



COMMONWEALTH OF AUSTRALIA

Proof Committee Hansard

SENATE

ECONOMICS LEGISLATION COMMITTEE

Reference: Tax Laws Amendment (Temporary Flood and Cyclone Reconstruction Levy) Bill 2011

FRIDAY, 11 MARCH 2011

CANBERRA

CONDITIONS OF DISTRIBUTION

This is an uncorrected proof of evidence taken before the committee. It is made available under the condition that it is recognised as such.

BY AUTHORITY OF THE SENATE

[PROOF COPY]

THIS TRANSCRIPT HAS BEEN PREPARED BY AN EXTERNAL PROVIDER
TO EXPEDITE DELIVERY, THIS TRANSCRIPT HAS NOT BEEN SUBEDITED

Committee met at 8.29 am**ESLAKE, Mr Saul, Private capacity**

Evidence was taken via teleconference—

CHAIR (Senator Hurley)—Good morning, Mr Eslake. Thank you for rearranging your time for us. It makes it much easier for us to hear all the witnesses in a row.

Mr Eslake—I understand that.

CHAIR—I declare open this first hearing of the Senate Economics Legislation Committee's inquiry into the temporary flood and cyclone reconstruction levy bills. The bills were referred to this committee for inquiry on 3 March 2011. The committee is due to report on 21 March 2011.

These are public proceedings, although the committee may agree to a request to have evidence heard in camera or may determine that certain evidence should be heard in camera. I remind all witnesses that in giving evidence to the committee they are protected by parliamentary privilege. It is unlawful for anyone to threaten or disadvantage a witness on account of evidence given to a committee and such action may be treated by the Senate as a contempt. It is also a contempt to give false or misleading evidence to a committee. If a witness objects to answering a question, the witness should state the ground upon which the objection is taken and the committee will determine whether it will insist on an answer, having regard to the ground which is claimed. If the committee determines to insist on an answer, a witness may request that the answer be given in camera. Such a request may of course also be made at any other time.

I remind members of the committee that the Senate has resolved that departmental officers shall not be asked to give opinions on matters of policy and shall be given reasonable opportunity to refer questions to superior officers or to a minister. This resolution prohibits only asking for opinions on matters of policy and does not preclude questions asking for explanations of policies or factual questions about when and how policies were adopted.

I welcome Mr Saul Eslake to today's hearing. Would you like to make a brief opening statement?

Mr Eslake—Thank you, Madam Chair, for the opportunity to appear before this committee. Consistent with your opening instructions I should say that, although I am employed part-time by the Grattan Institute, I am appearing here today in a personal capacity and my opinions and views will not necessarily coincide with or represent those of the board of the Grattan Institute or other members of its staff. In discussion with the committee staff yesterday they suggested that, because the time for each of your witnesses appearance is limited, because I did appear before the corresponding committee of the House on the same subject about a month ago and because the *Hansard* recording of my statement there has been circulated to members of the committee, it might be in everyone's interests if I sought permission to have that statement incorporated into the record of this committee's deliberations and offer myself to committee members to ask questions on that statement or any other matters that they think I might be able to help them with.

CHAIR—Thank you, Mr Eslake. I will ask the committee members to accept that tabling, which is agreed. We have present Senator Nick Xenophon, Senator Alan Eggleston and me. We have a copy of your statement to the House of Representatives committee. You have no particular problem with levies. Your statement really canvasses a range of options that Australia could have taken.

Mr Eslake—That is right. As I said to the House of Representatives Economics Committee, I do not start from a position that temporary or permanent levies on income tax are, *prima facie*, wrong. They are a legitimate policy instrument. I mentioned there and I do again that I have some sympathy with proposals that have been made elsewhere for a Medicare style levy to fund a national disability insurance scheme, for example. In the context of the matter that you have before you here today I said, and I still believe, that the income tax levy proposed by the government was one of three options that could have been considered, with neither of the other two being in any way economically irresponsible, either more so or less so, than the particular proposal which the government has put before you for consideration today. The other two options, just very briefly, were to have funded the entire cost of the Commonwealth's contribution to the Queensland flood recovery and reconstruction efforts through additional borrowing, and the second option was to cover all of it by reductions in expenditure rather than one-third of the cost by the temporary increase in taxation flood levy that is being contemplated here.

