote for the Coalition in the House of Representatives but a vote against it in the Senate. (The results of that election suggest that a large body of Australian electors agreed with me, but let that pass).

terms of trade this year. **"Despite some softness in some non-rural commodity prices in the past few months,[7] this forecast could once again be exceeded"**. [8]

• With the Commonwealth's net debt totally repaid during 2005-06, and with "surpluses to burn",[9] Mr Costello first devised, in that year, the unnecessary Future Fund. This was little more than a device for shoveling surpluses "off-Budget" — thereby further debauching the integrity of the Commonwealth's accounts.

• Beginning in a small way in 2003-04, Mr Costello at last began to grant some tax reductions in his successive Budgets. However, with the modest exception of the 2007-08 Budget, none of those moves has addressed the real problems of the personal income tax structure. The "once in a generation" opportunities for genuine tax reform have simply gone begging.

• Since at least 2003-04, there has been no reasonable case for continuing to budget for more than Budget balance. There has certainly been no case for budgeting for large surpluses. Still less has there been a case for recording (as a result of consistently erroneous forecasting) the even larger surpluses that, year after year, the actual Budget outcome figures have revealed.

• To take but one illustrative figure, in his 2007-08 Budget Mr Costello "delivered tax cuts ... amounting to only 39 per cent of the scope available to him".[10]

• **"Even this figure takes no account of the high likelihood that, when the year is over, we shall find that the scope ... has increased still farther"**.[11]

• With the Future Fund rapidly increasing, the Treasurer in his most recent Budget found it politic to invent another "off-Budget" receptacle, the Higher Education Endowment Fund (HEEF). Into this he ladled an "initial" $5 billion of his embarrassingly huge 2006-07 surplus.

Against that background, the article concluded:

• "What if, from (say) 2003-04 onwards, the Howard Government had actually set out to reform our personal income-tax (and associated corporate tax) system? What if it had actually sat down and framed a strategy...?".[12]

• Its failure to do so, **"and the failure of purpose and imagination involved on the part of the Treasurer, and the Government as a**

7. This comment/prediction was filed on 30 July 2007.
8. "Mr Costello's Repeated Budget Failure", *loc. cit.*, p.18.
9. *Ibid.*
10. *Ibid.*, p.23.
11. *Ibid.*
12. *Ibid.*

whole, speaks volumes".[13]

Post-Budget Events

The first of the post-Budget events referred to earlier occurred on 21 August 2007, when the Treasurer issued a press release[14] revealing that:

• The preliminary estimate of the final outcome for the underlying cash surplus in 2006-07, which on 8 May 2007 had been put at $13.6 billion, was now put at $17.3 billion.

• Of this sum, $7 billion would be transferred to the Future Fund and $6 billion ($1 billion more than proposed three months earlier) to the HEEF.

• This transfer to the Future Fund, "when combined with the proceeds from the second instalment of the sale of Telstra 3 ... will on current indications see the Future Fund accumulate sufficient assets to fully offset the Government's unfunded public sector superannuation liabilities in 2020".

• In short, "this scenario should allow the Fund to meet its objectives without any additional government contributions...".

• With the Future Fund effectively exhausted as a receptacle for surpluses, and the HEEF already showing signs of financial obesity, Mr Costello found it necessary to invent yet a third such entity to assist in concealing his budgetary failings. Thus, after allowance for some cash advances, "there is $2.5 billion remaining for investment" in yet another "off-Budget" surplus-receiving fund, "the Health and Medical Investment Fund (HAMIF)".[15]

The budgetary experience for 2006-07 can therefore now be summarised as follows:

• When the 2006-07 Budget was brought down in May 2006, the underlying cash surplus for the year was put at $10.8 billion.

• Over the following 12 months, new policy decisions (almost all new spending decisions) were taken which, *per se*, would have reduced that cash surplus by $6.3 billion, to $4.5 billion.

• That notwithstanding, on 8 May this year the 2007-08 Budget put the 2006-07 cash surplus at $13.6 billion.

