

Sustaining Prosperity Conference 2005

Speech Notes

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“The Way Ahead”

The way ahead begins with where we are today. After two days of advice and constructive criticism we have inevitably magnified the challenges ahead and diminished, even ignored, our achievements.

But we would be foolish to ignore our present circumstances, where we came from and how we got here.

Australia’s economy is stronger today than it has ever been. Inflation is low, unemployment is the lowest it has been for 28 years. Interest rates remain low. And perhaps most telling of all, in the years of the Howard Government, we have seen real wages¹ grow nearly seven times as fast as they did under Hawke and Keating. We are even having more babies...surely the most tangible vote of confidence in our nation’s future!²

A New Tax System was the most comprehensive single set of reforms to the tax system in our nation’s history. Company tax has been cut twice to its lowest level ever. Capital Gains Tax for individuals has been halved. Personal income tax rate has been cut on four occasions. More than 80% of Australian taxpayers face a top marginal rate of 30% or less.

As practical people we should judge our leaders, in whatever field, on output, not rhetoric; on substance not process. Now, I am not one of those people who imagines that the Government’s management of the economy means it is responsible for all our prosperity.

But unless you were to imagine that the economy has prospered **despite** the Government, then the record of the last nine years is one John Howard and Peter Costello are right to be proud of.

¹ Real F/T adult ordinary time earnings for males grew by 2% p.a. from Mar 96 to Aug 04 vs 0.3% p.a from Mar 83 to Mar 95: source APH Library Research Note no. 10 2004-2005, Economic Indicators Whitlam to Howard.

² See The Australian March 30 2005 “Fertility Slump Ends in A Boom” “For the past two consecutive quarters, about 67,000 babies were born in Australia, almost 10,000 more than for the March quarter, according to the Australian Bureau of Statistics. The surge has resulted in about 255,000 births over the past year - the largest 12-month total in nine years.”

Certainly Labor is in no position to criticize the Government's economic record; not least because they have no policies of their own to put up as alternatives. Last night Greg Combet, Secretary of the ACTU, complained about the lack of investment in "roads, ports, transport and other infrastructure". Well he might, but given that the Labor Party is the political wing of the trade union movement, it is a great pity that he has not directed his considerable political influence towards the Labor Premiers.

In New South Wales, where Bob Carr has perfected the concierge style of government, we have a Government which is rolling in money as a result of the GST and the property boom. They have never had it so good and possibly never will again.

Yet, a city which is running out of water has no plan to recycle its waste water. Sydney Water, the monopoly water company, has a profit margin of more than 25% and a massive dividend yield the envy of anyone in the private sector. It is being run for cash. There has been no significant addition to the city's water supply for forty years, and as the BCA points out within twenty years demand will be nearly 40% greater than sustainable yield.

Sydney is choking with traffic congestion, but the Government has neglected its public transport to the point where patrons are driven away. Their attitude of contemptuous indifference was well summed up a few years ago when the then Minister for Transport in NSW mocked me for my well known preference for traveling by public transport. "Surely you must get trains all the time." I innocently replied. "Oh, no," said the Minister "I've got a driver."

Much has been said about the failure to invest in our ports in Queensland and NSW and the way in which this has retarded our exports. But the way in which State Governments have misapplied their revenue boom to supporting a bloated bureaucracy rather than investing in transport, water, schools and hospitals is surely the political scandal of our times.

Many would say it is a failure of federalism. Citizens are impatient of the niceties of federal jurisdiction. If John Howard dares to point out to a talk back caller that the problems with public transport are a state matter, the rejoinder is "You're the Prime Minister, fix it."

So it is no wonder that the Federal Government is being drawn into more and more areas of traditionally State responsibility. But this trend contains a dangerous moral hazard: is the consequence of State Governments' neglect of their responsibilities to be simply that the Federal Government will intervene and pick up the tab?

In NSW the State Government's spending on its own schools barely keeps up with inflation. Children are leaving the State system in droves, every movement of a child from a State school to a private school shifts an expense from the State to the Federal Government. The neglect of school buildings has resulted in the Federal Government establishing a new programme of capital grants for all schools, including State Schools.

During the last election I was repeatedly told that the deficiencies in State schools were the fault of John Howard.

