Revenue Summit Speech

The Future Demands for Government Revenue

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Too often any discussion of taxation starts from the premise that taxation is a *burden.* That premise is, however, completely misleading. Instead, taxation represents the best way to pay for government services, many of which are vital to the economy, and which we all want. Furthermore, taxation revenue is also required to support the type of socially inclusive society, with reasonable equality of opportunity, that we also want, and on which the survival of capitalism depends. As the great American jurist, Oliver Wendell Holmes put it, “I like to pay taxes. In this way I buy civilisation”.

Those who support tax cuts, however, contend they will not jeopardise the ability of government to continue paying for our services and other forms of government assistance. Instead, these supporters of low taxation argue that tax cuts will incentivise people and businesses, and in that way increase our economic growth, and thus our capacity to pay for the services that we demand. Of course, we can all think of specific taxes, that if they are levied at a high rate, will change behaviour; indeed, that is the intention of taxes on cigarettes and carbon, and charges on congestion. But the empirical evidence shows that there is no correlation between present overall levels of taxation and any country’s economic growth rate: many high taxing countries in northern Europe for example, have a higher growth rate in their per capita GDP than low taxing countries such as America. Similarly, the drop in Australian income tax rates in the 1980s was not associated with any increase in employment participation or productivity growth. And, as research recently released by the Australia Institute shows, Australia is already one of the lowest taxing countries among the developed nations of the OECD.

Instead, what really matters is what a country does with its taxation revenue. If it is spent wisely on functions, such as research and development, education and training, health, and infrastructure, then this taxation can actually increase the nation’s economic capacity. For example, that is why, even within the same country, such as the USA, the economic performance of Massachusetts has been better than that of Mississippi, although Mississippi has lower taxes.

However, that still leaves open the question of whether these legitimate demands for government expenditure, which are supported by a substantial majority of the population, can be accommodated within the expected future government revenue, assuming present taxation policies are maintained?

The Government, for its part has invited us to believe that it can broadly maintain its expenditure obligations, while also introducing its promised tax cuts, and it will still return the budget to a surplus. My purpose today is to convince you that the Government is most likely wrong, and that sooner or later steps will have to be taken to increase future government revenue.

In short, I will argue that the Government has an over-optimistic view about future revenue, while it has also made insufficient allowance for future spending needs. First, the Government has capped its future revenue at 23.9 per cent of GDP. This revenue ceiling will be reached in the next few years, so that in the medium-term the level and rate of increase in revenue will be determined by the level and rate of increase in GDP. That in turn means that the Government's projected rates of economic growth are critical. But the Government has a very rosy view, as it has assumed that the very slow rates of economic growth that Australia, and other countries, have experienced over the last decade can be ignored and that we are poised for a return to previous higher economic growth rates. Second, the projected slower rate of expenditure growth, ignores past experience and the pressures for additional spending, and it does not allow sufficiently for the net cost of likely new policies in the future.

This is why I want to argue that an increase in taxation revenue will be needed if we are to meet the demands for government services and assistance that I think most Australians support. To substantiate that conclusion, I will now elaborate on my criticisms of the government's projections of the economic outlook and government outlays in turn.

Future Economic Growth and Its Implications for the Budget

As I am sure you are all aware, since the GFC the advanced economies of the OECD have experienced a decade of economic stagnation, growing at less than half the rate of growth experienced over the previous 13 years between 1993 and the onset of the GFC. However, over the last twelve months or so, employment growth in both the US and Australia has been quite strong, and both these Governments are pinning their hopes on better times ahead. Indeed, both Governments are claiming that economic growth in their respective countries is poised to return to a sustainable average annual rate of 3 per cent (or more), supported by tax cuts that heavily favour the rich, but from which the benefits will allegedly trickle down to ensure a broad-based recovery in economic growth.

However, I think these optimistic forecasts ignore the reasons why almost all the advanced economies have endured a decade of economic stagnation. The conditions that produced that stagnation have not changed materially, so it is surely an exercise in wishful thinking to blithely assume that we can expect to return to past rates of economic growth experienced before the GFC.