• In the final outcome, that already huge surplus was increased even further, to $17.2 billion.[16]

This was bad enough, but it was as

13. *Ibid.*, p.24.
14. *Preliminary 2006-07 Budget Outcome and Surplus Transfers*, press release by the Treasurer, Sydney, 21 August 2007.
15. *Ibid.* Attachment. Earnings from the HAMIF will be available (from July 2009) for various health- and medical-related purposes, all of which would normally be met from the usual budgetary spending appropriations.
16. This final outcome figure is slightly less than the $17.3 billion preliminary estimate referred to earlier. See *Final Budget Outcome 2006-07*, circulated by the Treasurer and the Minister for Finance and Administration, September 2007.

nothing to what was to come. On 15 October 2007 the Treasurer and the Minister for Finance and Administration released the Mid-Year Economic and Fiscal Outlook (MYEFO).[17] Significantly, they did so in conjunction with the announcement of the Coalition's tax policy for the federal election, called on the previous day. As was undoubtedly intended, the MYEFO itself therefore received almost no attention from journalists wholly focused on the tax policy announcement. Nevertheless, the document repays careful reading.

The MYEFO

Because the MYEFO incorporates the new policy proposals for further significant tax cuts, its estimates for the Budget surplus outlook are commensurately constrained. It is therefore revealing to look at what those estimates would have been **in the absence of the tax cuts**. It is these "notional" MYEFO figures that reveal the true enormity of Mr Costello's budgetary failure. Thus:

• **After** allowance for all new post-Budget policy decisions (including the tax cuts now proposed), the underlying cash surpluses for 2007-08 through 2010-11 are now estimated to be, respectively, $4.2 billion, $1.7 billion, $3.9 billion and $2.7 billion **greater** than was estimated in the Budget five months earlier.

• In 2008-09, 2009-10 and 2010-11, the budgetary costs of the now proposed personal income tax cuts are, respectively, $7.1 billion, $10.9 billion and $15.9 billion.[18]

• Without the now proposed tax cuts, the underlying cash surpluses that would have appeared in the MYEFO for the years 2007-08 through 2010-11 would have been $14.8 billion (unchanged), $21.5 billion, $28.7 billion and $31.0 billion, respectively, or a total of $96.0 billion over the four-year forward estimates period.

The Government's Tax Cut Proposals: Master Stroke or Unavoidable?

When the Prime Minister and his Treasurer released their election policy tax package on 15 October, it was widely hailed as a "master stroke" that took the Labor Party completely by surprise and set the Coalition's elec-

17. *Mid-Year Economic and Fiscal Outlook 2007-08*, statement by the Treasurer and the Minister for Finance and Administration, 15 October 2007.
18. *Ibid.* Appendix A: Policy decisions taken since the 2007-08 Budget, Table A1, p.62. While the income-tax proposals dwarf all other post-Budget policy decisions, nevertheless the latter have not been negligible. All told, policy decisions in the five months since the Budget (other than the now proposed tax cuts) are estimated to cost $3.9 billion, $3.7 billion, $2.9 billion and $2.1 billion, respectively, in 2007-08 through 2010-11 (the four-year forward estimates period). By the time of the MYEFO, of course, these earlier post-Budget decisions were effectively water under the bridge.

tion campaign off to a flying start. It certainly did do that; but in light of the figuring above, it seems clear that the Government **had absolutely no option but to do what it did**. Even then, Mr Costello's traditional reluctance to hand back our taxes has meant that he has done less than he could (and should) have done. Let me explain.

Imagine the public reaction if, on 15 October, the MYEFO had been published and the Government had **not** announced its tax cut proposals! Imagine the reaction from voters if the Treasurer had revealed, **without announcing the new tax cut proposals**, that his Budget surpluses over the four-year forward estimates period now totalled $96.0 billion! That is, he would be taxing us even more heavily than in his May Budget — which itself, politically, had sunk like a stone.

