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Sustainable budgets: underwriting Australia's social compact

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About this publication

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About CEDA

CEDA – the Committee for Economic Development of Australia – is an independent, not-for-profit membership organisation. We identify policy issues that matter for Australia's future and pursue solutions that deliver better economic, social and environmental outcomes for Australia.

CEDA's cross-sector membership spans every state and territory and includes more than 780 of Australia's leading businesses, community organisations, government departments and academic institutions.

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foreword

Melinda Cilento Chief Executive, CEDA



In CEDA's foundation document last year, *Connecting people with progress: securing future economic success*, we outlined the need for a fundamental reframe of how Australia approaches policy.

The federal budget is a key component of that, as it is vital for ensuring that we reliably connect people to the benefits of Australia's economic progress, something we know many Australians feel has not happened in recent years.

Australia's social compact is largely delivered through the budget via the tax transfer system and the delivery of critical services and programs that are important to the wellbeing of individuals and the community more broadly, such as health, education and infrastructure.

This means that it is important that scarce taxpayer dollars are well directed to areas that deliver the greatest net benefit and this is done transparently, to ensure the community can see we have an equitable system and that money is being well spent.

Australia has had various budget repair strategies since the GFC but real tax reform has been a contentious area with limited success. Community trust is vital to progress work in this area and shore up the tax base in the years ahead.

And make no mistake, as we face considerable uncertainties and very significant demographic, economic and technological challenges, achieving long-term budget sustainability, underpinned by a strong tax base, will be central to ensuring we have the services and infrastructure we need and want as a progressive society.

While there has been recent improvement in the Federal budget position, which should be welcomed, this is just the first green shoots that must now be cultivated to achieve sustainable budget balance.

As outlined in this report, there are real risks to maintaining a surplus in coming years. However, there are actions we can take now to reduce those risks.

I hope you find this publication a useful analysis that can help drive debate and discussion.



Melinda Cilento
Chief Executive, CEDA

Introduction

Budget repair
must remain
a **priority**

Budget repair continues to be the right priority for Australia, especially in an election year. Against a backdrop of geopolitical uncertainty, a weakening growth outlook, increasing community expectations and demographic, economic and technological pressures, we face a generation of tough decisions ahead for Australian governments at all levels.

Laying stronger fiscal foundations now will provide greater choice about how we address the critical issues impacting the future wellbeing of our nation. Rebooting long-term fiscal disciplines, paying down debt, strengthening Australia's tax base and reinstating basic spending discipline and accountability will bolster our economic and social resilience.

The recent improvement in the federal budget position is welcome and the government should be commended for a degree of spending restraint in recent years. But these improvements represent the tip of the iceberg compared to the future task.

Australia's budget position and net debt levels seem modest relative to global benchmarks. However, high levels of household indebtedness and a reliance on Asian markets and commodity exports and prices make us vulnerable.

Greatest budget vulnerabilities: from an election cash splash to health and retirement

Short-term

Loss of spending discipline

- The 0.6 per cent estimated increase in payments forecast currently in 2019-20 is rare and almost never achieved following an election.
- In the fiscal year following each of the 17 elections held since 1972 only three have resulted in real payments growth at this rate or slower.
- If spending grew just 0.4 per cent more on average over the forward estimates, it would be enough to wipe over \$16.5 billion from the underlying budget balance and place the 2019-20 budget surplus at risk.

Economy

- The momentum in global economic growth has slowed.
- Australia's corporate tax base remains volatile and heavily dependent on the fate of relatively few companies. The four major banks and two major miners account for a quarter of company tax revenue.

Long-term

Health

- If health expenditure grows at rates experienced over the last decade, governments will confront a cumulative funding gap of over six per cent of GDP by 2054–55.
- The incidence and cost of mental health issues is skyrocketing: 2.4 million people now receive Medicare subsidised mental health services and over four million people receive mental-health related prescriptions.

Social security

- There is growing pressure on the incredibly low growth of many payments. For example, the case for correcting the inadequate level of Newstart by \$75 a week is compelling and requires an investment of \$3.3 billion a year.

Aged care

- Changing community expectations, evidence of care falling short of these expectations and a tripling of Australia's 80+ population by 2066 will place significant pressure on current funding trajectories.

Education

- Projections point to Australians spending a third more time on education and training in the next two decades to keep up with technological change in modern workplaces.
- Despite this, expenditure on technical and further education has not increased in real terms over the last decade.

Increasing reliance on relatively inefficient tax bases

- The heavy lifting of budget repair remains highly dependent on the most economically damaging taxes on income – personal income tax and corporate income tax.
- At the same time, Australia's most efficient tax bases on consumption are eroding and an increasing number of Australians are subject to highly concessional tax treatment in retirement.

History also tells us that purse strings loosen around elections. The 0.6 per cent estimated increase in payments forecast for next year is almost never achieved in a fiscal year following an election.

Building larger fiscal buffers provides insurance against a deteriorating global economy. Freely casting around taxpayer dollars, in contrast, will do little to enhance Australia's productive capacity and will erode recent achievements and hard-won budget credibility.

There is a loud chorus of voices in support of budget repair. The goal of this report and the measures outlined by CEDA is to focus on how to lock in a sustainable federal budget position – one that ensures we can fund the services and infrastructure upon which the community relies, now and into the future. CEDA has done this through a long-term lens of funding Australia's social compact, maintaining intergenerational equity, retaining fiscal buffers, building productive capacity and having a robust, efficient and equitable tax base.

A few recommendations are win-win. For example, making sure money is well spent, delivering the outcomes sought; removing the handbrake on program innovation and flexibility created by excessively cumbersome and prescriptive inter-governmental funding agreements.

However, most of the options contemplated in this paper are much less straightforward and require grappling with difficult trade-offs. They include:

- Serious governance improvements to drive budget accountability and discipline, including a culture reset in policy-making via:
 - Compulsory evaluation of major government spending programs every five years.
 - An enhanced whole-of-federation intergenerational report prepared by the Parliamentary Budget Office (PBO) in close coordination with State and Commonwealth Heads of Treasury.
 - Regular independent reporting on the suitability of government fiscal strategies and fiscal rules.
 - Locking in rules to keep spending growth in check.
- Delivering value for money across spending on industry assistance, the Pharmaceutical Benefits Scheme (PBS) and healthcare.
- Re-booting reform of federal-state funding agreements to support innovation and flexibility in service provision and reducing wasteful administration
 - by consolidating agreements, reducing prescriptive impositions; and
 - reinstating the original intent of the intergovernmental agreement on federal financial relations.
- Options to shore up Australia's tax base
 - including reducing dividend imputation credits, capital gains tax, negative gearing, work-related expense deductions and taxation of alcohol.
- Taking steps over time to rebalance the tax system by reducing the negative economic impacts of taxes on labour and capital
 - including personal income tax relief for lower and middle income earners and addressing the competitiveness of our corporate tax system.