Fundamentally the economic stagnation of the last decade was caused by an insufficiency of aggregate demand, so that actual GDP growth did not match its then potential. The cause of this insufficient demand was the slow rates of wage increase and increasing inequality. As the Governor of our Reserve Bank, Philip Lowe, said last year, ‘The crisis really is in real wage growth’. But can we really expect that the rate of wage growth will pick up and return to past rates, even if the labour market remains tighter?

No-one can be sure of the answer yet, although in most countries, rates of wage increase are still much lower than in the past. In addition, even where there are some very recent signs of an increase in the rate of wage growth, what we don’t know is the distribution of those increases around the average rates of increase. For example, in the US the average real wage did increase over the past four decades, but that was not true for the lower six deciles in the earnings distribution, and ‘the typical American male [now] makes less than he did 45 years ago (after adjusting for inflation)’. It has been this slow rate of wage increase for the bottom half of the distribution, accompanied by the hollowing-out of middle-level jobs, that has been the main problem in sustaining aggregate demand. It is the lower and middle-income householders who have the higher propensity to consume, and a more equitable distribution of future wage increases will be necessary to sustain aggregate demand.

Prior to the GFC, increased household borrowing effectively acted to postpone the negative impact on aggregate demand and economic growth from rising inequality and associated low rates of wage increase for lower-paid people. But too often these loans were dodgy and many of these low-income households couldn't expect to service them, especially once interest rates rose. Thus, the loans were a way of postponing economic stagnation, but eventually they inevitably led to the crisis represented by the GFC. Since then these loans have largely ceased, but with no recovery in the rate of wage increases, aggregate demand has continued to stagnate in most advanced economies ever since.

In short, this experience, covering so many countries over such a long time-period, strongly suggests that a sustained return to past rates of economic growth will not be possible unless we can ensure a reasonably equitable distribution of income, involving a faster rate of wage increase, especially for the low-paid. But most research shows that the principal cause of this change in the distribution of income has been the impact of new technologies. And while government intervention can make a difference to how labour markets respond to these new technologies, there is little evidence so far of much change in the scope, nature or effectiveness of such government intervention. Equally there is little reason to assume that technological change is now having a more benign impact on the labour market than in the past few decades.

Accordingly, I remain very sceptical about the official medium-term projections for the Australian economy. These predictions are based on the assumption that as the labour market tightens the rate of wage increase will return to around past rates, averaging 3 per cent, and as much as 3½ per cent over the next few years when continuing economic recovery is assumed. Since 2011, however, every official forecast for the rate of wage increase has proved to be too high and has subsequently been revised down, so surely it is time to stop assuming that there have been no structural changes in the relationship between unemployment and the rate of wage increase in Australia.

In addition, the other factor to consider, in our assessment of the strength of economic recovery is the rate of productivity growth. Unfortunately, the data for productivity growth are also not reassuring. Understandably productivity growth dropped during the recession, but it still has not recovered and over the past five years the rate of increase in labour productivity in the OECD area has levelled off at approximately half its previous rate of growth prior to the GFC.

Indeed, in the US the productivity growth rate has averaged less than 1 per cent since the GFC, and it is only in the current year that it is forecast to be close to 1½ per cent; still substantially less than the 2 per cent average rate of increase in US labour productivity growth from 1991 to 2008. By contrast, productivity growth, at least until recently, has held up quite well in Australia, probably reflecting the smaller rise in inequality in Australia and our avoidance of recession. However, in the last four years there have been signs of a slow-down in the rate of productivity increase in Australia too, with the annual increase in labour productivity averaging only 0.7 per cent since 2014.

A critical question therefore when considering the future for economic growth in the OECD is why has the rate of productivity increase slowed and what will it take for a return to something closer to past rates of increase? We cannot be certain about the answer to this question – or at least not yet – but Stephen Bell and I have argued in our recent book, *Fair Share,* that the post-Keynesian economists are correct in their assessment. Essentially these economists argue that the decline in productivity growth rate reflects low rates of investment and the atrophying of skills, in response to an inadequate increase in aggregate demand; in turn this is a consequence of increasing inequality and low rates of wage growth, especially for those low wage earners who have a high propensity to consume.

The Government has assumed that the rate of productivity increase will pick-up from now on, increasing at an average annual rate of 1.6 per cent over the next decade or so, which is a bit faster than the average for this century. In my view a more realistic assumption would be that productivity will increase over the same period at an average annual rate of 1.3 per cent which is about the same as that achieved over the last ten years. After allowing for inflation and using the Government's employment forecast, I then find that nominal GDP should increase at an average annual rate of around 4¾ per cent between 2019-20 and 2028-29, and as I have explained this will largely determine the future growth of revenue so long as present policies are maintained.