Specifically, what would have been the public reaction to estimated surpluses in 2008-09 through 2010-11 amounting to $21.5 billion, $28.7 billion and $31.0 billion, respectively? Yet, without the tax cut proposals, these would have been the MYEFO estimates. "Master stroke" the tax cut proposals, in one sense, may have been. The truth is, however, that the Treasurer (and Mr Howard) **had no option** if they were to avoid the public storm that these figures, in isolation, would have generated. The tax cut proposals were therefore simply unavoidable.[19]

But, you may say, there was no need for the MYEFO to be published on 15 October anyway. Indeed, that document is not usually published until later in the year. To be totally cynical, couldn't the Government have simply sat on the revised figures?

I do not suggest that the Government would have considered doing that. All questions of public probity (not to mention leaks!) aside, Mr Howard would have recalled his own painful experience as Treasurer during the 1983 federal election campaign. When he was then informed by Treasury (more precisely, by me personally) of the "blow-out" in the 1982-83 Budget figuring, he was restrained (after consultation with the then Prime Minister) from making that information public — a decision for which he subsequently endured much public obloquy.

More importantly, even such speculations would not now have survived a moment's thought. Under the *Charter of Budget Honesty Act* 1996, the Secretary to the Treasury and the Secretary for Finance and Administration are now required, within 10 days after the issue of writs for a federal election, to publish the Pre-Election Economic and Fiscal Outlook (PEFO). This docu-

19. Even then, the proposals still left the underlying cash surpluses in the three years 2008-09 through 2010-11 some $8.3 billion greater than the earlier Budget figures. Mr Costello, it seems, just can't let go of our money.

ment, which updates all previous publicly available information on the economic and fiscal outlook, would therefore have contained all the revised budgetary figuring that appeared in the MYEFO. Therefore, while the Government might run from the MYEFO, it couldn't hide from the PEFO.[20] So, making a virtue of necessity, a tax-cutting announcement was duly made.

The Coalition's Tax Cut Proposals

The proposals announced on 15 October 2007[21] comprised two components: a so-called "tax reform plan" to take effect over the three years 2008-09 through 2010-11, and a "tax reform goal" for the following two years (2011-12 and 2012-13). The latter would occur "if the expected strong economic and fiscal conditions continue" (and if the Coalition should be re-elected not only on 24 November but also three years later).

This latter component is of the "promises, promises" kind normally to be found in the prospectuses of Pierpont's Blue Sky Mines (No Liability) company. The significant component is the "tax reform plan" for the next Parliament. That "plan" contains several elements,[22] namely:

• During this financial year, there will be no change to the tax cuts announced in the Budget.

• Commencing on 1 July 2008 the Low Income Tax Offset (LITO)[23] will increase significantly, in three stages, from the level of $750 to which it was raised on 1 July last, to $1,500 as from 1 July 2010. This will mean that the current effective tax-free threshold, which was raised to $11,000 on 1 July last, will increase in three stages to a level of $16,000 for those taxpayers eligible for the full LITO.

• The income threshold at which the 30 per cent marginal tax rate cuts in, which in the Budget was raised to $30,000 for the current financial year, will be increased in three stages to a level of $37,000.

• As announced in the Budget, the income thresholds at which the 40 per cent and 45 per cent marginal tax rates cut in will be raised from their current levels of $75,000 and $150,000 to $80,000 and $180,000 on 1 July next,

20. The PEFO document was in fact published on 23 October 2007. Naturally, coming so hard on the heels of the MYEFO, it contains almost no further new information. The budget surplus figuring is therefore to all intents and purposes identical with that of the MYEFO.
21. *Personal Income Tax Reform*, press release by the Treasurer, 15 October 2007.
22. Apart from those listed here, the "plan" also includes other minor elements of a more or less consequential nature.
23. The LITO currently applies to resident Australians whose taxable income is less than $30,000, and reduces by 4 cents in the dollar for incomes above that level, to the "cut out" point of $48,750.

but will otherwise remain unchanged.