Recommendations

Recommendation 1.1

The PBO should be tasked with preparing a report on the appropriate design considerations for fiscal strategies given prevailing economic and fiscal conditions every five years.

Recommendation 2.1

The PBO should be tasked with preparing future intergenerational reports. The transition of new responsibility could be undertaken progressively across the 2020 and 2025 intergenerational reports.

Recommendation 2.2

The scope and content of future intergenerational reports should be enhanced to:

- take account of whole-of-federation intergenerational fiscal pressures, in close coordination with Heads of Treasuries (HoT).
- include greater analysis of intergenerational equity issues, more rigorous scenario analysis and analysis of newly emerging funding pressures (as opposed to pressures confined to existing government programs).

Recommendation 3.1

Governments should adopt and maintain explicit rules to keep payments growth below GDP growth, as part of their fiscal strategy as long as economic circumstances permit.

Recommendation 3.2

To rebuild discipline in program evaluation, CEDA proposes that the Commonwealth Government legislate the regular review of all Commonwealth funded programs, with all programs to be reviewed at least every five years.

Evaluations should be conducted by the Department of Finance with the line department or agency responsible for the program. The legislation should require that all evaluations be made publicly available promptly after completion.

Recommendation 3.3

The government should increasingly restrict access to budgetary assistance to industry to those firms who genuinely require assistance and would not undertake the subsidised activity without it.

Recommendation 3.4

The Commonwealth Health Department should reinstate reporting against PBS price disclosure savings targets and accelerate further savings including through greater use of international benchmarking in price negotiations.

Recommendation 3.5

COAG should re-commit to the original ambitions and objectives of the Intergovernmental Agreement on Federal Financial Relations.

As a first step, the number of funding agreements should be consolidated and agreements that are being renegotiated should be assessed for their alignment to the IGA's principles and the capacity to support innovation in service delivery.

Recommendation 3.6

COAG should put a serious program of health system reform back on the table.

Useful starting points for such a program would include developing an architecture for patient-centred care, boosting performance information and transparency, defunding low-value health interventions and enhancing integrated care through Primary Health Networks and Local Hospital Networks.

Recommendation 4.1

To the extent that there is a need to increase taxes to address a revenue shortfall or fund tax relief, proposals should align with broader principles of good tax design, including simplicity, equity, revenue adequacy and efficiency.

Limiting work-related deductions, full volumetric taxation of alcohol, reducing the capital gains tax discount and removing dividend imputation refundability would move Australia's tax system in this direction.

There is time to progressively implement careful changes with well-crafted transitions for the community, to limit any unintended consequences.

Recommendation 4.2

As the budget position improves and there is fiscal capacity to do so, the Commonwealth Government should take steps to reduce the negative economic impacts of taxes on labour and capital. It can do this by:

- Continuing to address bracket creep through further targeted personal income tax relief focused on middle income earners most impacted by increasing average tax rates.
- Providing more generous allowances for new investment in the corporate tax system, in absence of an agreed plan for reducing the current corporate tax rate. This is increasingly urgent in light of the Australia's relatively unfavourable effective corporate tax rates recently reported by the OECD.

Summary

The importance of the federal budget

The federal budget is the cornerstone of public policy and programs. Through the structure of taxation and spending, the budget has a fundamental impact on business activity, innovation and investment. It influences decisions around participation in education and the workforce.

Australia's social compact is also largely delivered through the budget, through the size and composition of the tax transfer system, and the provision of critical services and programs.

The federal budget, and state budgets, are central to reliably connecting people to the benefits of Australia's economic progress.

CEDA therefore has a deep interest in the integrity and sustainability of the federal budget. Budget practices and processes must consistently enable sound policy decision making and program outcomes. This is the best way of ensuring that the federal budget underpins better social, economic and environmental outcomes for all of Australia over time.

For the past decade, federal budget conversations in Australia have been squarely focused on budget repair and returning the budget to surplus. This is an important priority, not because deficits are always bad, but because they should not be the norm. When deficits become entrenched, future choices and opportunities are severely and unnecessarily constrained.

Budget disrepair

Australia has had budget repair strategies – variously encompassing caps on spending and revenue and commitments to surpluses – in place since the immediate aftermath of the Global Financial Crisis (GFC).

Early progress post the GFC unravelled when commodity prices collapsed, after which revenues were consistently underestimated and spending rose in response to the impacts of the economic cycle and in some cases government decisions.

Projections for a return to budget balance and eventual surpluses were consistently revised and delayed. Net debt rose rapidly, as did concerns about the sustainability of rising debt, and at times perceptions of Australia's credit worthiness.

The importance of these issues prompted CEDA to release a major report in 2016, *Deficit to balance: budget repair options*, which outlined a range of budget repair measures available to the government – measures to credibly strengthen the federal budget.

Of the measures outlined in that report, a quarter have been implemented in some form, contributing to reported improvements of \$9.2 billion to the budget bottom line.

In the introduction to that report, CEDA Chairman, Paul McClintock, articulated the long-term costs of a failure to get Australia's federal budget back in the black, including the:

- adverse impact on the future generations that would ultimately have to pay the price for lax fiscal discipline today;
- absence of buffers to support Australia's economic and social resilience in the face of unexpected shocks; and
- weight of the growing interest burden associated with net debt that would constrain future tax and spending options.

Budget repair remains vital today, for the reasons above, but also because a sustainable budget will enable opportunities to be realised, including:

- funding to better deliver Australia's social compact through the provision of adequate social security and welfare, health, education and other services fundamental to people's wellbeing;
- investing in the productive capacity of the economy through built infrastructure and skills; and
- through supporting a strong economy, underpinned by business investment, that drives innovation and workforce participation.

Turning the fiscal corner?

In the three years since CEDA's *Deficit to balance* report, significant federal budget repair has been achieved. The budget position for 2018-19 has improved by nearly half a per cent of GDP and net debt should now have peaked.

A big factor in Australia's improved budget position has been the reimposition of spending discipline. In recent years, the budget has seen the lowest levels of real growth in payments for some decades. Real payments growth has been averaging under two per cent per year – the yardstick for expenditure discipline since the GFC. Expenditure restraint has been accompanied by stronger than expected economic growth in recent years and a substantial lift in tax revenues which is driving the path to surplus in 2019-20.

