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TITLE: Those income tax cuts don't look so good now

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Federal government budgets are always strange affairs. They are billed as fact-based, hardnosed economics, when in fact they are far more about political theatre and posturing.

While the budget is supposed to reveal the economic credentials of a government, most economists are left shaking their heads.

Take the debate around the surplus. Both the Government and the Opposition seem to believe that a surplus as soon as possible is incredibly important. Yet most economists (*academic* economists, not those who are paid to hold strong views) would have no problem with the budget being in deficit given the current economic conditions. Put simply, there is no economic case for a budget surplus.

The political attacks over the deficit and claims about budget responsibility are also very strange. While the Government has a fair amount of control over the final budget position, its power in this area is by no means absolute.

The economy impacts the budget much more than the budget impacts the economy. When the economy is booming, incomes, profits and spending all increase and this leads to higher revenues for the government. The opposite occurs when the economy is in a downturn. The booms and busts of the business cycle have been regularly occurring since the beginning of the industrial revolution, and governments have only been able to *lessen* their impact.

A good example of this is the mining boom, which has been driven mainly by economic growth in China. Obviously the Australian government has little to no influence over the Chinese economy, and yet the growth in the Chinese economy has had a big influence on the budget.

The other factor that lessens government control over the budget is previous budget decisions. The Labor Party is finding this out the hard way as it struggles to bring the budget back into surplus. Large income tax cuts made from 2005-06 to 2008-09 have created a structural hole in the budget that the government is having a lot of trouble overcoming.

The income tax cuts from 2005-06 cost this year's budget about \$40 billion. If those tax cuts had not occurred, this week's budget would have been a surplus, not a \$19.4 billion deficit. The slowdown in the economy has shown these income tax cuts to be unsustainable.

In the years leading up to the GFC, the government's budget swelled, driven by company tax revenues which increased more than 50 per cent between 2004-05 and 2007-08. Strong economic growth underpinned the budget surpluses and the increase in revenues was used to fund income tax cuts. This made the budget unsustainable since the growth in revenue had been created by the temporary boom and it was used to make permanent tax cuts. The tax cuts stripped away a quarter of the income tax collected in 2012-13.

Governments can cut taxes sustainably if they increase taxes in other areas or reduce spending. The income tax cuts in the lead-up to the GFC did neither; rather, they were funded by a temporary windfall gain from a booming economy. From then on it was just a matter of time before the economy returned to more normal economic conditions and the structural hole was revealed. With such a large amount of income tax taken out, the government is now struggling to bring the budget back to surplus.

Consider how different the debate around the NDIS and Gonski would be if the Government had generated an additional \$40 billion in revenue. Instead of a slow lead-in for both, it's possible that those living with a disability and those caring for them could have been helped far sooner. It's possible that kids going to disadvantaged schools could have been helped sooner.

Budget time has become a great big show in which the government and opposition play their parts. But these parts, like a good Hollywood action movie, bear only a passing resemblance to reality.

A better understanding of the structure of the budget would solve a number of its problems and reveal many others to be the creation of politicians' imaginations.

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