The lack of accountability of State Governments comes close to a failure of democracy and a failure of federalism. Why are the State Governments so unaccountable? Is it because the electoral arithmetic on the East Coast is such that it is most unlikely the incumbent Labor Governments can be removed at the next election? How can it be that vital elements of national infrastructure are so readily ignored?

Peter Costello's frustrations with the States is very understandable.

Consider State taxes. The Treasurer is seeking to persuade the States to stick to their bargain and remove some (not all) of the business taxes they promised to remove at the time of the Inter Governmental Agreement over the GST.

But they are not simply refusing to stick to their bargain, they are imposing new taxes (such as the vendor "exit" stamp duty in NSW) and they are expanding existing taxes.

Consider payroll tax, probably the most iniquitous tax of all: a tax on employment.

NSW has expanded that tax in recent years to include:

- Employer contributions to employee share schemes (from 1 July 2003)
- Trust distributions made in lieu of wages (from 1 July 2003)
- Eligible termination payments (from 1 July 2002)
- Director termination payments (from 1 July 2003)
- All lump sum payments made on termination for long service, annual, or sick leave (from 1 July 2003)
- The grossed up value of fringe benefits, as opposed to the taxable value of those benefits for FBT purposes (firstly, using the lower type 2 gross up rate from 1 July 2002 and then, with a cost of more pay-roll tax for the employer, applying both the type 1 and 2 gross up rates from 1 July 2003).

There are also **rumours** that the trend to broadening the pay-roll tax base is set to continue, with the abandonment of the otherwise deductible rule in determining the value of fringe benefits for pay-roll tax purposes.³

³ When pay-roll tax on FBT was first imposed, the State government was at pains to point out that it would adopt the Commonwealth's definition of taxable benefits and would apply all ATO rulings on benefit valuation. This was done to reduce compliance costs for employers. The same rationale was applied by the NSW government when it moved from using the lower (and fairer) gross up rate for all benefits, to applying both gross up rates. Employers were meant to be pleased that it would be so convenient to identify the value of benefits subject to pay-roll tax, even though the change cost them more pay-roll tax.

So serious is the neglect of the Labor State Governments that the next conference should focus sharply on what is happening at the State level; or perhaps there should be a series of similar conferences to shine the spotlight on what is happening at the State level.

But as this is a national conference and Dr Emmerson and I are both members of the Federal Parliament, I will return to the debate about tax and welfare reform which the media has been quick to characterize as being criticisms of the Government, even criticisms of its record.

The truth is that the reason we have today such an exciting public debate about the possibilities for policy reform and in so many areas is because over the last nine years we have not only seen a Government which is prepared to undertake serious and controversial economic reform, but we have also seen the real economic dividends that that reform has produced.

It is the Government's record of reform in the past that gives all of us the confidence to discuss and promote reform in the future. It is the Government's energy over nine years that causes us to demand, and indeed expect, energy in the future.

By way of contrast the reason there is so much less energetic debate about infrastructure in our big cities is, I suspect, because most people have no confidence the State Governments have the will or the capacity to do anything about it.

The debate about economic reform, of which this conference is an important part, far from being a criticism of the Government's record is, in truth, paying it the very highest compliment.

As we consider the Way Ahead: let us first reflect on what we know lies ahead, the terrain over which we must travel. Then we can consider how we may best tackle the social and political ridges and gullies of the decades before us.

The single biggest change to our society, and to the world, is demographic. The dimensions of this change were well described several years ago by the Treasurer in the Inter-Generational Report.

Because of a decline in fertility and an increase in longevity the percentage of our population which is "aged" is going to dramatically increase. Those over 65 today are 12% of the population. In less than 40 years they will number a quarter of the population.

Given the speculation that the NSW government is considering eliminating the otherwise deductible rule, the previous concern to minimise the compliance costs faced by employers seems to have been moved firmly to the back seat. Very clearly, if this proposal is adopted, not only will it increase the pay-roll tax take in NSW, it will mean employers have to calculate the notional FBT taxable value of a benefit solely for the purpose of deciding what their pay-roll tax liability is, ie compliance costs will rise.