However, the challenge is to build on these achievements so that there is broadly based confidence about our fiscal future in the face of demographic, technological, geopolitical and economic headwinds and uncertainties.

Short-term risks – are the days of the cash splash over?

Elections are typically not periods of great fiscal discipline. The risk of accelerating payments growth is real. Already spending is expected to increase by 4.8 per cent in 2018-19, in stark contrast to recent discipline. There has already been media speculation of the possibility of one-off cash payments to parts of the electorate in the April Budget. Surely the days of the cash splash are over – future generations cannot afford them.

At present the budget factors in a 0.6 per cent increase in payments next year. This rate of growth is rare and almost never achieved following an election. In the fiscal year after each of the 17 elections held since 1972 only three have resulted in real payments growth at this rate or slower.

However, the greatest risks in the near term may well come from shifts in economic circumstances. The September Quarter National Accounts reported economic growth slowing through the year, uncertainty around the outlook for economic growth in China has grown, and the IMF has downgraded its global economic forecasts, calling for governments to start building fiscal buffers. These developments underscore the risks of soft nominal GDP outcomes and tax revenues surprising on the downside.

Restoring trust in fiscal standards

It seems reasonable to conclude that the federal budget is in a stronger position today than it might otherwise have been as a result of fiscal disciplines and processes adopted in the 1990s. These include the adoption of the Charter of Budget Honesty and the regular preparation of an Intergenerational Report (IGR).

When the IGR was introduced it was heralded as an important step in ensuring better understanding and scrutiny of the implications of long-term demographic trends and the ability of federal budgets to withstand and respond to these pressures.

Over time, however, the quality of the IGR reports has diminished, and some have argued that the IGR could be improved and broadened to deliver a more robust assessment of the intergenerational equity and sustainability of fiscal policy.

Taking account of declining trust in governments more broadly and the confidence-sapping impact of significant repeated revisions to core budget projections, the time has come to bolster important elements of Australia's existing fiscal frameworks.

Fiscal frameworks

- governments adopt and maintain explicit rules to keep payments growth below GDP growth in all but the most exceptional circumstances;
- the Parliamentary Budget Office (PBO) be tasked with preparing a report every five years on the effectiveness and sustainability of fiscal strategies in light of prevailing economic and fiscal conditions, including analysis of adherence to these strategies;
- the independence of the IGR be demonstrably reasserted by shifting responsibility for its preparation to the PBO; and
- the PBO formally review and report on the robustness of the frameworks and models used to prepare the IGR and evaluate scope for improvement.

Our federal system of government means long-term fiscal trends in the states impact on Commonwealth Government policy and its fiscal position. It is also often the case that reforms deliver savings at one level of government but impose costs at another. These interdependencies must be made central considerations in federation-based reform. This requires a whole-of-federation intergenerational report.

PBO and whole-of-federation IGR

CEDA supports previous recommendations that the PBO be tasked with preparing an enhanced whole-of-federation IGR.

A whole-of-federation IGR could draw on the framework established by the Productivity Commission's *An Ageing Australia: Preparing for the Future* research paper in 2013 and the New South Wales Government's intergenerational report. Preparation of such a report would require careful collaboration with state departments of treasury.

Additional resourcing for the PBO would need to be provided.

Wanted: a culture reset

Spending discipline is critical to sustainability of the federal budget, particularly in the face of structural spending pressures.

Yet it seems the accepted wisdom is to kick the can down the road for the next generation. Tax reform, health reform and redesigning spending programs are all in the too-hard basket, by common consent.

Without a culture reset, soon added to that basket will be population ageing, the rising incidence of chronic disease and mental health issues and technological changes.

Ad hoc responses highlight a serious issue, which we are seeing at present in aged-care, where it is expected that the Royal Commission will expose higher needs, but where the advance response has been to introduce a bit more ad-hoc spending.

Adherence to fiscal rules will assist. But far more important is robust program analysis and evaluation. This is critical to ensuring scarce taxpayer dollars are well directed to areas that deliver the greatest net benefit.

Unfortunately, there are signs that there is not a strong culture or expectation of regular, robust program evaluation at the federal level.

The lack of systematic evaluation in the Commonwealth Government was starkly illustrated by the Productivity Commission's estimate that just 34 of 1000 Indigenous programs have been properly evaluated. This is a shocking finding given the amount of spending directed to these programs coupled with the unsatisfactory outcomes, as evidenced by the failure to achieve key policy targets such as those outlined in the Prime Minister's annual Closing the Gap report.

The health sector provides many examples that suggest the focus on evaluation, and action in response to it, is inadequate. Australia has an Atlas of Health Care Variations – which details evidence of medical treatments that are of little or no value, and not cost effective. Despite this valuable public information there has been no consistent action to respond to it, by challenging the ongoing funding of low-value treatments.

There has also been a watering down of institutions to collect and report on data that would support better evaluation in the health system. The National Health Performance Authority previously had accountability for preparing comparative data on the performance of the health system in accordance with the COAG Performance Accountability Framework. It was abolished as a budget saving measure in 2016. The reporting functions of the Authority were transferred to the Australian Institute of Health and Welfare, the Australian Commission on Safety and Quality in Health Care and the Department of Health. This has reduced ease of access and transparency, and therefore accountability.

Expecting governments (or for that matter other stakeholders) to better prioritise spending and resource allocation is impossible in the absence of an evaluation culture and enabling processes and practices. But embedding the required culture, discipline and capabilities has proven difficult.

Five year reviews for Commonwealth funded programs

To rebuild discipline in program evaluation, the Commonwealth Government should legislate the regular review of *all* Commonwealth funded programs, with programs to be reviewed at least every five years. Evaluations should be conducted by the Department of Finance with the line department or agency responsible for the program. The legislation should require that all evaluations be made publicly available, promptly after their completion.

Achieving more bang for the budget buck

While spending discipline and accountability are important, in reality the greatest gains to long-term budget sustainability are likely to be delivered through innovation in policy and human service delivery.

How to drive such innovation is the focus of considerable activity and interest in how to build relevant capabilities in the public sector and how to better use data and technology. Yet there is an area of reform that is being overlooked – the extent to which states are being hamstrung by federal funding arrangements and agreements.

There is growing recognition of the efficacy of place-based approaches to service delivery and the need for innovation and flexibility in response to complex and evolving needs. Despite this, federal funding agreements have become increasingly prescriptive in terms of outcomes sought and the way those outcomes are to be delivered. This is a significant area of micro-economic reform that is being overlooked. It also undermines the spirit of reforms to the intergovernmental agreement on federal financial agreement made a decade ago.