The first option would not have been in any way economically irresponsible, because the amounts of additional borrowing that would have been entailed, if the government had chosen to go down that particular

path, were so small relative to the economy as a whole, particularly when you consider that the amounts of borrowing would be spread over three financial years rather than concentrated in one, that they would represent a smaller amount than the amounts by which typically forecasts of the budget bottom line are in error from year to year—and certainly not enough to have any material impact on inflation or interest rates.

The second option the government could have considered—that is, reducing expenditure by the full amount of the additional requirements of the Queensland reconstruction and recovery expenditures that the Commonwealth is meant to meet under the national disaster scheme arrangements, was based on the observation that there are plenty of things the government could have done by way of reducing expenditures that would have more than covered that task.

The third option, which is the one that the government has pursued, is to fund a third of the costs by a temporary levy on about 40 per cent of income tax payers. I noted in speaking to the House of Representatives Standing Committee on Economics that that was an option that would appeal to many Australians' sense of fairness, particularly given the way in which the levy has been constructed to avoid impacting on people earning less than \$50,000 per annum and thus, in particular, avoiding high effective marginal tax rates that are often encountered by people on lower incomes who are contemplating re-entering the workforce after a period of caring for family members or in other ways coming off various forms of social security payments that have an income test or means test associated with them.

The key point I was seeking to make to the House of Representatives committee, and I would make to you here today, is that the choices which the government has made are political choices which a government is perfectly entitled to make but that, contrary to some of the things that the Prime Minister and other spokespeople for the government have said from time to time, I do not believe that the choice of funding one-third of the government's contribution to Queensland's reconstruction effort through an income tax levy was something that had to be done in the name of good economic management. Either of the other two choices which the government could have made would have been, in my view, no less economically responsible, no less fiscally responsible than the one which the government has elected to make for what I regard as political reasons.

CHAIR—Thank you, Mr Eslake. Could I take a step back from that for a moment and look at the actual funding of the Queensland reconstruction. People talk about the Queensland and Victorian reconstruction, and of course that state needs to benefit enormously to repair the damage caused by natural disasters, but Queensland is a significant part of the Australian economy and it is in the interests of all Australians, is it not, that Queensland gets back on its feet as quickly as possible and restores its economic vigour?

Mr Eslake—Yes, I think that is absolutely right. Queensland is the third-largest state in the Commonwealth. It has the third largest economy, it is a significant generator of export income, and it is also—particularly the city of Brisbane—an important services sector hub. So it is certainly in Queensland's interests and in the nation's interests that the Queensland economy and the infrastructure which supports it be repaired and restored as soon as possible.

CHAIR—Thank you.

Senator EGGLESTON—Mr Eslake, thank you very much for being with us today. We know you have appeared before a House of Representatives committee on this same subject. They are discovering committees down there in the House of Representatives and realising that they produce a lot of information of great value.

You made the point that there were alternatives to imposing a levy. One of my basic questions is—and, of course, you may not be able to answer this—how was this figure of \$1.8 billion struck? If we are not sure that that is going to be enough to deal with the problems, is it reasonable to impose a levy to raise that much money to cover it when, as you suggest, there could have been alternatives, such as cuts in expenditure or borrowing? In an economic sense, which would you feel was a better way to approach this?

Mr Eslake—As I said before, the choice which the government made was essentially a political choice. There is no principle that I am aware of of economics, no yardstick of good economic management, that says that, when confronted with the situation the government was confronted with here, some proportion should be financed by borrowing, some proportion should be financed by reductions in other expenditures and some proportion should be financed by taxation.

