

The Federal Budget has been delivered and Australians are headed for the polls. In this series, Reform Revisited, we ask writers for innovative ways to tackle our reform agenda.

It is generally recognised that Australia has a [structural budget deficit](#) which needs to be reduced. There is also quite widespread acceptance that our [tax system is in need of reform](#)

. Two glaring omissions from the recent federal budget were plans to reduce the deficit any time soon or embark on meaningful tax reform. Is there any connection or conflict between the two?

In trying to address this question there are really three different issues: the size of government expenditure; how much of this expenditure should be financed from taxes; and how the tax system should be structured in order to prevent endless deficits in the future.

In theory these three issues are quite separate but inevitably they become confused and political. For instance, Labor might say schools expenditure must rise because improving education of the nation's children is far too important for us not to do so. This means raising more revenue through increasing the deficit (borrowing) or raising taxes where the burden must fall on "big business" or "wealthy people". The Coalition would have a different set of priorities which change the mix or amount of government expenditure, how it is financed and who bears the tax burden.

Governments provide many goods and services, including health, education, infrastructure and national defence. They also regulate individual and private sector business activity. One way to address the structural deficit is to permanently reduce government expenditure as a percentage of gross domestic product (GDP). Government expenditure as a proportion of GDP is currently higher than the long-term average.

There is a well-articulated economic theory underlying the principles governing efficient government expenditure on goods and services. There is no space here to develop this further but the main point is that the benefits of this expenditure should exceed the costs in terms of all the other things that could be done with these funds. Clearly governments of all persuasions have been somewhat less than rigorous in spending wisely according to this criteria rather than according to their own or, vested interests', preferences.

Equity vs efficiency

Much of government expenditure however, is not based mainly on the efficient provision of goods and services such as infrastructure projects, which facilitate economic growth and productivity. Instead, it aims to address equity issues based on the principle that the market, left to its own devices, will result in an inequitable allocation of income, goods or wealth. Thus, the biggest single item of government expenditure in Australia is social welfare.

It could be argued that most social welfare reduces economic efficiency since most welfare payments go to people who produce little or no market output such as the unemployed, disabled or elderly, but most humane societies accept the need to help the worse off. Countries, however, differ quite markedly in the weight given to equity versus efficiency.

Governments also need to allocate expenditure just to actually carry out the functions of government administration through, for instance, the public service and the legal system. The size of these operations depends, among other things, on the amount of regulation imposed on individuals and firms plus the number and quality of programs government uses to provide goods and services.

To raise the revenue for these activities governments must impose taxes on households, consumers and firms. Most taxes are used to raise revenue, but some taxes, such as those on cigarettes or alcohol, are also intended to discourage what society views as “undesirable” behaviour. But the fact that these taxes are such huge revenue raisers implies they are pretty ineffective at reducing consumption.

Income tax is the largest source of revenue for the federal government and is levied on the wages, salaries and other income of households (personal income tax) and the profits of firms (company income tax). Clearly, reducing the deficit is most easily done by raising income tax rates since revenue from this source is so big. Restructuring the tax system to rely less on direct (income) tax to indirect tax (such as the GST and excise taxes) requires a big shift in revenue collection.

Why reform is so hard

Although raising taxes seems like the easy way out for reducing the deficit, critics (many

economists) argue that the loss to efficiency (growth and productivity) of raising taxes, particularly income taxes, is too great. Even harsher critics argue that the current level (and structure) of taxation is stifling economic activity.

The essential argument, which again would require another article to elaborate on, is that the private sector (households and firms) is best placed to generate output and growth of goods and services in the economy; and reducing the resources available to the private sector leads to less output, jobs, etc.

Income taxes are regarded as particularly inefficient because they also reduce rewards to effort for both workers and firms and therefore act as a disincentive to wealth (and employment) creation. In fact, just about every tax (and most government payments) results in distortions, many of which were unanticipated, in behaviour by individuals – the most recent one that comes to mind is [negative gearing](#).

Unfortunately, in economics any distortion usually has people who gain from government revenue and taxes. So although it may be in the interest of the economy as a whole to reduce taxation, change the tax structure, rationalise benefits and reduce the structural deficit, some groups (which may be quite large) of individuals will usually be worse off by the changes.

And in a democracy these individuals vote, have the ability to influence the media, or lobby politicians to prevent any changes which would disadvantage them. Witness the way just about every idea to reduce the deficit, reduce government expenditure or restructure taxes tends to get shot down so quickly in Australia without sensible consideration or debate.

Perhaps fixing the structural deficit is too big a task given the reluctance to tackle any meaningful tax and spending reform!

Read more in the series [here](#).

Phil Lewis does not work for, consult to, own shares in or receive funding from any company or organisation that would benefit from this article. He also has no relevant affiliations. During his

Explainer: why we can't fix the structural deficit without tax and spending reform

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career he has received funding from many private and public sector organisations including most recently the ARC, NCVET, DEEWR, the AFPC, ABLA and CPA Australia.

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