Realignment of federal-state financial relations

COAG should re-commit to the original ambitions and objectives of the Intergovernmental Agreement on Federal Financial Relations. As a first step, the number of funding agreements should be consolidated and agreements that are being re-negotiated should be assessed for their alignment to the IGA's principles and the capacity to support innovation in service delivery.

In line with re-invigorating the financial principles underpinning the federation, it is also time to put serious health reform back on the table at COAG.

Sustainable government budgets will not be realised without getting health system redesign right. With Governments collectively spending \$124 billion on health, programs of continual improvement cannot be put off if we are to make government budgets robust in the future. Done properly, it will also deliver better health outcomes for the community.

If Australian Government health spending grew at 3.1 per cent a year rather than the 3.6 per cent envisaged in the Intergenerational Report, spending on health would be one per cent of GDP less in 2054-55 or around \$18 billion in today's terms. The Productivity Commission estimates that health reform could save \$140 billion over 20 years.

Putting **health reform** back on the table

COAG should put a serious program of health system reform back on the table. Useful starting points for such a program would include developing an architecture for patient-centred care, boosting performance information and transparency, defunding low-value health interventions and enhancing integrated care through Primary Health Networks and Local Hospital Networks.

The government should not wait for these larger reform frameworks to be fixed before pursuing better value for money. There are savings opportunities that have been long identified but never fully realised when it comes to Australia's Pharmaceutical Benefits Scheme (PBS) and industry assistance.

Through price disclosure and other reforms, some progress has been made in improving the value for money in pharmaceuticals but there is a need to keep up the momentum. Similarly, there has been some progress in better targeting the \$5.3 billion of annual budgetary assistance to industry, but uncertainty remains as to whether it is going to businesses who genuinely need it and invest it in beneficial activity they would not otherwise undertake.

Reviewing the PBS and industry assistance

In pursuing savings in upcoming budgets, the government should:

- Seek to apply the principles of means testing and additionality to all budgetary assistance to industry. This would ensure that payments are incentivising:
 - those companies who genuinely require assistance ('capacity test'); and
 - activities with an economic benefit that a company would not otherwise undertake ('additionality test').
- Reinstate reporting against PBS price disclosure savings targets and accelerate further savings including through greater use of international benchmarking in price negotiations.

A taxing agenda

Advancing substantive tax reform in Australia has proven to be a vexed issue. But reconfiguring and shoring up the Commonwealth Government tax base in the years ahead will be central to achieving long-term budget sustainability.

Evidence from a range of sources confirms that Australia's tax system is costly and complex and much more reliant on tax bases that have significant economic costs including taxes on labour and capital than other advanced economies. This is particularly so now, with surging personal income and company tax receipts driving budget improvement. At the same time, tax bases on consumption (including the GST), which have a lower economic cost are narrowing.

Despite steps by the government to lower the burden of personal income tax, it is still expected to increase as a proportion of GDP over the next decade. All income quintiles will still have increasing average tax rates as a result of bracket creep, with income earners in the second and third quintiles hardest hit.

On the corporate side, Australia's relatively high statutory corporate tax rate among advanced economies has been well publicised. Recent OECD analysis also confirms that Australia has high effective tax rates with Australia ranked in the top 10 for highest effective tax rate out of 74 jurisdictions. Yet, at a time when productivity growth is both elusive and necessary, Australia has failed to generate ideas that vary tax bases in favour of investment, productivity and economic activity.

In the absence of an agreed plan to make Australia's corporate tax regime more competitive, a stopgap is necessary to improve incentives for new investment in Australia. Tax allowances for new investment are the most logical step to address high effective rates of tax without a cut to the statutory rate or reconfiguring the corporate tax system completely.

While the preferred course of action on tax is more substantial reform, Australia's track record over the past decade suggests a more pragmatic approach must also be contemplated.

Addressing bracket creep and the corporate tax rate

As the budget position improves and there is fiscal capacity to do so, the Commonwealth Government should take steps to reduce the negative economic impacts of taxes on labour and capital. It can do this by:

- continuing to address bracket creep through further targeted personal income tax relief focused on lower and middle income earners most impacted by increasing average tax rates;
- providing more generous allowances for new investment in the corporate tax system, in absence of an agreed plan for reducing the current corporate tax rate.

Shoring up the tax base

To this end, the following options should be given priority in any future decisions to shore up the tax base:

- Limiting work-related expense deductions to broaden the personal tax base and simplify administration and compliance.
- Reducing the capital gains tax discount, to take account of the changed inflationary environment and reduce the distortionary impact it has across different asset classes.
- Moving to more uniform volumetric taxation of alcohol, which would simplify the system, broaden a relatively efficient consumption tax base and better target the social costs of alcohol use.
- Removing dividend imputation refundability to address equity and sustainability concerns with the increasing number of Australians utilising concessional tax treatments in retirement.

Australia still has budget choices

The progress on budget repair made over recent years means that Australia still has enough time and choices to put the country onto a sustainable long-term budget path. But there is no room for complacency – the economic environment is constantly shifting and the demands on the budget are significant.

The government must move decisively to address the issues outlined in this report.

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Why budget repair still matters

The budget remains vital for delivery of services – such as health and education – and infrastructure that is important to Australians. A strong budget provides a buffer against global economic downturn and also provides greater choice about how we address the critical issues impacting our nation.

In 2016, CEDA's Balanced Budget Commission delivered its report *Deficit to balance: budget repair options*. The Commission's report illustrated how a balanced budget could be achieved by 2018–19 with alternative packages of measures.

CEDA was concerned that budget deficits would continue accumulating indefinitely unless taxes increased in lockstep with increased spending, eroding economic strength and political choices.

While the budget position has improved since then, a balanced budget is still at least a year away. A significant task remains to realise continuing budget surpluses and pay down debt, amid slowing global economic growth. If Australia is to avoid budget complacency and make further inroads on budget repair it is necessary to build broader understanding and consensus for why balanced budgets matter.

The budget is critical to our quality of life

The debate on the federal budget over the last decade has often focused on the achievement of a budget surplus as an end of itself. In many respects, this is not surprising. It is the result of a debate in which politicians seek to use the budget to assert their superiority as economic managers, given it is the most significant macroeconomic lever under their control.