• On 1 July 2009 the 40 per cent rate will be marginally reduced to 38 per cent, and the 45 per cent rate marginally reduced to 43 per cent. On 1 July 2010 these rates will be even more marginally reduced further, to 37 per cent and 42 per cent, respectively.

The new "plan" is structured along very similar lines to the Budget tax package. That is, it significantly lightens taxation of low and lower-middle income earners, provides some limited relief for upper-middle income earners, but offers little (and considerably delayed) relief for higher income earners. It may therefore be worth recalling my assessment of that Budget package,[24] namely:

• After Mr Costello's successive budgetary tax cuts, "we now have in 2007-08 a largely unaltered rate scale (15/30/40/45)"; increased marginal rate thresholds, which "taxpayers are doubtless glad to have"; and a modest but genuine reform in the low income area that constitutes "a useful step in the right direction".

• For the rest, the changes "have been meagre in terms of the opportunities the Treasurer has had to do more".

• In particular, "they have also left the **structure** of our personal income tax system almost untouched".

Broadly speaking, those words again sum up the Coalition's "tax reform plan". It does contain an element of reform, by reducing further the disincentives against job-seeking by low income earners; but it does almost nothing (and even that, considerably delayed) to address the **structural** flaws of our current personal income tax system.

So, faced with this new initiative (if something forced upon you by your past failings can be so described), what has been Labor's response?

Labor's Response

On 19 October 2007 Mr Rudd and his Treasury spokesman, Mr Wayne Swan, announced Labor's response. Like the Coalition, Labor also divided its proposals into two components, the first covering the years of the next Parliament and the second comprising a set of "aspirational goals" to be embraced in the following three years.

These latter gave rise to sharp criticism from Mr Costello, who said (rightly) that Labor had made a major mistake by failing to continue to index its tax thresholds for purposes of its second component. More generally, however, this component resembled even more closely that Blue Sky Mines (No Liability) prospectus referred to earlier. For that reason, and since in any case nobody believes either Labor's or the Coalition's promises about what they would do in the **second** Parliament after the one now recently dissolved, I do not propose to

24. "Mr Costello's Repeated Budget Failure", *loc. cit.*, pp.21-22.

discuss the second component of Labor's package (or Mr Costello's criticisms of it) further.

The first component can be readily summarised. As Mr Costello (again rightly) said, it differed little from the Coalition's announcement four days earlier. Specifically:

• Of the five dot-points listed above to describe the Coalition's "tax reform plan", Labor adopted the first four unchanged.

• It did not adopt the final point relating to the 40 and 45 per cent marginal tax rates. With the resulting budgetary saving, it proposed tax rebates for certain limited educational expenses by Family Tax Benefit (Part A) recipients. These proposals appear both administratively cumbersome and technically questionable; but because they concern education policy rather than tax policy, I leave them aside.

Since the Labor package differs so little from the Coalition's, so does the verdict on it. Like the Coalition's, it does contain an element of reform in the low-income area, but is otherwise merely a tax-cutting, as distinct from tax-reforming, exercise. Its abandonment of even the Coalition's meagre move to restructure the marginal tax rate scale is simply a case of the "politics of envy". (It would argue that it has proposed some restructuring in its "aspirational" component, but as noted earlier, nobody believes such blue-sky stuff in any case).

The Post-24 November Situation

Whoever the victors may be on 24 November, they will have committed to significant tax cuts (particularly for low, and lower-middle, income taxpayers) over the three years commencing on 1 July next. The Coalition (but not Labor) has additionally committed to some minor fiddling with the 40 and 45 per cent marginal tax rates, in two stages commencing on 1 July 2009.

These tax cuts notwithstanding, the underlying cash surpluses for the four-year forward estimates period are currently put at $14.8 billion, $14.4 billion, $17.7 billion and $15.1 billion, respectively.[25] This is in a context where the Commonwealth ceased to have any net debt two years ago. It is also in a context where, even if you actually believed in the alleged need to put money away in the Future Fund, the transfers already made to that Fund "should allow the Fund to meet its objectives without any additional government contributions".

