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With reform an uphill battle, Canberra must cut spending instead

HENRY ERGAS THE AUSTRALIAN MARCH 30, 2015 12:00AM

The good news is that Mike Baird has been re-elected Premier of NSW. The bad news is that there was a large swing to Labor, undeserving though it was.

And the worse news is that if merely leasing NSW poles and wires can trigger the mother of all scare campaigns, one can only imagine the Armageddon any attempt at comprehensive tax reform would ignite.

That is not to suggest tax reform has ever been easy.

But it is even harder today than in the past.

Despite offering potential losers massive compensation, John Howard barely scraped home in the GST election; now, however, the giveaways needed to appease every conceivable interest group are simply unaffordable.

And without the ability to dispense largesse on a Pharaonic scale, overcoming virulent opposition would require far more political capital than the government can hope to muster.

Nor is it obvious that comprehensive tax reform should be the government's priority.

Sure, there are real gains to be had by switching from more distorting taxes (such as the income tax) to less distorting taxes (such as the GST), as the discussion paper the government released today argues.

And improved tax design (for instance, in terms of better aligning the rates at which different forms of savings are taxed) would yield gains too.

Those gains, however, are likely to be small compared with the benefits from reforming and restraining public spending.

After all, every tax distorts behaviour, creating efficiency losses; and even the GST, which is the most efficient of our major tax sources, is only marginally less distorting than the income tax.

Moreover, the distortion a tax imposes is like the buckling a truck causes to a road's surface: increase the weight on each axle and the damage rises more than proportionately.

With a widely used rule of thumb showing that doubling a tax's rate increases its efficiency costs fourfold, any large-scale transfer of revenue-raising responsibility from the income tax to the GST would cause the efficiency gap between them to shrink.

That means the gains from restructuring the tax mix may not be as great as the discussion paper implies. For example, shifting the task of raising $1 of government revenue from the income tax to the GST would likely yield an efficiency gain of no more than 10-15 cents; and were the shift in the tax mix very large, the efficiency gains per dollar of revenue-raising responsibility trans-ferred would be even less than that.

In contrast, many major spending programs have benefits that are 30 per cent to 40 per cent below their costs; eliminating those programs, or restructuring them so that they provide value for money, should secure gains two to three times those available from a change in the tax mix.

Of course, the immediate need to focus on the spending side is made all the more pressing by our looming fiscal nightmare.

Budget deficits are simply a form of deferred taxation, which transfers the burden of paying for current spending on to future taxpayers.

But in addition to being inequitable, persistent structural deficits are inefficient, as the need to finance rising levels of public debt crowds out private investment, reducing the future incomes out of which the debts we leave will ultimately have to be repaid.

And mounting public indebtedness weakens the economy's resilience to shocks, further increasing the pain future taxpayers will bear.

If those harms are to be averted while keeping the tax take close to its historical share of GDP, outlays must be put under far tighter limits. So with scarce political capital on which to draw, the government would do better to focus on restraining public spending than on ambitious schemes for tax reform.

But that doesn't mean tax issues can or should be ignored. And the fact that we are going backwards on many tax issues only underscores the need for the government to take tax seriously.

There is, for example, a compelling case, which the Henry review accepted, for moving to a flatter income tax, with marginal rates that increase less steeply than they now do. But, far from making that tax flatter, the Abbott government has increased the top income tax rate.

The prospect of having two company tax rates, with a lower rate for smaller businesses, is another case in point.

No doubt, company tax imposes proportionately greater administrative costs on small businesses than on large; but a lower rate does nothing to address that problem.

Rather, its main effect could be to increase the incentives for the owners of small businesses to shift income from personal to company tax, with the perverse effect of increasing the resources devoted to administration and compliance.

But even putting that danger aside, the emphasis in the Henry report was (quite rightly) on the inefficiencies the company tax creates in a world with high levels of capital mobility — inefficiencies which surely affect large, international businesses that operate in global capital markets far more than they do smaller Australian firms.

And with 10 companies paying one-third of all company tax, the argument for cutting the tax rate is much more compelling in respect of large business than of small. Yet the opposite seems likely to occur.

None of that detracts from the government's achievement in repealing the mining tax, which was fatally poorly designed, along with the ill-conceived carbon tax.

Nor does it reduce the usefulness of the discussion paper, or the importance of the mature and wide-ranging conversation it invites.

And, yes, Baird has shown that even deeply contentious reform is possible.

But he has also shown that means carefully picking one's fights. With public spending still out of control, the government has its work cut out for it.