What is often lost in the political debate is that the budget is the means for achieving critical socioeconomic objectives rather than being an end of itself. The *Charter of Budget Honesty Act 1998* is clear that "...fiscal policy is to be directed at maintaining the ongoing economic prosperity and welfare of the people of Australia..."¹

Meeting this objective on a sustainable basis is undermined by a weak budget position. Australia has experienced 10 consecutive years of fiscal deficit, accumulating net debt of over \$340 billion, with a current annual net interest bill of \$13 billion.²

Budget repair remains vital to reliably underpin Australians' quality of life. This requires:

- funding Australia's social compact through the provision of adequate social security and welfare, health, education and other services fundamental to a safe and productive life
- maintaining intergenerational equity by ensuring that the government is not financing current consumption at the expense of future generations
- having the capacity to buffer economic shocks as necessary through the application of targeted fiscal stimulus
- contributing to productive capacity including targeted investment in skills and infrastructure
- doing all of this with a tax base that raises enough revenue, without unnecessarily discouraging saving, investment, innovation and work.

Funding Australia's social compact

The community continues to place a high priority on Australia's social compact and the provision of services and supports that underpin that compact, as evidenced in CEDA's *Community Pulse 2018: the economic disconnect*. The federal budget reflects this importance. Almost 60 per cent of expenditure today is devoted to social security and welfare, health and education, up from under 50 per cent three decades ago.³

Budget repair is critical to reliably fund Australia's social compact in the future. The net interest expense of the Commonwealth Government's debt highlights the extent to which debt and deficits weaken the capacity to maintain this compact and improve it. Current annual interest expenses on net debt are equivalent to the annual cost of the Pharmaceutical Benefits Scheme (PBS).

Maintaining intergenerational equity

As long as the government runs continuous deficits during a period of sustained economic expansion, it is financing current consumption at the expense of future generations. Future generations will pay not only part of the bill for today's spending but also the interest accumulated on that bill. The Charter of Budget Honesty suggests that sound fiscal management requires policy decisions to have regard to the financial effects on future generations.⁴

In principle, each generation should be contributing as much to the budget as it receives over a lifetime. It is possible for each generation to take more than it receives, but this requires rapid increases in incomes. As highlighted in CEDA's 2018 research, *How unequal? Insights on inequality*, Australia has experienced unprecedented rises in income over recent decades benefiting younger Australians in particular. But this was built on a once-in-a-generation mining boom and historically high rates of productivity growth. The future requires prudent vigilance to keep intergenerational budget inequity in check.

Buffering economic shocks

Economic shocks can have harmful and prolonged impacts – long-term unemployment, deep collapses in asset prices and spiralling government debt levels. All of these can reduce wealth and income for individuals and exacerbate inequalities across generations. Australia has been very effective at minimising the impact of economic shocks over the last three decades. Fiscal policy will have an important role to play if this is to continue.

It is not possible to predict the timing and nature of economic downturns. What we do know is that historically an economic downturn has occurred around once a decade. Such downturns have resulted in cumulative deficits of over 10 per cent of GDP.⁵ This includes both the impact of targeted stimulus and the impact of 'automatic stabilisers' as particular revenue and spending items that are sensitive to the economy adjust – for example reduced income tax and increased welfare spending.

It is therefore prudent to build up a strong budget position to withstand an economic downturn. The IMF has recently called on governments to strengthen fiscal buffers in line with global economic uncertainty.⁶ Australia entered the Global Financial Crisis in surplus and with a strong balance sheet free of debt. While it is possible Australia will be in surplus the next time there is an economic downturn, it will almost certainly not have a balance sheet free of debt.

Building productive capacity

A strong budget position is also necessary for governments to invest in the productive capacity of the economy. That is, programs that maintain and enhance the country's stock of public infrastructure, as well as the skills and education of Australia's workforce.

Having a robust and efficient tax base

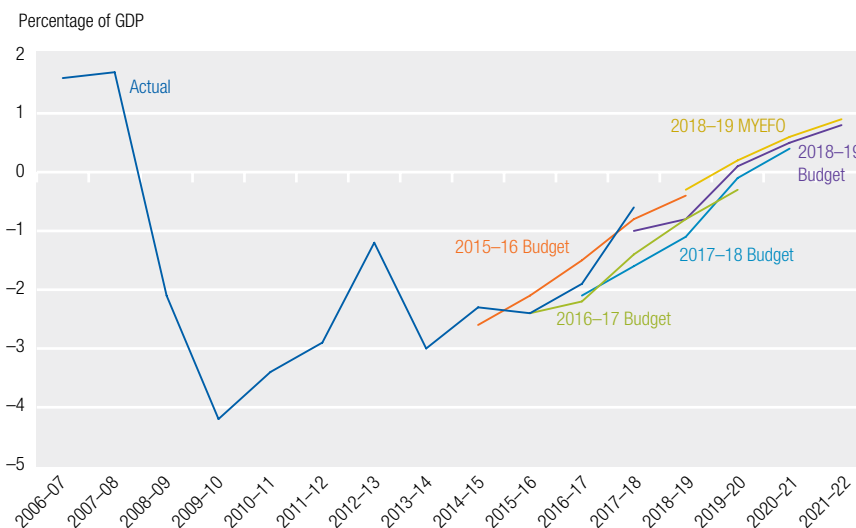
Meeting these objectives sustainably over time requires a fit-for-purpose tax base. The tax base needs to raise enough revenue to meet expenditure needs now and into the future. This should be achieved with a tax base that is as efficient as possible – it should not impede decisions to save, invest, innovate and work.

Current budget status – prepared or precarious?

How has the budget position changed?

Since CEDA's *Deficit to balance: budget repair options*, published in March 2016, the actual budget position has improved, with a surplus now in sight as evident in Figure 1.1. It also shows that the forecast budget position

FIGURE 1.1
UNDERLYING CASH BALANCE (PERCENTAGE OF GDP)



Source: Commonwealth Budget Papers.

deteriorated in subsequent budgets until the 2018–19 Mid-year Economic and Fiscal Outlook (MYEFO), where it has finally returned to a forecast path that continues the envisaged path to surplus from the 2015–16 Budget.

CEDA's 2016 report based its proposals on the aspiration of a one per cent of GDP improvement in underlying budget balance in 2018–19. This was underpinned by a spending limit of 25.5 per cent of GDP, matched by revenue at 25.5 per cent of GDP (tax revenues of 23.9 per cent of GDP and non-tax revenues of 1.6 per cent of GDP).

