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Labor is taking Europe's road to ruin

HENRY ERGAS THE AUSTRALIAN APRIL 25, 2016 12:00AM

It is easy to understand why Labor wants to increase taxes on higher-income earners. And it does not take much nous to figure out why the government might feel under pressure to do so too. But what does require explaining is how the need to raise taxes in next month's budget has become an unchallenged part of the conventional wisdom.

After all, we are hardly slouches in the revenue stakes. On the contrary, data from the International Monetary Fund shows Australia is exceptional in the reliance we are already placing on higher revenues, rather than on better controlled public spending, to restore budget balance.

Taking the advanced economies as a whole, about 25 per cent of the projected fiscal improvement over the decade will come from increasing the share of taxes in GDP, with the remaining 75 per cent being achieved by slowing the growth of outlays. In Australia, however, virtually all the fiscal effort will be on the revenue side, with public spending growing at a rapid rate.

Yet there is little reason to think that our lopsided emphasis on raising revenues makes any sense. Rather, simple economics suggests the emphasis should lie squarely on public expenditure restraint.

An example illustrates the point. Assume the last dollar of public spending yields 10c in net benefits, but that by reducing the incentives to work, save and invest, the additional dollar in taxes required to make that spending fiscally sustainable would impose 30c worth of costs. In that case, cutting spending would clearly be preferable to boosting taxes. Conversely, it is only if the net benefit from the last dollar of public spending exceeds the cost of raising taxes that a tax hike might be justifiable.

The question, in other words, is how the social loss from higher taxes compares with the social benefit of sustainably higher expenditure. And while such comparisons are inevitably fraught, the former is likely to greatly exceed the latter.

That is partly because the options for tax increases have been narrowed to the point where only the most inefficient possibilities remain on the table. Obviously, no tax is costless, but some are plainly more distorting than others. And with the top rate of income tax already at 50 per cent (and closer to 58 per cent when the GST is taken into account), plugging the deficit by raising that rate could reduce national income by up to 60c for each additional dollar in revenue raised. Such a tax increase would therefore only be sensible if each dollar of public expenditure yielded $1.60 in benefits.

The hurdle would not be any lower were taxes hiked on superannuation or capital gains. An efficient tax system should be neutral between consuming today and consuming tomorrow; ours isn't, taxing many savings heavily.

Aggravating those distortions would have substantial economic costs. That doesn't mean total savings would necessarily fall were taxes on savings raised. Rather, just as higher income taxes — by making taxpayers poorer — may force them to work longer hours, so taxpayers, faced with steeper taxes on savings may offset some of the impact on future incomes by maintaining their savings effort.

But much as it would be absurd to believe the longer working hours meant the higher income taxes had not distorted decision-making, so it is foolish to claim, as the Grattan Institute's John Daley regularly does, that the near constancy of total savings implies raising taxes on savings is harmless.

Instead, put in the jargon of economics, the "income" effects of the tax hike — which raise savings — disguise the "substitution" effects, which reduce them; but it is those "substitution" effects that measure how seriously efficiency is being undermined.

The efficiency losses would be every bit as great were negative gearing abolished. In simple terms, this would raise the cost of providing rental housing, compared with the cost of owner-occupancy, by a further 6-10 per cent in a market where that choice is already severely distorted.

Of course, those costs could be worth bearing if the spending they made sustainable had high net benefits. In reality, as public spending has burgeoned so its quality has deteriorated, to the point where its benefits are far below the thresholds needed to justify raising taxes.

For example, real commonwealth expenditure on childcare has increased from $1.8 billion in 2002-03 to just less than $7bn, so that spending per child under the age of five has literally trebled; yet there are few signs of any social returns from massively boosting outlays. Merely reversing that increase would yield savings that exceed the revenues that could plausibly be obtained from abolishing negative gearing and halving the capital gains tax concession.

Equally, real commonwealth school spending per school-aged child has doubled since 2002-03, but the proficiency level of lower performing students has barely increased, while that of higher-performing students has dropped. And in healthcare too there is a great deal of "flat-of-the-curve" spending, which yields no health benefits, and evidence of widespread waste.

Obviously, reforming spending programs is tough. But it is not the substantive difficulties that impede reform: it is the fact that in those areas and others the benefits of the spending have been captured by producer lobbies, going from the teacher unions to the self-appointed welfare advocates, whose swarms of petty appetites are as vicious as their rhetoric is sanctimonious. Taking them on is far harder than shafting taxpayers, all the more so when the slugs can be cloaked in the mantle of "fairness".

That has been Europe's road to ruin. And it has long been Labor's chosen road too. The test for Scott Morrison is whether the Coalition can do better.