More significantly perhaps, those over 85 who today represent 1.4% of the population (about 300,000 in number) will increase to nearly 6% of the population (or nearly 1.6 million). Between now and 2045 about 2.3 million will be added to the working age population (defined as 15-64) but there will be 4.3 million added to the 65s and over of which more than half a million will be over 90.⁴

Instead of there being more than 5 people of working age for every person over 65, by mid century there will be only 2. This demographic change will add considerably to expenditure on health (especially the PBS), aged care and age pensions. After taking into account some modest savings on education (fewer kids), there will be by mid century additional fiscal pressure of 6.5% of GDP, amounting over 40 years to \$4.2 trillion. If this were to be met by increased taxation, far from reducing tax we would need to increase it by 21%.⁵

These momentous changes are upon us. They cannot be averted in the medium term. They make further substantial economic reform a vital necessity. As Peter Costello warned last night the last “golden era” for Australia’s economy was the 1960s which ended in the chaos of Whitlam. This golden era could end as badly if we do not pursue continued economic reform⁶.

As Michael Chaney said yesterday, standing still is not an option. Nor is running up and down in the one spot.

The consequences of ageing will be somewhat more severe if life expectancy continues to improve (and who among us would object to that) or if fertility starts to decline again. However, there are no realistic increases in either fertility or immigration that will make much material difference.

The importance of increasing fertility to closer to the replacement rate of 2.1 is not to avoid the ageing crisis of which I am speaking. That is a function of the decline from a birth rate in the baby boomer years of 3.5 down to where it is today. But whether it had declined from 3.5 to 1.75 as it has or instead down to 2.1 we would still have a problem. The importance of maintaining a replacement level birthrate is so that we do not have a perpetual cycle of ageing which, as I have said elsewhere, is for many countries just a euphemism for dying.

On that point, I would observe that a stable population with a birthrate of 1.3 (which is higher than Italy, Spain, Greece, Japan, Korea, most of Eastern Europe) reduces by 75% over the course of a century. To put that in context, it means that if in a century Italy has the same population as it does today not much more than 20% of its population will be the descendants of today’s Italians.

⁴ These projections are taken from the Productivity Commission’s report on the Economic Effects of Ageing (November 2004)

⁵ *ibid*, and Gary Banks address to Sustaining Prosperity Conference 31 March 2005

⁶ Peter Costello speaking at at the Sustaining Prosperity Conference Dinner 31 March 2005

Without diminishing the scale of the challenges ahead of us, we must note that Australia is better positioned than any other developed country to deal with the consequences of ageing: we have little or no government debt, our retirement income system includes a growing element of personal savings and superannuation and our birth rate while below replacement level is much higher than that in most other developed countries (apart from the USA).

Our prosperity, our “national income” , is a function of three factors: Population, Participation and Productivity.

It is clear we cannot, between now and mid century, do a lot about population. Vital though a strong skills based immigration programme is, there is no practicable level of immigration which can materially offset the ageing phenomenon.

I emphasise here that promoting a higher birth rate should be a national priority. Fertility is a critical element in our forward planning. For that and other reasons we should promote marriage and discourage divorce. But the results of those pro-natalist, pro-marriage policies will be seen many decades in the future.

In the foreseeable future, our own lifetimes, we know that the growth of our working age population is going to slow; by mid century it will represent 54% of our population versus 63% today. But at least it is growing in absolute terms. Japan on the other hand will by mid century have seen its population reduce in absolute terms by 14% (17 million fewer Japanese) but its working age population by 38% (30 million fewer Japanese 15-64). However there will be nearly 15 million more Japanese over 65.

The only factors we can work on therefore in that timeframe are participation and productivity.

Our national goals, our compass markings as we chart our national journey through this century must include greater levels of participation in the workforce and higher levels of productivity.

Every aspect of Government policy, be it tax, welfare, corporate regulation, workplace relations should be tested at least by these questions:

- Is this policy making it easier and more attractive for people to go to work?
- Is this policy enabling Australian workers to be more productive?
- Is this policy promoting or assisting the formation of Australian families.

Any policy, any law, which does not receive a YES to all questions should require a very powerful countervailing argument to remain part of our national agenda.

Given the short time we have, I will discuss on this occasion only the first two objectives. I have spoken at length about the third elsewhere.⁷

Greater participation and greater productivity, are of course closely linked. If people are more productive they will be better paid, if they are better paid they will have a greater incentive to go out to work.