Different choices will have different effects on the distribution of income, on different parts of the economy and on some measures of economic performance but, in this particular case, whichever method is chosen the overall consequences are small for the economy as a whole, bearing in mind we are talking about in the case

of the flood levy revenue of \$1.8 billion in an economy which every year is running at about \$1.4 trillion or \$1.5 trillion, so it is a fraction of a percentage point that we are talking about. As I say, the choice the government has made was essentially a political one.

It would not in my view be possible to say that, had the government chosen to fund some or all of the costs it has to meet by borrowing, that would have been an economically irresponsible choice. It would not even have threatened the government's objective of returning the budget to surplus by 2012-13 because nearly all of the additional borrowings would have occurred in the current financial year and in the 2011-12 financial year, years in which the government is proposing to run budget deficits well in excess of \$10 billion.

As to the flood levy itself, most of the \$1.8 billion that that is designed to collect will be collected in the 2011-12 financial year, a year in which the government is proposing on its latest forecasts to run a deficit of \$12¼ billion. Only about \$200 million of the levy's proposed revenue will be collected in 2012-13; therefore, if the government had decided not to impose a levy at all but to fund that proportion of its expenditures by increased borrowings, borrowing would have been \$200 million higher in 2012-13 in respect of the amount not collected by the levy plus an additional \$100 million of interest on the amount which it would then have to have borrowed in 2011-12, so \$300 million in total out of a forecast budget surplus of about \$3¼ billion. It, therefore, would not have had any impact on the government's timetable for returning the budget to surplus, something which probably it is entitled to say is a yardstick the financial markets use for assessing the credibility of its overall economic strategy.

My point is that that would not have been undermined had they chosen to fund some or all of their expenditures by borrowing. Certainly, they could have chosen to fund all of them by reductions in government expenditure, something for which I believe there would have been ample scope, not least because senior members of the present government had when they were in opposition repeatedly, and in my view correctly, castigated the then government for what they described as wasteful and extravagant spending—criticism with which I agreed at the time—and very little of that 'wasteful and extravagant spending' has since been unwound, so there is in my view ample scope for doing that. But let me emphasise that to have done that would also have been a political choice and the government, as it is entitled to do, made a different political choice.

Senator EGGLESTON—I understand what you are saying, and I agree it is a matter of assessment, judgment and a political choice. One of the central issues which concern me is that I fail to be assured that the total cost of the repairs or restoration needed in Queensland has yet been determined. So it may be that, if this estimate of \$1.8 billion is below what is actually required, this government is going to have to go to one of your alternatives of either cutting expenditure or borrowing more to meet the costs.

Mr Eslake—I think that is a perfectly legitimate question. It is one that I am not in a position to answer, but let me make two observations. First of all, it may well be the case that the cost of making good the damage done by the Queensland floods will exceed the \$5.6 billion for which the Commonwealth is, on present estimates, likely to be responsible. Indeed, given that that figure was based on an assessment of the damage caused by the floods, and since that estimate was made we have had Cyclone Yasi, which has created an additional requirement for expenditures, and there has also been continued flood damage in northern Victoria for which the Commonwealth will be responsible for making a financial contribution, it is likely that the Commonwealth's overall expenditure will be greater than the \$5.6 billion that was first mentioned by the Prime Minister when she announced the flood levy. As I recall, the Prime Minister said at the time that, if the costs turned out to be greater than the \$5.6 billion figure, those additional costs would be funded by additional reductions in expenditure rather than by increasing the rate of the levy or extending the time for which it was payable. Again, to me that emphasises that the choices which the government has made are political choices rather than things that it had to do in order to satisfy the requirements, such as they are, of good economic management.

Senator XENOPHON—You said both in evidence to the House of Representatives committee and this morning that this is a political judgment that elected governments are perfectly entitled to make. In relation to Australia's fiscal reputation if the government reviews its policy of returning to surplus by 2012-13, would there be any impact either way, whether we have this levy or not?

