

From Timber to Tax – Ken Henry, The Treasury

When Ken Henry was 13, his father, a timber worker cutting logs out of the Landsdowne State Forest near Taree, in the mid North Coast of NSW, came home excited and early and bundled his boys into his car. Normally he'd leave before sun-up and be home after sundown, but this afternoon he took the three brothers down to the sawmill. "He wanted to show us the log he'd taken out of the forest that day", Henry says. "The thing was huge. He was a short man. He stood at the base of the log and it just towered over him. It must have been two metres in diameter. It was as big a log as the biggest log truck could carry, just one log. That's all that would fit on it. You see these log trucks rattling round the ACT and they might have 30 pine trees on them. This was one log and when I spoke to him subsequently about it he said the truck was probably overweight. He also told me that he had had to climb a long way up the tree to get to a point where he could remove this log himself because he was just one man with one chainsaw. Well we started asking questions like how old was the tree the log had come from? He told us anywhere between 100 and 500 years old."

"How many houses could you build with that log? He said 'the framing for three pretty good sized houses'. 'Whoa, it must be worth a lot. Well, dad, how much do you get paid?' 'A few dollars'. 'So who gets the rest of the money? Does the sawmill get the rest?' And he said, and this was very revealing to me, he said, 'Oh No. No. The State Government takes some money as well in royalties, like a tax'. I said, 'Ok fair enough. How much?' He said there'd be a few dollars royalty. And the penny dropped. Like 'hang on, this tree has been in Australia longer than white settlement ... it can properly be regarded as the property of the people of NSW. And the Government of NSW had effectively sold it off to a sawmill operator for a few dollars'. That had a profound impact."

So what does this tell Henry today? "It teaches you that governments have responsibilities, including responsibilities over the assets of the people that they represent – timber stocks, fish stocks, quality of the air, water, generally the quality of the environment. When you see something that grates or offends, where you think the outcome is inequitable, where somebody's getting away with something they shouldn't be getting away with, there's a temptation for people to point the finger at the operation of markets and say, 'well, that's how the free market operates, right?' There's a temptation to say 'well, it's all the fault of the free market'. But often it's not. More often than not it's poor government policy."

As an economist Henry agrees that markets handle assets by setting a price and adds that, "nobody ever asked the people of NSW at what price they would be

prepared to sell that tree.” Well, at what price should it be sold? Should there be an environmental or societal bid? “Sure, exactly,” he says. “It is the responsibility of governments to put themselves in the position of the people they’re representing. That’s what the job is. That’s a tautology. Put themselves in the position of the people they represent and ask the question: Well, this tree that’s been here for those hundreds of years, just how much money would the people of NSW want me to charge for somebody taking this tree?”

Is that happening today? Is somebody making that sort of bid? “Look it’s better but it’s ... that’s all I’d be prepared to say in respect of royalties ... It’s better.” As a sign of change Henry nominates the petroleum resource rent tax, which has behind it, he says, “precisely the thinking that I’ve been talking about.”

But how would that help preserve the dodo when the collectors looked at their costs of getting to the islands, collecting the dodos and making a bit of a profit and were unaware that they were harvesting the last bird? He agrees there are no environmentalists putting in the bid to preserve the bird.

So is this a problem for these sort of environmental assets? “Absolutely it is. There is a role for governments in that area. Governments – we’re going back a long way now – but Australian governments are culpable for the extinction of the thylacine and I think it’s something like 110, or 120 species of Australian flora and fauna that have been made extinct since the time of white settlement. Australian governments have a responsibility for that. They’re culpable for that ... They’re responsible, not only to look after the interests of the present generation of voters but future generations as well. Who else can put themselves in that position? I mean it’s too much to expect people like my ancestors who harvested red cedar on the north coast of NSW, it’s a bit much to expect them, on their own, not to take out so many trees on the basis of concern for future generations having access to red cedar. But it is not a bit much, surely, to expect a government to look after the interests of future generations.”

So is he an environmentalist or the head of Treasury? “I think most heads of Treasury, most of my 14 predecessors, would have been environmentalists in this sense.” Henry says one economist who has influenced his thinking more than any other is Nobel Prize winning, Amartya Sen. Sen, he says, proposes that people should have the capabilities to choose lives that they have reason to value. “Now, without a decent education, without decent health, you can’t say that people have the capability to choose a life that they have reason to value. Those are fundamental ... we could have a debate about to what level, obviously; and what sort of education, obviously. But they’re second order issues for this discussion.”

He refers favourably to Sen’s article, *Why We Should Save the Spotted Owl*, and says that in it he talks about the concept of sustainable development. “Nobel prize winning economists back in the sixties and seventies were talking about

sustainable development in terms of every future generation having a standard of living at least as high as the present generation. Sen says that's not enough."

