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The arbitrary 23.9 per cent tax revenue to GDP figure

From a convenient assumption to a 'speed limit'

Briefing note

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Summary

The government has recently been putting the case that Commonwealth taxation as a share of GDP should be capped at 23.9 per cent. The present brief notes that the present 23.9 per cent cap was just a working assumption underlying Treasury projections in the 2015 *Intergenerational Report* and budget documentation that included discussions of long-term and medium-term projections. That working assumption has morphed into a ceiling or, in the Treasurer Scott Morrison's words, a 'speed limit'.

The present 23.9 per cent limit is just the latest of equally arbitrary ceilings to which governments have committed from time to time. As arbitrarily chosen targets they have also been at the mercy of data revisions and even definitions of what constitutes a Commonwealth tax.

When they are taken seriously arbitrary tax to GDP ratios can severely limit choices available to the electorate. The arbitrary cap cuts across questions such as the appropriate level of government services, their composition, their financing and how the distribution of income might be addressed. All of these are properly questions to be addressed in the political arena.

Introduction

The government is now using an arbitrary cap on the tax-to-GDP ratio as a tool in its approach to budget setting. It is an assumption Treasury makes in its modelling that the government has adopted as a target. We now outline the history of this target and then the history of tax targets generally. Following that we discuss the consequences of tax targets.

Treasury documents assumed a "tax-to-GDP ratio" cap/target of 23.9 per cent in medium-term and long-term projections. In years following the projected return to surplus in 2020–21 any excess in tax receipts beyond 23.9 per cent of GDP is assumed to be returned in "tax relief".[1] The 2017-18 budget papers say

> These projections incorporate tax receipts reaching the tax-to-GDP 'cap' of 23.9 per cent of GDP in 2022-23, as was projected at the 2016-17 MYEFO. Beyond 2022-23, tax receipts are assumed to remain constant as a share of GDP. A tax-to-GDP 'cap' assumption is adopted for technical purposes and does not represent a Government policy or target. It is based on the average tax-to-GDP

[1] Australian Government (2014) *Mid-Year Economic and Fiscal Outlook 2014–15,* p 31; Australian Government (2016) *Budget 2016-17*, paper 1, statement 3, p 3-19.

ratio over the period from the introduction of the GST and to just prior to the global financial crisis. It reflects that a strict no-policy change scenario would be unrealistic, as unconstrained revenue projections imply constantly increasing average tax rates on personal income.[2]

Treasury has decided it is not reasonable to use a "strict no-policy change" scenario because in the absence of a policy change average tax rates on personal income will constantly increase because of bracket creep.[3] Using a cap based on a historical average is an attempt to avoid the potentially absurd projection that bracket creep will continue indefinitely.

According to the budget documentation the 23.9 per cent figure is "an assumption … and does not represent a Government policy or target".[4] However, it is clearly being treated as a government target. For example, Phil Coorey wrote in April 2017 that "Finance Minister Mathias Cormann has hinted there could be tax increases in the May budget but says the government will adhere to its medium-term target of the overall tax take not exceeding 23.9 per cent of the economy".[5]

And in February 2018, "'An assumption of future tax cuts is already reflected in our revenue forecasts as we speak,' Finance Minister Mathias Cormann told ABC radio Friday, as he repeated a pledge to keep tax to 23.9 per cent of GDP."[6] By late April 2018 the Treasurer Scott Morrison said "We have imposed a speed limit on taxes in our budgets, that requires that taxes do not grow beyond 23.9 per cent of our economy".[7]

Where did it come from?

The setting of fiscal targets similar to the tax-to-GDP cap goes back to at least the Hawke/Keating 'Trilogy' of budget restraint, which pledged that Commonwealth revenue would not increase as a percentage of gross domestic product (GDP) with

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[2] Australian Government (2017) *Budget 2017-18*, paper 1, statement 3, section 3-16.