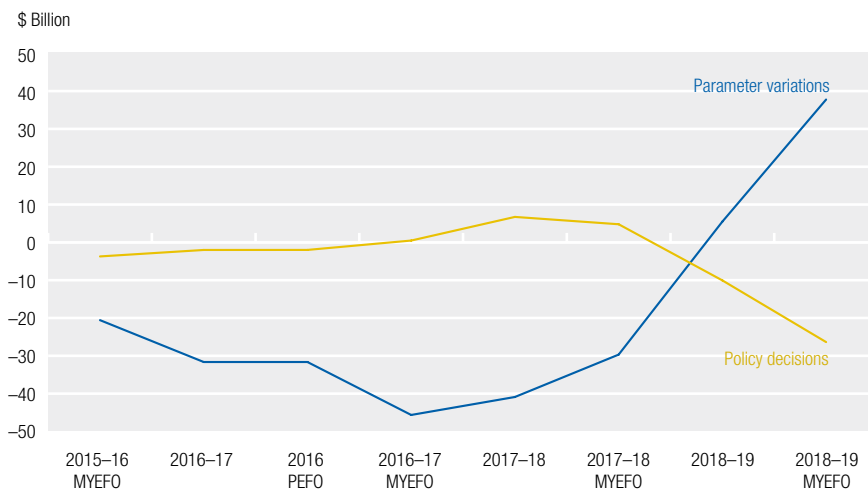
Against this aspiration, the 2018–19 MYEFO suggests that the estimated 2018–19 budget position has fallen short. It has improved by 0.4 per cent of GDP, with a small deficit of 0.3 per cent expected in 2018–19, before a surplus in 2019–20. Revenues are not projected to reach 25.5 per cent of GDP until 2021–22, but the budget is currently well under the spending limit (24.9 per cent of GDP).

What's driving the improved position?

The improvement in the bottom line is explained by the government's fiscal restraint over previous budgets and more recently improvements in corporate health and economic growth. These more recent improvements have pushed tax receipts higher and payments lower without the need for greater policy intervention.

Tracking the cumulative net impact of parameter variations and policy decisions across the four years in each budget (Figure 1.2) gives a running score of how the economy and other factors outside the control of government are impacting the budget and how the government is responding with its policy decisions. It shows that on a net cumulative basis since CEDA's 2016 report, parameter variations have driven an almost \$38 billion improvement in the budget position, while policy decisions have cost the budget over \$26 billion.

FIGURE 1.2
NET IMPACT ON BUDGET BALANCE (\$B)*



Source: CEDA calculations based on Commonwealth Budget Papers. *Calculated on a cumulative rolling four-year basis in each Budget document. Excludes net Future Fund earnings.

Since the 2018–19 Budget, policy has broken out of its straight jacket. The government has loosened the purse strings as actual budget outcomes came in ahead of budget estimates and there was a major upgrade in tax revenue forecasts.

The government has introduced tax relief in the form of personal income tax cuts (\$13.4 billion⁷) and accelerated small business tax cuts (\$3.2 billion). It has also provided additional GST payments to the states (\$4.7 billion), and new spending on hospitals (\$1.3 billion) and schools (\$1.2 billion). There is also another \$9.2 billion of decisions taken but not announced which have been provisioned for in MYEFO, the majority of which is believed to be tax relief.

Prior to this, the net budgetary impact of government policy decisions was slightly positive. During this period, new expenditures were largely being offset by savings in other areas or government decisions to increase revenues. This occurred alongside continuing downgrades in tax revenue forecasts.

There has been only limited take-up of the 20 potential revenue and expenditure measures canvassed by CEDA in 2016. Of the 20 measures canvassed:

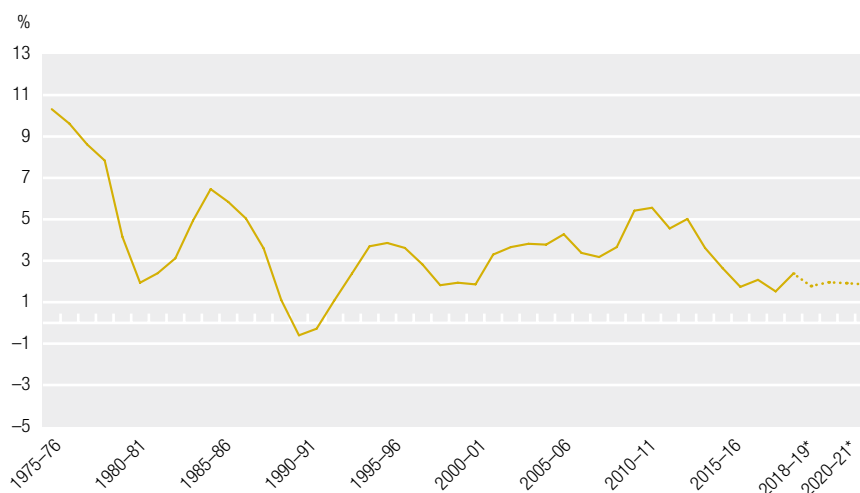
- A quarter have been implemented (either partially or fully), including increasing tobacco taxes, reducing concessional superannuation contributions, savings in the PBS and Medicare Benefits Schedule (MBS), along with an increase in the higher education efficiency dividend.
- Half have not been implemented or adopted in any form.
- A quarter have been adopted by the Opposition as policy in some form.

It is difficult to ascertain the full net budget impact of measures implemented as some savings have been reinvested within the same program area or grouped with other savings. CEDA's estimates suggest about \$9.2 billion of reported improvements have been realised.⁸ Further details on the measures are provided in Appendix I.

Recent trends in expenditure

As Figure 1.3 below demonstrates, expenditure has been on a relatively tight leash and the government is to be commended for this discipline. In recent years, the budget has seen the lowest levels of average growth in payments for some decades. Real payments growth has been averaging under two per cent, which has generally been a yardstick for expenditure discipline. It is important to note, however, that expenditure is expected to increase by 4.8 per cent in real terms in 2018–19 driven by new spending measures and timing shifts.

FIGURE 1.3
REAL PAYMENTS GROWTH (PERCENTAGE, ANNUAL 5-YEAR ROLLING AVERAGE)



* 2018–19 onwards relies on budget estimates and projections.
Source: CEDA calculations based on Commonwealth Budget Papers.

The recent restraint in spending growth is evident in the major programs outlined in Table 1.