"What do you mean by standard of living? If you're going to measure standard of living in terms of only material wealth and incomes, then Sen would demur. He would say that there is an argument for protecting the spotted owl that has nothing to do with preservation of the standard of living. And it is that the present generation has the capability to enjoy the existence of the spotted owl ... Future generations should also have that capability – well Sen uses the word freedom – to enjoy the existence, to appreciate the existence, of the spotted owl. And so I would say the same thing with respect to the thylacine. I'd say it with respect to the northern hairy nosed wombat that is now on death row."

Henry agrees that this relates to the level to which we consume forests and the resources of the seas and the environments in which spotted owls live. "All I'm saying is that government has a role in this. It's an appropriate role of government. And that governments should not practice benign neglect, or even worse, actually participate in destruction."

Henry says he was initially interested in economics because of the intellectual challenge. After completing an honours degree at the University of NSW he was invited by his supervisor, the late Professor Richard Manning, to do a PhD at Canterbury University in New Zealand where Manning had taken a chair. Henry's two children were born there while he lectured and continued his studies. "Those were tough years," he says. "I was a lecturer in economics in New Zealand in the last years of the Muldoon Government. And the Muldoon Government was a disgrace. In almost any terms, but certainly in economic policy terms, it was a disgrace."

Although Henry's thesis was highly theoretical and mathematical he says he found himself getting involved in and eventually becoming motivated by real world policy issues. Looking back across the Tasman he saw what was happening, particularly when the Hawke Government was elected in 1983, and he applied for a job with the Australian Treasury working on tax. With tax reform a major issue on the political agenda for the next twenty years, he was destined to occupy positions which could not go unnoticed.

When the Coalition Government was elected in 1996, Henry would have been an unlikely prospect as a future head of Treasury. A highly qualified Division Head and professional public servant he might well have been, but his close working relationship with Labor guaranteed long odds on the Coalition offering him the top job five years later. "Initially, I'd have to say, my relationship with the Government was a bit tense," he says. This is hardly surprising. Henry joined Tax Policy Division in 1984 at the executive level and moved across to Labor Treasurer Paul Keating's office in 1986. Over the years when the Coalition was in Opposition he worked on tax models, including the model that played a key

role in destroying former Opposition Leader, John Hewson's *Fightback!* economic package. "Over time they obviously grew comfortable with me," he says.

Henry experienced the full roller coaster of major tax change events that occurred from the mid-1980s to today. The year he joined Treasury he was right in the middle of the small team of officers putting together the Government's white paper on tax reform that went to the tax summit in 1985. "We were putting that together confronting absolutely impossible deadlines," he says. "We were working crazy hours through the night ... [with] kids sleeping under desks." Henry's children were four and five at the time. "I don't think there was any case where I brought my kids in and they slept right through. But there were times when they were there sleeping until late in the night."

Henry says he did not see a lot of his kids growing up and this was a huge loss'. He observes that he was not unlike his father but says it has had an interesting effect on his son who is now 24 and, has two university degrees. "He's not quite sure what he wants to do with his life and the reason is that he saw first hand the sort of life I had." He notes that there were a number of periods when he was working 100 hours a week and says the impact on his family was "Pretty bad" but his wife was understanding – "more than I could reasonably have expected." Henry's Division Head in the mid-1980s was David Morgan, now head of Westpac. Henry would typically work on a tax draft and slip it under Morgan's front door by 3 am. Morgan would get up and read it and have dealt with it by 8 am.

Despite all the work, Keating's preferred Option C tax package did not win the support of the Tax Summit. Henry says this was "almost soul destroying ... along with the others in the team, I had invested everything ... I knew as soon as Bob White, who was chairman of the Business Council of Australia, got to his feet and said, 'Business Council doesn't like option A. Business Council doesn't like Option B. And Business Council doesn't like option C'."

"We were listening to this over the in-house service in the old Parliament House and I turned to the others and said, 'Well that's that'." That was on the morning of the Summit. After lunch the Prime Minister, Bob Hawke, announced that the Government would not proceed with Option C. Henry says the support of the business community had pretty much been taken for granted and they had thought the problem was going to be getting the support of the ACTU. "Now of course the Business Council didn't support it at the time ... because Option C contained Option A with the income tax base-broadening measures of fringe benefits tax, capital gains tax and so on ... Well, of course, the business community didn't want any of that, did they? But what an extraordinary blunder from the Business Council because Keating needed nobody's support to legislate fringe benefits tax and capital gains tax [and] of course that's what he did ... on the last night of the Summit [Keating] got us together in his office in old

Parliament House and he said, 'Look, we're going to push on. We've lost the consumption tax. But we're going to push on. We are going to get the fringe benefits tax and the capital gains tax and so on. And nobody can stop us'. And so we did."