Another objective, which should always be present in the mind of Government, is to be frugal in the manner in which it spends public moneys. We all know, from our own life's experience in business, politics, even academia, that different people can in different ways achieve similar outcomes with significantly less (or indeed more) money.

As a Liberal, I believe a dollar is generally better situated in the citizens pocket than in the Treasurer's coffers. Governments spend other people's money, extracted from them by force of law. Governments have an obligation to spend no more of the public's money than they need to, and when they spend it to do so to ensure the biggest bang for the smallest buck. Governments also have an obligation to ensure that the growth in labor productivity in the economy at large is reflected in the public service.

However in addition to that common sense view of matters fiscal, there is another consideration. A consequence of ageing which we can at best ameliorate but not avoid is that the legitimate claims on Government for health care, pharmaceutical benefits, aged care and pensions and the like will increase and do so significantly. As the IGR projects, we could be looking at a Federal Budget deficit equal to 5% of GDP by mid century.

This adds to the urgency of promoting participation and productivity. But it also means that we must ensure that Government dollars, and particularly welfare dollars, are spent where they are really needed. To put it in a business context: we cannot allow our national cost base to expand willy nilly just because our revenues are strong, because the reality is that the inescapable claims on Government are going to grow and with labor force growth slowing one would be rash to project continued high growth in Government revenues over the decades to come.

For the balance of these remarks , I will limit myself to only two important issues directly connected to the attainment of both these goals. They are tax and welfare. This is not to diminish the importance of other important issues, such as workplace reform and the development of infrastructure (touched on briefly earlier) especially in terms of transport and water. In that regard I would commend the recent BCA Report by Port Jackson Partners as being particularly insightful.

In common with almost every other person or organization who has made a considered comment or critique of the Australian tax system, I have made the following observations.

⁷ See for example my address to the Australian Population Conference in 2003. A copy can be found in the Speeches section of my website www.malcolmturnbull.com.au

- many people on low incomes who are in receipt of welfare benefits will, as they start to earn more income, lose in net dollars a considerable part (often much more than half) of each dollar earned by reason of the combination of the tax system and the loss of means tested benefits. This is known as an Effective Marginal Tax Rate (“EMTR”). For reasons I will come to, that is a very misleading term.
- The highest marginal rate (effectively 48.5%) is high relative to comparable developed countries (especially the UK and the United States not to speak of Hong Kong and Singapore) and cuts in at a very low multiple of average weekly earnings (after July 1, about 1.4 x AWE)
- This high tax rate is imposed on a tax base which has been eroded over the years by special deductions and concessions and can, quite legitimately, be avoided by those able to earn income through corporate entities (taxed at 30%) and effectively split income between family members and corporations.
- While tax avoidance of the artificial or highly structured kind is, thanks to a concentrated effort by the Government, harder to effect successfully than ever before, there remains ample opportunity for businesses to defer and thereby reduce income.
- PAYE and other “unincorporated” taxpayers, however, have limited scope for tax avoidance, even of the most elementary kind, other than negative gearing where investments (more often residential real estate) is acquired with borrowed money and the excess of interest over rental income can be offset against other earned income.

In the light of this, I have observed, in common with many others (BCA, CPA Australia, ACCI, AIG etc) that our tax system would be a better one if rates were lower and the base broader. To that end a worthy objective is to aim, over time, to have a top marginal rate of tax equal to or at least not materially greater than the corporate rate of 30%.

Ever since the introduction of the GST and the New Tax System, subsequent changes to our tax system have been incremental. The system has become more complex and compliance more of a burden. So much is obvious.

There is an appetite in the community for a second round of substantial tax reform. As I’ve said before, I believe the direction of that reform should be towards lower rates and a broader base. I believe that it is important for all of us to engage in that discussion. There is no need to be defensive. Reform should be debated and modeled. It may be that in the final analysis the conclusion is that the only reforms practically available are incremental ones; but we will never know unless we have an open and lively debate and I congratulate the Melbourne Institute and the Australian newspaper in particular for contributing to that debate.

It is important to note here that while there is always scope for increased efficiencies in the delivery of Government services and therefore cost savings, given the demographic challenges we face, it would be rash to assume that overall the expenditures of the

Federal Government can be materially reduced. As a consequence, tax reform proposals need to be at least revenue neutral.