TABLE 1
RECENT EXPENDITURE GROWTH IN MAJOR SPENDING PROGRAMS

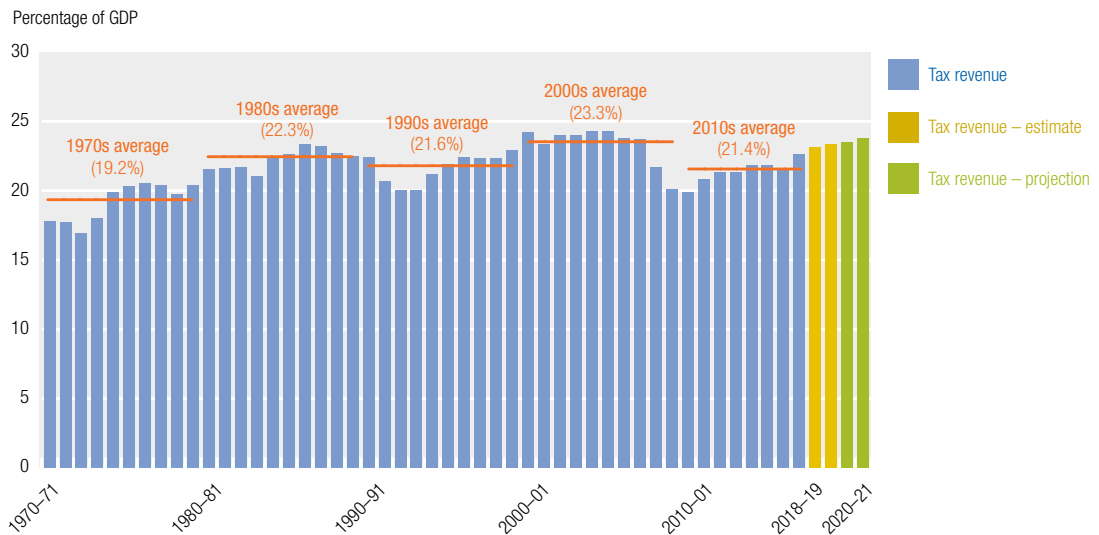
Area of Expenditure	Proportion of expenditure (Percentage 2017–18)	Average annual real growth (Percentage decade to 2013–14)	Average annual real growth (Percentage since 2014–15)
Age pension	10	4.4	1.6
Medicare	4	5.6	3.4
Disability pension support	4	5.1	-1.1
Carer income support	2	9.5	3.3

Source: CEDA calculations based on PBO, 2018–19 Budget: Medium-term projections.

Policy changes and restraint over the last decade have played a role in slower spending growth across these programs.⁹ For example:

- The age pension assets test taper rate has been doubled from the start of 2017, constraining eligibility.
- Extended Medicare safety net benefit caps have been in place since 2010, there have been no new large additions to the benefits schedule and the indexation for some benefits has been frozen.
- There have been substantial changes to assessment processes for the disability support pension including for work-related impairment and job capacity.
- There have been very few policy changes to carer support payments since 2009.

FIGURE 1.4
TAX REVENUE (PERCENTAGE OF GDP)



Source: CEDA calculations based on Commonwealth Budget Papers.

Recent trends in revenue

Since 2017–18, this expenditure restraint has been accompanied by a substantial lift in tax revenues, as evident in Figure 1.4. In 2017–18, tax revenue reached levels not seen since the Global Financial Crisis with continued increases expected across the forward estimates, just shy of the government’s tax to GDP cap of 23.9 per cent by 2021–22. Surging corporate tax revenues in 2018–19 and the abandonment of the government’s enterprise tax plan are helping to lift tax revenues higher faster, along with continuing growth in personal income tax receipts.

How secure is the budget position today?

While the recent improvement in the economic outlook and upgrade to revenue forecasts is a positive development, securing sustainable budget balance is hardly assured. As always, the budget position is highly susceptible to the economic cycle. It is also susceptible to the impact of election promises in 2019.

Current risks to the budget position

Just as revenues have benefitted from an improvement in the economic outlook, they are also likely to weaken if the economy slows down.

The September 2018 Quarterly Accounts released after MYEFO showed economic growth slowing at 2.8 per cent through the year, compared to 3.4 per cent the previous quarter. This comes amid the release early this year of slower global growth forecasts from the IMF and others.

Australia's company tax base is very sensitive to economic conditions and remains highly dependent on the fortunes of a small number of Australian companies.

For example, in 2016–17 the four major banks and two major miners accounted for a quarter of company tax revenue. Bank profits have been falling and mining profits will remain highly dependent on global commodity prices. A US\$10 per tonne reduction in the iron price over a year would reduce tax receipts by almost \$5 billion over two years.¹⁰

After the 2018–19 aberration from recent expenditure discipline, real payments growth is expected to drop back to just 1.1 per cent on average to 2021–22. Holding revenue constant, if this was to increase to 1.5 per cent this would be enough to wipe over \$16.5 billion from the underlying budget balance over the forward estimates and place the 2019–20 budget surplus at risk.¹¹

The risk of faster payments growth in an election year is real. At present the budget factors in a 0.6 per cent increase in payments in 2019–20. This rate of growth is rare and almost never achieved in the fiscal year following an election. In the fiscal year following each of the 17 elections held since 1972 only three (2014–15, 1988–89 and 1978–79) have resulted in real payments growth at this rate or slower.

The Commonwealth and states are also continuing to negotiate a new National Health Reform Agreement for 2020 to 2025, which could see higher Commonwealth expenditures than expected.

Box 1 Budget repair strategy

The budget repair strategy is designed to deliver sustainable budget surpluses building to at least one per cent of GDP as soon as possible, consistent with the medium-term fiscal strategy.

The strategy sets out that:

- New spending measures will be more than offset by reductions in spending elsewhere within the budget.
- The overall impact of shifts in receipts and payments due to changes in the economy will be banked as an improvement to the budget bottom line, if this impact is positive.
- A clear path back to surplus is underpinned by decisions that build over time.

The budget repair strategy will stay in place until a strong and sustainable surplus is achieved and so long as economic growth prospects are sound and unemployment remains low.

Source: Commonwealth of Australia. 2018. Mid-Year Economic and Fiscal Outlook 2018–19. p.38.

Budget repair strategy discipline

With these factors in mind, it is natural to question whether policy should be more prudent and restrained in the path towards budget surplus. The government's budget repair strategy (Box 1), which is part of its overall fiscal strategy and rules guides the government's pursuit of fiscal consolidation.

On the first requirement that new spending measures will be more than offset by reductions in spending elsewhere within the budget, performance is mixed. New spending measures appear to have been more than offset by savings in more than half of the budgets and MYEFOs since the 2015–16 MYEFO. For the remainder, depending on the interpretation of the strategy it could be argued that positive parameter variations to payments offset the new spending.

Improving the budget bottom line by banking any positive shifts in receipts and payments due to the economy is also a critical foundation of the strategy.