Mr Eslake—First of all, the point I would make is that the prospect of returning to surplus by 2012-13 or otherwise is not affected by any of the decisions that the government has made in this particular context. That is to say, suppose the government had decided to fund all of the \$5.6 billion figure, or whatever it ultimately turns out to be, through additional borrowing. As I said earlier, since nearly all of that borrowing would be

done in 2010-11, the present fiscal year, or 2011-12—years in which the government is proposing to run budget deficits in excess of \$10 billion—it would run deficits of, say, \$13 billion to \$14 billion but would still expect to return to surplus by 2012-13. So, to the extent that returning the budget to surplus by 2012-13 is a yardstick for the government's economic and fiscal credentials, they would not be in any way imperilled by a decision to fund all of the expenditures associated with damage caused by the Queensland floods through additional borrowing, let alone a decision to fund two-thirds of it by expenditure cuts and one-third by borrowing—that is, simply not to proceed with the flood levy.

Suppose for the sake of argument that funding all of the Commonwealth's expenditure through additional borrowing had put at risk the prospect of returning the budget to surplus by 2012-13—and let me emphasise that is purely hypothetical. Personally I do not think the government's credentials would have been seriously affected, particularly insofar as the government's credentials depend on comparisons between Australia's fiscal performance and that of other Western economies. As I think senators will be well aware, large in dollar terms though the deficit that is currently being run by the Australian government appears to be by our own historical standards, as a proportion of GDP, and having regard to the level of net debt which the Commonwealth has at the moment and where it is expected to peak, at just over six per cent of GDP in a couple of years time, these are incredibly strong figures by international standards. Governments of most other advanced economies are still grappling with budget deficits of between five and 10 per cent of GDP, in one or two cases higher than that, and with levels of public debt anywhere between about 70 per cent of GDP and, in Japan's case—the outlier—about 200 per cent of GDP. So even in the entirely hypothetical counterfactual situation—

Senator XENOPHON—Let's not go there.

Mr Eslake—that the government was not able to return to surplus by 2012-13, in an international context it would still be rightly regarded as having a very strong set of public finances.

Senator XENOPHON—I want to get your views on Professor Makin's assertion that higher marginal tax rates limit productivity growth by adversely affecting work incentives and risk taking in skills acquisition and cause resources to be wasted in pursuit of tax minimisation. Do you see those comments as relevant in the context of this particular debate?

Mr Eslake—There is certainly a strand of the economics literature that supports all of those assertions on the part of Professor Makin. There is another strand in the economics literature which suggests that higher tax rates may stimulate additional work in order to achieve the same level of after-tax income, and there is no empirical evidence to suggest that countries with relatively high income tax rates, such as the Nordic countries, perform any worse than countries with relatively low tax rates, such as the United States or Australia. As I am sure you are aware, the Nordic countries, despite having very high marginal income tax rates, often cutting in at relatively modest incomes, are nonetheless high-income countries by Western standards and ones which have fared pretty well through the global financial crisis as well—Iceland aside—without having had serious banking crises of their own.

In the Australian context, I think there is a lot of evidence that a lot of resources are wasted attempting to evade or avoid income tax or exploit various concessions and loopholes in the income tax system for purposes for which they were not intended. It is certainly my view that those concerned with tax reform ought to be looking at eliminating many of those loopholes and avenues for avoidance and redressing the ways in which the tax system distorts incentives and behaviour in ways that are harmful to the economy. The point is that one cannot necessarily generalise across all countries as to the impact that particular rates of taxation or forms of taxation instruments are going to have.

One other observation I would make is that, while as I said at the beginning I do not have any in principle objection to the imposition of income tax levies for worthwhile purposes, I would be troubled and I suspect over time there might be adverse economic consequences if people came to believe that every time something unfortunate happened that required additional expenditure by the Commonwealth government those earning more than some arbitrarily chosen amount such as \$50,000 per annum would be expected to pay for it. I think that probably would have an adverse impact on a variety of things that matter to Australia's economic performance.