There are numerous models proposed; most of them revolve around a lower rate approximate to the company tax rate⁸ and the removal of many deductions and allowances so as to broaden the tax base. But every tax deduction once created develops a constituency which will fight to defend it. As a consequence, in my view, the only way in which a major simplification of the tax system can be practically effected is if there is a very significant reduction in the top marginal rate.

I am not sure whether it is necessary to waste many words in justifying taxation reform. I would simply observe that apart from the obvious principle that citizens' wealth is better off in their pockets than that of the government, there is little doubt that our productivity would be enhanced if our tax regime were more competitive and if enterprise therefore were better rewarded. That after all was in large measure the rationale for the New Tax System in 2000.

We may be doing well with our natural resource sector today, but the real wealth of Australia is not under the ground, but consists of the intellect and energy of Australians. We live in a borderless world. We cannot have a tax system which serves to encourage our brightest to seek to make their wealth somewhere else.

Yesterday Ross Garnaut proposed, in effect, a flat tax of 30%. It appeared to constitute a traditional flat tax design with a twist: a low universal tax coupled with the removal of concessional deductions and instead of a generous tax free "personal allowance" to ensure that low income earners are not prejudiced., Dr Garnaut proposed a substantial cash payment to all those in the work force ("negative income tax") which would be around the level of the unemployment benefit.

Attractive though they appear, I remain very skeptical about flat taxes. In particular, I could not see how Dr Garnaut's proposal could possibly be funded. The combination of the negative income tax element AND reducing rates to 30% will constitute an enormous drain on Commonwealth revenue.

Having said that, flat taxes are no longer solely the province of academics and Steve Forbes. Some of the new members of the EU have introduced flat taxes. In the last ten years Estonia, Latvia, Lithuania, Russia, Serbia, the Ukraine and Slovakia have all introduced flat taxes. Poland will shortly follow suit. The average rate is around 20%.

Their experience will be observed with great interest. Perhaps the skeptics, like myself, will be confounded.

⁸ A number of commentators such as Peter McDonald and Rebecca Kippen have observed that you do not need a precise equivalence between the top personal marginal rate and the corporate rate. They have recently argued that a top personal rate of 35% would, in practical terms, remove the personal/corporate tax arbitrage which currently exists.

Another observation I would make is that the experience of substantial reductions in tax is that it generally results in increased collections as a consequence of greater compliance and increased economic activity, and hence we have seen that as the top tax rate is cut, the top tax payers account for more of the total income tax take. Reagan's tax cuts controversially slashed high marginal rates. Yet the bottom 50% of taxpayers' share of tax collection was 8.3% less in 1984 than it had been in 1981 before the cuts. Similarly the top 5% of taxpayers paid 35.3% of tax in 1981, but in 1984 paid 38.9%.⁹ A similar experience was had in the UK when Mrs Thatcher cut the top rate of tax from 83% to 40% where it remains today. In 1979 the top 10% of earners paid 35% of total revenues. In 1990, they were paying 42%.¹⁰

I said earlier that the term EMTR was a misleading one. When we speak of high Effective Marginal Tax Rates we create the impression that this phenomenon, which undoubtedly does act as a disincentive for people to go to work and get off welfare, is a function of the tax system.

The truth is that in almost all cases the contribution of the tax on additional income earned is by far the smaller part of the so-called EMTR the bulk of which is the result of the welfare benefit being withdrawn by reason of income rising above the means test.

For example, ACOSS recently identified an unemployed adult on New Start Allowance would face an EMTR of 75% as they start to earn income and lose their welfare payment. Given that tax is only 17% (and that over \$6000) it is obvious that the bulk of the EMTR is a function of the withdrawal of benefits.

This insight is important, because it underlines the difficulties confronting Government in dealing with this problem. It doesn't matter whether you call the benefit a transfer payment or a tax credit either. Any benefit which is means tested creates the same disincentives.

We will not eliminate high EMTRs simply by raising the tax free threshold to, say, \$13,000 as recommended by Peter Saunders in his excellent work for the CIS. The only way to completely eliminate high EMTRs would be to either remove the welfare payment completely or remove the means test. The other approach, of course, is to impose a more stringent work obligation so that the optionality (receive benefit vs work) is removed or at least heavily qualified. As Peter Costello said last night it is inappropriate in a country with a labor shortage, facing the consequences of demographic change to have people capable of work in the welfare system without those people having an obligation to seek work.