Hawke had always said unless there was community support for Option C he would not proceed with it. "That's right; that's fair enough I suppose," Henry says. "But you don't just get the support by publishing something and waiting for people to tell you how good it is. And Hawke knew that ... he knew that getting support for the position involved an element of hard work ... he didn't bear any scars from it at all. None at all. Keating bore all the scars."

Henry stayed in the team designing the fringe benefits tax and the capital gains tax that appeared in the September 1985 tax reform package. He spent the next year helping with implementation of the package before moving to Keating's office where he stayed for nearly five years until Keating lost his first challenge for leadership of the Government in June 1991. "Those were extraordinary years", he says.

Keating had made his statement that Australia was in danger of becoming a Banana Republic shortly before Henry joined his office and economic policy dominated the political agenda during his time in the office. Despite the pressure of work in the office Henry says "I'd be very surprised if you would find anybody who had ever worked for Keating in his office who had a bad thing to say about him." Asked why he had this level of support, he says, "He valued people and you knew that you were valued. He was inclusive. He discussed all sorts of issues with people in the office ... at least in the office he never pushed his view down anybody else's throat. I often saw the opposite, that is, attempts by people in the office ... to push views down his throat. And he'd sit and he'd listen and he'd take it. And sometimes he'd agree and sometimes he'd say, 'well ...' There was always a healthy debate in the office."

After Keating lost his first challenge in June 1991, he retired to the backbench before mounting a second challenge in December of that year, which he won. John Kerin had replaced Keating as Treasurer, but he in turn had been replaced by Ralph Willis in December. When Keating won the prime ministership, he appointed John Dawkins as Treasurer and they mounted an attack on Opposition Leader John Hewson's Fightback! tax reform election package.

While Keating was sitting on the backbench, Kerin instructed his department to build a capacity to quantify the price, revenue and distributional implications of any indirect tax change. Henry, with his academic tax-modelling background and previous Treasury tax experience, was appointed to lead the Treasury team to develop this modelling capacity. He was given half a dozen people and told to build the modelling capacity in four months. In the end it took five.

“It was like 1985 all over again. But in other ways it couldn’t have been more different ... The way in which it was the same was that the deadline was impossible. And so we were working absurd hours ... again it was 100 hours a week stuff. But it was completely unlike 1985 in the sense that we were not helping the Government to develop a positive package. Kerin had never said to the department, ‘I’m going to use this to monster Hewson’s tax package when he gets it out.’ Although he’d never said that, we knew, obviously, what it was going to be used to do. We knew that Hewson’s package was going to include a broad based consumption tax, the thing which in 1985 we were helping the Government to design. So you could say that our hearts were not in the job. But we nevertheless had an instruction from the Government. ‘You do it.’”

Did anyone think of saying, this is improper to do? “Look, in the department there was quite a discussion about that issue. And I’m sure there are bits of paper that deal with that question of whether it’s proper or improper to do, but the view that was taken in the department, from the Secretary down, was there was no basis on which we could refuse to do this. And that’s true. If I were to get an instruction from the Federal Treasurer – and the instruction from Kerin was in writing – today, ‘I want you to do X’, unless it’s illegal, I turn to section 57 of the Public Service Act and that says it is the responsibility of the Secretary, under the minister, to manage the department.”

“That’s very clear. Unless it’s illegal you do it. And that’s part of being a professional public servant ... if you think that it shouldn’t be done for some broader policy reason, philosophical reason, political reason, whatever, you simply have to put that aside. And here was a case where not only did we not want to see this done, because we knew for what purpose it was going to be used and we didn’t think that was a good policy purpose. We had invested a large part of our souls in the particular policy objective in 1985. Nevertheless we were being told, ‘You’ve got to do this’. And as professional public servants we did it.”

When Fightback! came out, the model the team had developed enabled the identification of a major failing in the package. Income tax bracket creep had been used to fund the package but bracket creep had not been used in the analysis of the after tax income various taxpayers would receive. Treasury was accused by the Coalition of having acted improperly. “We did not act improperly,” Henry says. “We rejected that charge at the time. I would always reject it. There was nothing improper in what we did. But it is the case that our work was used by the Government to attack publicly an Opposition policy. That’s just the fact of it. And the great irony, of course, in this for me personally is that then 1997 comes along and the Prime Minister, Prime Minister Howard, wants me as chairman of the Government’s Taxation Taskforce to develop the

GST that we now have. So I've seen all sides. It's been, I have to say, a huge emotional rollercoaster."