Senator XENOPHON—So you can get away with it once or twice but you would not want to make a habit of it.

Mr Eslake—Indeed. As I say, if it came to be the accepted norm that whenever some unfortunate event befell part of the country those earning more than, say, \$50,000 would be expected to stump up for it, I think that would be regrettable.

Senator XENOPHON—My final question goes to the issues of behavioural economics, if that is what it is. Do you think that the introduction of a levy to fund infrastructure spending in this disaster situation may change public perceptions about donating to charities to assist families, such as the Queensland Premier's relief fund? If so, how do you countervail that? Is that done through a publicity campaign? Is that done through governments making it clear that this fund is for infrastructure, not for families as such?

Mr Eslake—The government is not actually setting up a fund in this particular case; it is levying taxpayers to pay for infrastructure that has been identified, presumably by the Queensland government, as needing to be repaired or made good. I hope that the imposition of a levy in these circumstances does not make people less willing to donate to funds that are intended to provide relief to individuals and businesses in distress—relief that probably would not be provided by governments in the ordinary course of events. But, to go back to my earlier point, where I said that it would be regrettable if it came to be believed that whenever an unfortunate event occurred people earning \$50,000 per annum or more would be slugged in the form of a temporary increase in taxation, then it may well be that people became less willing to give to causes like that. That I think is one of the regrettable consequences—that an entrenched perception that higher income taxpayers were always going to be slugged in these situations would flow from that.

Senator XENOPHON—Thank you, Mr Eslake.

CHAIR—Just to follow up, there is the question too of the government cutting back expenditure to redirect a bit of effort into Queensland in terms of, I think, labour and so on. If there were further cuts in programs, do you think that might impact—that there might be too much redirection of effort around the country?

Mr Eslake—It would depend on the magnitudes involved. Just as I said before, one of the reasons why I think that there would have been no adverse implications for the government's economic credentials if it had chosen other courses than the one which it actually has was that the numbers involved are relatively small compared with the economy as a whole. Similarly, if the government had made different choices—for example, to cut expenditure by more than it is proposing to in other areas—that too would have had a very small impact on the economy as a whole. I guess the point I was seeking to make earlier, when I referred to criticisms by senior members of the present government when they were in opposition of wasteful and extravagant spending by the former government, was that there are plenty of areas of expenditure which could have been reduced without any adverse consequences for the economy, and I would argue without any adverse consequences for the kind of people that you would expect governments to be concerned about, in order to make room for additional expenditure on flood relief and reconstruction and rebuilding in Queensland.

The best example I can give of that is the first home owners grant, particularly for purchases of established dwellings. I did say earlier, in speaking to the House of Representatives Economics Committee, that the one expenditure decision taken in the context of the Queensland rebuilding that I thought was very poor policy was the decision to scale back yet again the National Rental Affordability Scheme to save I think \$200 million or \$300 million. I note that the government has since reversed that decision, and I commend them for being willing to do that. But, as I said to the House of Representatives Economics Committee, if the government wanted to make savings in the housing area then a prime candidate would be the first home owner grant for purchases of established dwellings—first of all because that was introduced ostensibly as compensation for the introduction of a GST in 2000, even though a GST never applies to purchases of established dwellings; secondly, because the grant for purchases of established dwellings does absolutely nothing to increase the supply of housing, which in my view is something that ought to be a policy objective of government given the chronic shortage of housing that exists in this country, particularly low-cost, affordable housing; and, thirdly, because the sole effect of the grant for purchases of established dwellings is to push up the price of housing, thereby making it less affordable for those that policy makers presume to be concerned for—that is, people attempting to get into their first home and onto the ladder of home ownership. So there, for example, was a situation where the government could have used this opportunity to unwind what was a bad policy decision in the first place, as I note the government did when it used this particular occasion to reduce spending on programs designed ostensibly to promote reductions in carbon emissions, which the Prime Minister said were no longer necessary if we are to have a carbon price. That is why I used that as an example of where the government could have made decisions on the expenditure side if it wanted to that might have obviated the need for a levy. But—and I respect the government's right to make these choices—it elected instead to impose

a levy rather than to fund all of the expenditures associated with the Queensland floods through reductions in other forms of government spending.

