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It takes brains to be a swindler

HENRY ERGAS THE AUSTRALIAN MAY 20, 2013 12:00AM

Illustration: Eric Lobbecke Source: The Australian

LAST week's budget seems the farewell card Labor had to have. It constrains spending, while funding DisabilityCare and the Gonski reforms; it projects sustained revenue increases, with receipts rising twice as rapidly as payments to 2014-15; it heralds a surplus in 2015-16; and it paints a strong picture of the outlook to 2023-24, at which time net debt will be negative and the government will be accumulating assets on behalf of taxpayers.

Having thus tabled a budget that could glow in the dark, Wayne Swan can leave office holding his head high.

If you believe any of it, that is. For there's the rub: it is one thing to present numbers; another to make them plausible. And on that score, the budget doesn't get off to a promising start.

Having previously committed to holding real spending growth to 2 per cent until the return to surplus, the qualifier "on average" has crept into the government's fiscal rules. Understandably, as spending actually rises by more than twice the cap next year.

Echoing Saint Augustine's prayer imploring God to "make me chaste, but not yet", what spending virtue there is comes safely down the track. And given a government that has gold medals for missing its targets, the little-noticed assumptions on which it rests hardly inspire confidence.

For example, comparing Labor's record with the budget's estimates for the period ahead, the average annual growth rate of real health spending is projected to collapse from 6.3 per cent to 2.4 per cent; that of education plummets from 9.5 per cent to barely 2 per cent; while the growth rate of welfare spending halves.

Since the 1980s, there is no five-year period in which growth rates of those outlays have been so low; and with scant detail as to how such drastic reductions are to be secured, Baldrick's words "I have a cunning plan" can be heard marching in one's direction.

As for the revenue side, it too makes Walter Mitty seem positively unimaginative. Take the carbon price. Only days ago, Greg Combet, looking like an anarchist whose bomb had gone off moments too soon, was forced to concede that with European permits trading for about $5, Australian prices would not reach the $29 level he had stubbornly clung to.

Apparently, in Combet's world, what goes down, must come up, so the budget predicts a 2015-16 price of $12.10 - which on current European futures prices, is more than 50 per cent too high.

That initial canter in carbon prices then becomes a gallop, with the budget projecting a 50 per cent increase in 2015-16 and a sustained rise thereafter.

Why? Because that returns prices to their path in Treasury's carbon modelling, with its assumption of global agreement on carbon trading by 2016.

Optimistic? For sure. But nothing a miracle couldn't fix.

The other parts of the revenue side don't do much to improve the view. The trouble with these is not that Labor won't do as it says, but that it will.

Among the areas of greatest concern are the proposed changes to company tax.

According to the government, the multinationals are ripping us off, avoiding their fair share of the tax burden.

Combining its favourite betes noires, foreigners and big firms, gives it an opportunity to hit two birds with one stone - all the more as the changes are so arcane as to be incomprehensible to anyone but specialists. Unfortunately, those changes will impose high economic costs.

For example, far from closing an abuse-ridden loophole, the modifications to the "thin capitalisation" rules (which limit how much interest firms operating internationally can deduct from their tax bill) will discourage foreign investment by increasing the effective tax rate on globally mobile capital.

Estimates in the Henry Report imply that by so doing, they will reduce GDP by $19 billion over the next decade (details are on my blog).

It doesn't end there, however. For those changes will also deter Australian firms from investing overseas, notably in Asia, as interest on debt used to finance foreign acquisitions will no longer be assured of tax deductibility.

That their global rivals also vying for those acquisitions will generally benefit from such deductions in their home countries only increases the damage.

The biggest losers will probably include - don't say it in front of the children - Australian banks and miners, whom Labor especially loathes; but all major industrials are likely to be adversely affected, hindering the adjustment to the "Asian Century" the government promotes.

Nor are those the only changes. They come on top of measures that speed up company tax payments, which increases pressures on corporate cashflows, and abolish the R&D tax concession for large firms, penalising our few knowledge-intensive multinationals.

Overall, while the countries with which we compete for investment are reducing their already low corporate tax rates, this government is increasing ours. From a political point of view, that makes sense, as these increases, unlike higher personal income taxes, are scarcely visible to voters.

But they make our tax base even more dependent on highly volatile company tax receipts; and by taxing investment, they inefficiently reduce productivity growth. As the Henry Report showed, it is not the profits of the big, bad multinationals that will suffer from that fall, but the real wages of ordinary Australians.

So much for "Labor values". And so much for a budget Swan can remember with pride. The problem, as Charles Ponzi observed, is that it takes brains to be a swindler; and most importantly, you mustn't try to fool the same people twice. Despite repeated debacles, Swan seems determined to learn that lesson the hard way.