Henry says he's never discussed why he was appointed by the Prime Minister to that role but "I'm sure the way the Prime Minister would have looked at it is that if there's anybody in Australia who can see a chink in the thing, it's going to be this bloke. That's probably the way that his mind worked. Anyway, had I been in his shoes that's what I would have thought."

So Henry got another team together and brushed the cobwebs off his Prismod model they had built in 1991. Prismod had taken 12 hours to run the first time it operated and was a nightmare. "Literally a nightmare," says Henry, "because I would set the alarm at home for 2 o'clock or 3 o'clock in the morning, come into the office and check whether it had crashed or not. If it had crashed I'd set it going again so that by 8 o'clock we could check it again. But by 1998 it could be run in one and a half minutes."

Despite the Government's commitment to the GST, not everything ran smoothly. The Government did not have control of the Senate and initially sought the support of Tasmanian independent, Senator Brian Harradine. "I was travelling with Costello when Harradine said that he couldn't support it," Henry says.

"I think we were in Singapore on our way, I can't remember to where ... and he got the call that Harradine had finally stood up and said that, in all conscience, he couldn't support a GST. I thought, 'I've been through this before. I've seen this before'. It's difficult for me to put myself in Costello's shoes, and I try not to ... but I'm sure had I been in his shoes I would have said, 'I'm just not going to go on with this. Forget it. It's gone'." But, to his credit, Henry says, Costello kept going. The end result was a deal that saw the GST introduced with food excluded. "Is a GST without food as good as a GST with food? In my view, No, if only for the compliance issues involved. But is a GST without food better than no GST at all? Yes. And, as I said, to Costello's great credit he continued to push on with it and we got it."

Henry says that usually governments which introduce such taxes are defeated in the next election but the Coalition government was not defeated. He says this in part may have been because it was well implemented. Both the IMF and the OECD have said that the implementation of the Australian GST was a model for other countries. "In terms of its impact on the economy it was an absolute textbook case," he says. "We drew pictures for the Government showing what we thought the time path for the CPI [consumer price index] effect was going to be. And when we got the actual figures and you laid them over the top you'd scarcely see daylight between the two lines."

Henry maintains that the economic policy settings are absolutely fundamental to the strong performance of the economy. "Running disciplined medium term

fiscal policy doesn't happen by accident", he says. "And it certainly doesn't happen without Treasury ... it certainly doesn't happen either without the right micro-policy settings, without an appropriate tax system, without the right regulatory structures in the financial system, which is Treasury responsibility, and corporate governance and competition policy which are Treasury responsibilities. In most of those areas we have the responsibility ourselves to develop policy and I would say that in most of those areas – financial regulation, corporate governance, competition policy – certainly in those areas the policy settings in Australia are widely regarded around the world as world's best practice. And that's got a lot to do with Treasury."

He also points out that one of his *ex officio* roles is to sit on the Reserve Bank Board which sets interest rates. This workload places strains on the agency of 800 people. Henry says the way that they are funded, where an efficiency dividend requires a cut in administrative costs each year, requires the department to reduce staff numbers by about 30 people a year. This requires a rate of productivity growth that is about double that in the private sector, he says. He recognises that the public sector does not have the market discipline that exists for businesses. The Government exerts the discipline. It decides what price it is going to pay for services.

As head of Treasury Henry is in one of the key service positions to present a policy alternative, so does he have anything else in mind? "Not yet. But I'm thinking about it," he says. Another serious issue he nominates for the department is freedom of information requests about the development of government policy. "The way this is going, there are only two possible consequences I can see for this department," he says. "I'm satisfied, having reviewed a number of them, that by and large they have been motivated by a desire to either embarrass the Government and Treasurer, or the department. Now it is not my role to help people embarrass the Government. So how am I going to respond? There are two likely responses. The first is that you will see Conclusive Certificates, stating conclusively that it is not in the public interest for the information to be released, issued on every one of them. That's very likely."

The second response, which he says is already happening, is that documents will not be produced. Communication on sensitive policy issues will be verbal. "Communication with the Treasurer is obviously vital. But, because of FOI, records are not always kept." Yet Henry says he thinks it is "very important that records are kept of oral communication with ministers and ministers' offices and that there is an accurate recording of not just the decision, but the considerations underlying the decision. It's very important."

FOI requests cannot be made for Cabinet documents but Henry says he cannot just stamp Cabinet-In-Confidence on a document to keep it private. "It has to

be a document of the Cabinet which seems to mean that at least it has been noted in the Cabinet decision. Well, I can't remember a Treasury briefing to a Treasurer for a cabinet meeting that's ever been noted in a Cabinet decision. So somebody needs to think through the implications of the increasingly aggressive use of FOI for record keeping in departments like this one. And I can tell you it is having an adverse impact on record keeping. There are documents that are simply not being prepared. It's an issue."

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