CHAIR—Thank you. Senator Eggleston has one last follow-up question as well.

Senator EGGLESTON—I did, but it may be that we have run out of time. It was a question about whether you felt there was a need for a policy decision to be made by the government to set up a means of providing finance for reconstruction after natural disasters, which might mean that additional measures such as this levy are not needed.

Mr Eslake—I think there is merit in exploring the implications of setting up some kind of fund similar to that which New Zealand has to finance the reconstruction of areas affected by earthquakes. In the aftermath of the Christchurch earthquake, of course, that is a very topical consideration. New Zealand has had a fund like that, as I understand it, for a long period of time and it is financed by a levy on insurance. I am not sure that financing any similar fund in Australia through a levy on insurance would be the right way to go, because that would in effect mean that the entire burden would fall on those who were prudent enough to insure their properties against some other form of damage. As we know, when it comes to, for example, fire brigade levies that are often imposed by state governments in Australia, many people feel that that is quite unfair and amounts to free riding on the part of those who choose or do not even think about the need for taking out fire insurance on their own properties. That is to say, we have to think carefully about the so-called moral hazard dimensions of any proposal like that. But that said—and I do not think I can go any further than this—I think proposals of that nature are certainly worth exploring.

Senator XENOPHON—It should also be noted that the New Zealand government also had extensive reinsurance on the global market for natural disasters—unlike the Queensland government.

Mr Eslake—Indeed, and I think that many people, myself included, are somewhat aggrieved that the costs falling to the Commonwealth are higher than they would have been if the Queensland government had taken out insurance and, as has come to light more recently, other state governments are having to pony up a share of the Queensland government's contribution because of the way in which the Grants Commission formulae redistributes some of that burden back to other states.

Senator XENOPHON—That should change soon, Mr Eslake.

Mr Eslake—Yes, and I note and broadly support the measures that you have been advocating to that end.

CHAIR—Thank you, Mr Eslake. That concludes this session and we will let you get back to your work.

Mr Eslake—Thank you very much for the opportunity to share my views with the committee.

[9.04 am]

FURNELL, Ms Peta Patricia, General Manager, Social Policy Division, Department of the Treasury

O'CONNOR, Mr Mark, Assistant Commissioner, Australian Taxation Office

ROBINSON, Mr Marty, Manager, Household Modelling and Analysis Unit, Department of the Treasury

WHITE, Mr Damien, Principal Adviser, Department of the Treasury

WILLCOCK, Mr Michael, General Manager, Personal and Retirement Income Division, Department of the Treasury

CHAIR—Thank you for coming in this morning. Do you have an opening statement?

Mr Willcock—No, we do not.

CHAIR—We have the 16 February *Hansard* testimony to the House of Representatives committee on this bill. Can you update for us some of the figures for those costings? Can you tell us if you have any better costings and give us a feel for what has happened, what cost the reconstruction effort will be?

Mr Robinson—The costings that were undertaken at the time of the announcement basically estimated the revenue that would be gained from the introduction of the flood levy, which we estimated to be around \$1.8 billion. At that time the estimates included the adjustment to revenue that would be as a result of exemption of some of the exemption groups. In particular, we estimated the impact of exempting Queensland flood victims and also those that were associated with the flooding in WA. Those estimates were included in the 1.8 billion. We are still working on advice from the department of finance on the final estimate for the number of adjustments that we need to make for subsequent events from Cyclone Yasi, the flooding in Victoria in February and for WA bushfires.