[3] Strictly speaking bracket creep refers to the issue whereby as incomes increase with inflation more of that income is shifted into higher tax brackets with the effect of increasing the proportion of income paid in tax even in the absence of increases in real income. A separate issue is the fact that increases in real incomes over time can drag more of the income into higher tax brackets.

[4] See e.g. Australian Government (2014) *Mid-Year Economic and Fiscal Outlook 2014–15,* p 266-267

[5] Coorey P (2017) 'Budget could contain tax increases, says Mathias Cormann' *Australian Financial Review*, 2 April.

[6] Farr M (2018) 'There's some very good reasons why Malcolm Turnbull is smiling', *News.com.au*, 3 February.

[7] Martin P (2018) 'Tax cuts for low and middle earners as budget takings soar, says Scott Morrison', *Sydney Morning Herald*, 26 April.

similar commitments for spending and the deficit.[8] At that time the latest figures available were for 1984-85 when the budget balance was minus 2.6 per cent of GDP and the tax-to-GDP ratio was 22.5 per cent while total revenue to GDP was 25.0 per cent.[9] In an effort to appear fiscally 'responsible' the Trilogy commitment used whatever the then current figures happened to be and as such were entirely arbitrary.

During the Howard Government revenue caps or assumed ceilings were introduced through the intergenerational reports. The first introduced as a paper within the 2002-03 budget papers assumed a ceiling of 22.4 per cent as the ratio of total revenues to GDP with "taxation revenue … assumed to remain constant at 20.8 per cent of GDP from 2005-06, the final year of the forward estimates period, to 2041-42'.[10]

This seems a puzzle when we look back today and we note taxation receipts were well above 20.8 per cent at 24.0 per cent of GDP in the 2002-03 year. The answer is that after the introduction of the GST the Howard Government used that as the occasion to declare the GST was not a Commonwealth tax and so it was excluded from these sorts of calculations. That error was corrected by the subsequent government. But to get a feel for the size of the difference a 23.9 per cent target as presently defined would be smaller by 3.4 per cent of GDP if the GST receipts were excluded.[11] But it is worth noting that caps or ceilings obviously depend on how the government chooses to define taxes and other items; in this case whether the GST should be treated as part of the Commonwealth Budget.

With the election of the Rudd Government, the 2008-09 budget included as part of its medium-term fiscal strategy the goal of "keeping taxation as a share of GDP on average below the level for 2007-08" which was reported as 24.7 per cent of GDP at the time. The 2007-08 budget was the last budget under the Howard Government. Subsequent revisions reduced the tax-to-GDP figure to 23.7 per cent of GDP which then became the target. Hence as an example, on the occasion of the 2012 budget Treasurer Wayne Swan was able to say: "In the coming year tax as a proportion of the economy is just 22.1 per cent, compared to the 23.7 per cent we inherited from our predecessors – that's $24 billion less tax".

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[8] National Archives of Australia (n.d.) *The economy, Budget and wages policy.*

[9] Historic data from Australian Government (2017) 'Budget Paper No 1: Budget Strategy and Outlook', *Budget 2017–18.* Note that the figure in the text is likely to have been revised from the figures available to the government at the time.

[10] Australian Government (2002)*, '*Intergenerational Report', *2002–03 Budget Paper no 5,* p 55.

[11] Authors' calculations based on Australian Government (2002) 'Intergenerational Report', *2002–03 Budget Paper no 5* and ABS (2017) *Australian System of National Accounts,* cat no 5204.0

The setting of a constant tax-to-GDP ratio has long been the practice in the intergenerational reports (IGRs) published every five years. The latest, the 2015 IGR, says:

> This report assumes, in the long-run, a constant tax-to-GDP ratio of 23.9 per cent. This rate is based on the average tax-to-GDP ratio of the years following the introduction of the GST and prior to the global financial crisis (2000-01 to 2007-08 inclusive).[12]

When did the 23.9 per cent rule start?