The challenge to the winners on 24 November is therefore this: given this unique opportunity to strike a major

25. On past experience, even the now much increased estimates of the budget surplus position may still, come the next Budget, be revealed as having once again been understated.

blow for that "productive Australia" they have both been harping on over these past boring weeks, will they rise to that challenge, or fail to do so (in the Coalition's case, again)?

The Tax Reform Challenge

In my previous article I noted that, while many things could be done to reform our personal income tax system, "the major ones, however, are straightforward". As stated, they are:[26]

• "Compress the current four-rate structure[27] to a two-rate one (at current rates, that is, a 15/30 structure)".

• "Move progressively over time to drive down those two rates (including also the 30 per cent corporate tax rate) proportionally further — for example, to 14/28, 13/26, 12.5/25 and so on".

• "Abolish the remnant capital gains tax which, even at a 50 per cent discounted rate for assets held for more than 12 months, is a serious disincentive to risk-taking".[28]

Whoever is in office on 25 November should immediately institute a thoroughgoing review directed to these ends. It should be aimed at announcing major changes to our personal income tax structure in the next Budget, on a staged basis, commencing on 1 July next. This review should take as a basic assumption that the federal Budget should continue to be balanced. However, it should also take as a basic assumption that, commencing with the 2008-09 financial year, **there is no longer any basis for continuing to run significant budget surpluses**.

For some time now there has been no rational argument against such a course. Now, however, the budgetary situation post-election is such that all past objections must surely vanish. One of them (the interest rate bogey) will however undoubtedly continue to be raised. So without discussing that bogey exhaustively, here are a few thoughts about it in conclusion.

The Interest Rate Bogey

Since this article is being filed just prior to the Reserve Bank board meeting on 6 November, the bank's decision on its official cash rate is unknown to me. If however we assume that the Bank does decide then to raise the rate by another 0.25 per cent (to 6.75 per cent), my only comment is, "So what?".

For at least two years now the "mix"

26. *Ibid.*, p.22.
27. Five-rate if you include the zero rate for taxable incomes less than $6,001.
28. The previous article also recommended that the capital gains tax abolition should be accompanied by a strengthening of "the anti-avoidance provisions of the *Income Tax Assessment Act* to give the Commissioner greater powers to strike down 'schemes' that seek to present income as capital gains". My impression is that the Commissioner's present powers in this regard are already sufficiently extensive, but if he needs more he should be given them for this limited purpose.

of fiscal and monetary policies has been seriously awry. That is, fiscal policy has been too restrictive, and monetary policy too accommodating. As a general principle, there is no virtue in taxing people too heavily so that other people may enjoy lower interest rates than would otherwise be appropriate. That is particularly true when a high proportion of those enjoying those lower interest rates are speculators, either in the stock market or the housing investment market.

Much is made, particularly by short-sighted politicians, of the adverse effect of higher interest rates on those with housing mortgages, and on those seeking to purchase homes. For example, in this election campaign Labor has carried on about "housing affordability". Yet nothing more clearly worsens housing affordability than having house prices pushed up by the over-ready availability of cheap money, and its use by speculators to push up property prices. I say nothing of the nonsense whereby first home buyers, encouraged by such behaviour, take on mortgages that they risk being unable to afford on homes more expensive than is appropriate to their pockets.

In short, as I had hoped we had learned from past bitter experience, overly cheap money is not a blessing, but a curse. If, by the new government really cutting personal income taxes, and reforming their structure in the process, the Reserve Bank were forced to address its present over-accommodating monetary policy stance, that would be inherently desirable. Both our fiscal policy stance, and our monetary policy stance, would be the better for it.

Conclusion

In concluding my earlier article I said that the Howard/Costello Government's "failure of purpose and imagination" in this matter of personal income tax reform "speaks volumes". If, nevertheless, the Coalition is re-elected, it will have a voter-given opportunity to make good that earlier failure.

Alternatively, a Rudd Government will, because of that failure, have a unique opportunity to write its name in Australia's history books.