The Outlook for Public Expenditure Growth

I now want to turn to why I think it is unlikely that expenditure restraint can be sustained so that expenditure increases more slowly than GDP over a decade. This of course is especially true if GDP growth in future is less than the Government seems to expect, but I also think it is likely that expenditure growth will be higher than the Government is projecting.

The Government's forward estimates and the PBO's projections imply that spending growth in real terms will increase at an average annual rate of 1.8 per cent over the four years from 2017-18 to 2021-22, and by 2.4 per cent between 2022-23 and 2028-29. This represents a rebound compared to the average annual real increase in government spending of 1.5 per cent over the period 2012-13 to 2016-17, but that period of relative restraint followed a large real increase in outlays in response to the GFC. In fact, a more 'normal' rate of increase in outlays is probably represented by the average annual real increase of 3.2 per cent over the period from 1992-93 to 2006-07, which is about one percentage point more than is currently being projected.

A second reason for doubting that this degree of expenditure restraint can be maintained is it ignores the pressures for new spending. In some instances these pressures have arisen because of the impact of past restraint, but new needs have also emerged. Most importantly, I think that we are now living in a much more uncertain world, and the cost of responding to the potential threats to Australian security may well require a very substantial increase in spending on defence and foreign aid, equivalent to another 1 or even 1½ per cent of GDP over the next decade.

Equally important will be the need to respond to the impact of technological change on the labour market. A return to a more equitable distribution of income is critical to achieving higher investment and the associated take-up of new innovations. In addition, the jobs being created today are not the same as those which have disappeared because of structural adjustments mainly brought about by technological change and there have also been changes in the patterns of demand, which tend to favour services over manufactures. Much more investment in skills training will be required to respond to these changes, and this investment should embrace life-long learning, but it will add significantly to the projected Budget outlays needed to restore economic growth and maintain full-employment.

Of course, some will object that expenditure savings should or could be found in other programs to offset these new demands on the budget. I personally am sceptical, however, about such arguments. In the late 1980s very large savings were found, mainly by tightening eligibility conditions to better target assistance on low-income households and the wider introduction of user pays, such as HECS. As a result, for the first and only time, real outlays declined in three successive budgets. But few or none of these opportunities for significant expenditure savings are now left. Indeed, the present situation is that recent expenditure savings have too often been focussed on politically vulnerable areas, so that most cultural institutions, many welfare agencies, and VET are now severely under-funded. Equally it is arguable that increasing the rate of NewStart and rental assistance, and improving aged and child care, should be high priorities if we are genuinely concerned about maintaining an inclusive society.

And finally, I don't think the Government's forward projections for budget outlays reflect the way in which they are likely to respond to political pressures. For example, the $1.2 billion to achieve a political fix with Catholic schools is contrary to the goal of a needs-based system of school-funding; while the decision to drop the policy of increasing the eligibility age for the age-pension to 70 is also indicative of a lack of the political fortitude needed to achieve expenditure restraint.

In sum, I suggest that, even if we assume reasonably tight expenditure control in future, it would be prudent to plan on government outlays increasing in real terms at an average annual rate of at least 3¼ per cent over the next decade or so. After allowing for inflation, this projection for real government outlays would translate into an average annual increase of 5½ per cent in nominal terms. This rate of increase in government outlays compares with my earlier projection of an average annual rate of increase in nominal GDP, and revenue, of around 4¾ per cent. In other words, in my view, it seems highly likely that over the next decade, the increase in outlays will exceed the increase in revenue, unless policies are changed.

In these circumstances it is difficult to see how we can avoid lifting the present revenue ceiling if the budget is to return to a modest surplus, while also meeting legitimate expenditure demands. However, in my assessment, the additional revenue required should amount to no more than 3 per cent of GDP, and it would be achieved over the next few decades. This would still leave Australian taxation levels well below the OECD average, and below New Zealand's present level. On the other hand, the longer we delay starting to plug this prospective revenue gap, the more government debt, and the interest bill on that debt, will rise and consequently the size of the necessary tax increase will also rise.