The cap at 23.9 was articulated in the 2014–15 MYEFO, although it appears to have been part of the assumptions that went into the 2014–15 budget.[13] 23.9 per cent is the average of tax receipts to GDP between the introduction of the GST and the Global Financial Crisis (i.e. between 2000-01 and 2007-08).[14]

Consequences

A higher cap or no cap means higher projected revenue and so higher projected surplus in future years. For example, Treasury calculations for the 2016–17 Budget projected a surplus of 0.8 per cent of GDP in 2026–27 with a “cap” of 24.4 per cent instead of surplus of 0.2 per cent of GDP in 2026–27 with the standard 23.9 per cent “cap”. A lower level means deficit, e.g. a “cap” of 23.4 per cent would have resulted in a deficit of 0.5 per cent of GDP in 2026–27.[15] Of course a higher tax-to-GDP ratio would also permit higher spending within a balanced budget.[16]

In the lead up to the 2016 election, for the first time, the Pre-election Economic and Fiscal Outlook report (PEFO) contained a political statement by the secretaries of

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[12] Australian Treasury (2015) *2015 Intergenerational Report: Australia in 2055,* p 113

[13] See e.g. Australian Government (2014) *Mid-Year Economic and Fiscal Outlook 2014–15,* p 6, 31-36, http://www.budget.gov.au/2014-15/content/myefo/download/MYEFO_2014-15.pdf

[14] Australian Government (2016) *Budget 2016-17*, paper 1, statement 3, 3-19, http://www.budget.gov.au/2016-17/content/bp1/download/bp1.pdf; can also be calculated from MYEFO 2014-15 figures.

[15] Australian Government (2016) ‘Statement 3: Fiscal and Economic Strategy’, *Budget 2016-17, Budget Paper No 1*, p 3-20.

[16] Even under the cap, personal tax receipts may still increase as a percentage of GDP because (proposed) company tax cuts will cause a decline in company tax receipts. See Hutchens G (2017) ‘Coalition shifting tax burden from businesses to individuals, budget office reveals’, *The Guardian (Australia edition)*, 5 July

Treasury and Finance.[17] For example, the Secretaries tell us what has to be done 'to achieve a surplus of one per cent of GDP'.[18] The reader is immediately struck; where does this goal come from and why is it that the independent umpires should give us a goal for fiscal policy? Surely it is the job of elected politicians to interpret the wishes of the people and from that to distil the implications for the fiscal stance.

There is no objective reason why a government should aim for a one per cent surplus. One per cent is an arbitrary number for a start; why not zero or two per cent of GDP? More importantly the aim of achieving a surplus is a form of austerity program that has been spectacularly harmful wherever it has been tried.[19] Moreover there have been occasions where the budget papers themselves have set out the arguments for a fiscal stimulus and arguably at all times the objective of fiscal policy should be whatever is appropriate for the state of the economy. One of the best defences of deficit spending was presented in the 2001-02 Howard/Costello budget. At the time the weakness in the economy warranted a stimulus through government spending. As the budget papers put it:

> The Government has provided a moderate stimulus in the 2001-02 Budget through targeted tax reductions, discretionary spending and by allowing the Budget to respond to the temporary slowdown in economic growth (through the operation of the `automatic stabilisers' which reduce tax revenues and increase expenditure). This is an appropriate policy response to recent economic developments.[20]

As might be expected, the 2009 budget also presents a good argument for fiscal activism being the occasion of the global financial crisis. PEFO has instead told us that we have this goal of a one per cent of GDP surplus without any justification. The PEFO makes long run projections to 2026-27 that fail to make a surplus of one per cent of GDP because the secretaries assume:

[17] The charter of budget honesty provides for the Secretary to the Treasury and the Secretary of the Department of Finance (the Secretaries) to release publicly a Pre-election Economic and Fiscal Outlook report (PEFO) within 10 days of the issue of the writs for a general election.

[18] Australian Government (2016) *Pre-election Economic and Fiscal Outlook 2016: A report by The Secretary to the Treasury and The Secretary of the Department of Finance*, May.

[19] Stiglitz J (2014) 'Austerity has been an utter disaster for the eurozone', *The Guardian*, 2 October.