Neither approach is feasible (obviously) and so the avenues open to Government are essentially limited to reducing the taper rate at which a benefit is lost as income increases.

⁹ see Feldstein, "Tax Avoidance and the Deadweight Loss of the Income Tax" National Bureau of Economic Research Working Papers 5055 cited in "A Flat Tax for the UK – A Practical Reality" by Richard Teather. Adam Smith Institute 2004

¹⁰ Teather op cit.

Over the last four years, Family Tax Benefit A, for example, has seen its taper rate reduce from 50 cents (ie 50 cents of Benefit lost for every dollar over the means test limit) to 20 cents.

However the consequence of reducing the taper rate is to broaden the range of people who are in receipt of the benefit (a taper rate of 0 cents is equivalent to no means test obviously.)

Another measure which Governments can employ is to reduce “stacking” which is to structure benefits so that their means tests cut in at different levels, however even with different means test thresholds and lower taper rates, it is inevitable that those in receipt of multiple benefits will lose part of their benefits simultaneously.

There are real risks in reducing taper rates over and above the obvious additional cost to the Commonwealth. As Professor Dawkins recently observed, reduction in taper rates may lead some income support recipients, such as those on Newstart Allowance, to work part-time rather than full time, representing a loss to the productive capacity of the labour market.

The short point therefore is this: high EMTRs are an inevitable consequence of means tested welfare payments.

There is, therefore, no silver bullet. But apart from continuing to tweak the interaction between tax and benefits to insure the loss of benefits tapers smoothly, we need to examine seriously the state of social welfare in Australia today.

Let us consider a few facts about welfare:

- Australians have enjoyed enormous growth in their real incomes; more than 25% over the last ten years. They are now more than twice as high as they were in the 1960s.
- Australians are healthier now, than we have ever been. Perils of obesity to one side, we are living longer and healthier than our parents and grandparents.
- Yet the welfare state has never been larger:
 - o Forty years ago only 3% of working age adults relied mainly or wholly on welfare. Today 20% of the working age population are in receipt of income support. 70% of those welfare recipients have no obligation to seek work; almost of all that 70% are made up of recipients of the Disability Support Pension or the Single Parenting Payment.
 - o Some parts of our welfare system are clearly anomalous. Recipients of the Disability Support Pension have more than doubled in the last twenty years to equal 5.5% of the working age population 16-64.
 - o The welfare system operates to redistribute income from the top 40% of income earners to the bottom 40% with the 20% in the middle getting not much more in welfare and other benefits than they pay in tax. It is also redistributive from the young and childless to the over 65s. Families with

children on average are only modestly advantaged. Despite its significant redistributive effect, there is a great deal of churning in the system.

- The cost of managing the welfare system is enormous. The cost of administering the family tax benefits system alone runs into hundreds of millions of dollars.
- For example, NATSEM has found that while younger people without children generally paid more in tax than they received back in welfare, and older people generally received more in welfare than they paid in tax, for people in their middle years earning and raising a family, the activities of the tax and welfare agencies tended to cancel each other out.”¹¹ For example, the average couple with school age kids 5-14 received \$507 a week in benefits but paid \$393 in tax. A couple 55-64 with no kids received \$264 in benefits but paid \$223 in tax. On the other hand a couple under 35 with no kids paid \$426 in tax and received only \$107 in benefits. The upshot is that singles and young childless couples are subsidizing Australians over 65 to a considerable extent, and families with kids to a modest extent.

The circumstances of our times make continued economic reform a necessity. It is not an optional extra. It is vital to sustaining any prosperity, let alone the level we enjoy today as the Treasurer observed last night.

We have the opportunity, the chance, to ensure we are best positioned to deal with the challenges of demographic change. It is customary nowadays to say demography is destiny. So it is, but the consequences of that destiny, the way in which it affects our lives and those of our children and grandchildren will depend on the decisions we take today.

¹¹ Rachel Lloyd, Ann Harding and Neil Warren “Redistribution, the welfare state and lifetime transitions” paper to the Conference on Transitions and Risk, Melbourne 24 February 2005