[20] Australian Government (2001) 'Statement 1: Fiscal strategy and budget priorities', *2001-02 Budget Paper No 1,* May, p 1-10. The 'automatic stabilisers' refer to the natural tendency for the deficit to increase as a consequence of an economic downturn as a result of two factors:

- First is the tendency for tax collections to fall as there is less taxable income earned in the economy during a downturn.
- Second is the tendency for government spending to increase in a downturn as more people claim government benefits, especially unemployment benefits.

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> that tax receipts as a proportion of GDP do not rise above 23.9 per cent over the medium term. This is the average after the introduction of the GST and before the Global Financial Crisis.[21]

This again is a completely arbitrary constraint as emphasised in this paper. More troubling though is the combination of a surplus objective and a tax ceiling means that there is only one degree of freedom that the secretaries allow a government of either side. Spending is to be sacrificed. That is the fiscal straightjacket the secretaries would impose on Australia. As society's living standard improves over time it is natural that people want to see improvements in infrastructure, health, education, aged care, the environment and the other things that only the government can provide. There are a host of things like this that people want to see expanded rather than private spending on the many other relatively less important goods and services provided by the private sector. Yet these are precisely the sorts of choices that should be part of the political arena – part of our democracy. It has never been the PEFO's role to try to restrict or channel political decisions into the overall targets which make it impossible to achieve democratically chosen goals that involve public provision of goods and services. And they pretend this is an objective exercise.

There was an implied threat that the PEFO's objectives (higher surplus and limits on tax) will not be met if there is a failure to implement the draconian Abbott/Hockey measures which fortunately never passed the Senate. Hence PEFO suggested measures that would hit the poor and the middle income groups particularly hard.

When the PEFO says 'it is prudent for Australia to run a relatively conservative fiscal stance', we have to assume that is what it has in mind. Equally we could imagine the message from the secretaries said something to the effect that fiscal policy in Australia should be framed around the shared objectives of giving everyone a fair go, of addressing inequality as well as social and economic disadvantage; of achieving world class health, education disability support systems, not to mention innovation, environmental goals, infrastructure and the other things Australians care about.

In prosecuting the 23.9 'speed limit' Scott Morrison talked about 'get[ting] spending under control' and used Margaret Thatcher's famous words when he said 'What I'm seeking to do today is point out that *there is no alternative* (emphasis added)' .[22] The Australia Institute's chief economist talks about the 'right-wing ratchet' as the tendency to give tax cuts to companies and the well-off during upsurges in revenue

[21] PEFO *op cit,* p. 21.

[22] Morrison S (2016) *Staying the course – strengthening our resilience in uncertain economic times: Q&A*, Bloomberg address, Sydney 25 August.

but cutting cash and in-kind assistance to the poor in the bottom of the business cycle when revenues tend to fall.[23]

Conclusion

In 1945 the famous Australian economist Colin Clark wrote an influential article in which he claimed:

> 25% of the national income is about the limit for taxation in any non-totalitarian community in times of peace.[24]

Anything above this he expected would result in ruinous inflation and other social evils that would not be tolerated in a democratic society. Such predictions look quaint when total government revenue, from all levels of government in Australia, is running at around 28.0 per cent of GDP[25] and is much higher in other economies.

Our own discussion of the history of the caps/targets/speed limits shows how arbitrary they are, being subject to redefinitions, revisions to data and so on. There is certainly no science in picking the opposition's last figure or the average between two arbitrary times in history, or indeed Colin Clark's famous 25 per cent limit.

[23] Denniss R (2018) 'Evidence', Senate Economics Reference Committee, Transcript of evidence, 24 April 2018.

[24] Clark (1945) 'Public finance and changes in the value of money', *Economic Journal,* Vol 55, p 380. Colin Clark worked at the University of Melbourne from 1937 and was the first to use gross national product and to present estimates of the main components of aggregate demand.

[25] Authors' calculations based on ABS (2018) *Taxation revenue, Australia, 2016– 17,* cat no 5506.0 and ABS (2017) *Australian System of National Accounts,* cat no 5204.0