As was evident in Figure 2.2, this impact has been positive since 2017–18. In fact, since this time there has been a cumulative \$83 billion improvement up to the most recent MYEFO. During the same period policy decisions have had a cumulative net negative impact of almost \$27 billion. Therefore about 68 per cent of these parameter variations have been banked as an improvement to the budget bottom line.

Part of the reason that not all these improvements have been banked is that this fiscal rule comes into conflict with the broader fiscal strategy's tax cap of 23.9 per cent of GDP. The government has argued that if surging revenues were banked to the budget bottom line the government would exceed its tax cap.¹² It has therefore opted for tax cuts.

This highlights the risks and challenges of adhering to such an explicit tax to GDP ratio. As the International Monetary Fund has noted being bound to such a number can lead to cyclical improvements being seen as an opportunity for permanent tax cuts.¹³ The only way of maintaining adherence to both fiscal rules in this situation would be to fund all tax cuts with savings. With spending already growing at such a slow rate, finding savings of this magnitude is likely to be challenging.

This is one example of the vagaries of fiscal strategies and rules, and the challenges of ensuring full transparency and accountability in the fiscal choices that are made to meet them. Another notable example is the commitment to achieve budget surpluses on average over the course of the economic cycle. With 11 consecutive deficits accumulating to over 24 per cent of GDP during a period of continuous expansion, it is unclear how any government will realise the necessary surpluses to now reach this goal.

In order to ensure that fiscal strategies including associated goals and rules are enhancing budget performance, there is a case for independent reporting on the key design considerations for fiscal strategies.

It could also contain analysis of the effectiveness of existing fiscal strategies. This could be achieved through periodic reporting (every five years) by the PBO. The government would still have the autonomy to set and implement its fiscal strategy but the PBO analysis would improve transparency and assist governments in formulating their strategies. Similar proposals have been put forward by the IMF and PC.



Recommendation 1.1

The PBO should be tasked with preparing a report on the appropriate design considerations for fiscal strategies given prevailing economic and fiscal conditions every five years.

Endnotes

- 1 Part 3, Clause 4. Accessed from: <https://www.legislation.gov.au/Details/C2014C00438>
- 2 Commonwealth of Australia. 2018. *Mid-Year Economic and Fiscal Outlook 2018–19*.
- 3 CEDA analysis of various Budget papers – 1998–99 to 2018–19.
- 4 Part 3, Clause 5. Accessed from: <https://www.legislation.gov.au/Details/C2014C00438>
- 5 Commonwealth of Australia. 2015. *2015 Intergenerational Report: Australia in 2055*.
- 6 IMF. 2019. *World Economic Outlook Update, January 2019*, 21 January. Accessed from: <https://www.imf.org/en/Publications/WEO/Issues/2019/01/11/weo-update-january-2019>
- 7 All figures quoted in parentheses are over forward estimates.
- 8 Based on timeframe in which government has reported savings. This is primarily over the forward estimates of budgets but also over five years (PBS changes) and two years (higher education changes).
- 9 PBO. 2018. *2018–19 Budget: Medium-Term Projections*, Report No. 03/2018. Available from: https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Budget_Office/Publications/Research_reports/Medium-term_budget_projections
- 10 Commonwealth of Australia. 2018. *Mid-Year Economic and Fiscal Outlook 2018–19*. p.71.
- 11 Based on simple illustration of 1.5 per cent growth in each of the three years to 2021-22, compared to current expenditure growth rates. Different expenditure growth scenarios across the year averaging 1.5 per cent could result in lower or higher deteriorations in budget balance.
- 12 Kehoe, J. 2018. 'MYEFO 2018: There's a big risk to pre-election tax cuts', *Australian Financial Review*, 17 December. Accessed from: <https://www.afr.com/news/economy/myefo-2018-theres-a-big-risk-to-preelection-tax-cuts-20181217-h19741>
- 13 IMF, February 2019: Australia selected issues, IMF Country Report No. 19/56.

two

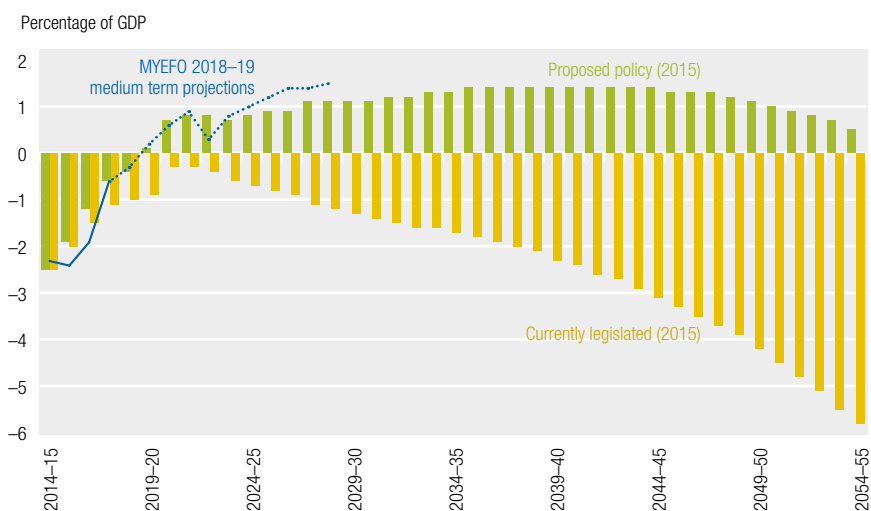
The long-term budget position

There are areas of pressure on Australia's fiscal position, including expenditure on health, education and aged care, while other areas are at unsustainably low levels such as Newstart. Increased transparency will be key to better long-term decision making on these key areas.

How to assess the long-term position?

On the face of it, the medium-term projections in 2018–19 MYEFO or the ‘proposed policy’ scenario in the 2015 Intergenerational Report (IGR) could give the impression that the budget is finally out of the woods. But such optimism is not warranted yet.

FIGURE 2.1
UNDERLYING CASH BALANCE (PERCENTAGE OF GDP)



Source: 2018–19 MYEFO and 2015 Intergenerational Report.

The ‘proposed policy’ scenario in the 2015 IGR is no longer relevant on the basis that its key policy assumptions do not hold. For example, the government did not proceed with revised indexation arrangements for school and hospital funding agreements with the states and territories, that would have reduced payments by \$80 billion by 2024–25. Similarly, the government did not proceed with the decision to increase the pension age to 70 by 2035. Instead it will only increase to 67.

This then raises the question of how the medium-term projection and ‘currently legislated’ scenario in the intergenerational report differ and whether the medium-term projections imply a fundamentally different path will emerge in the 2020 Intergenerational Report.

The key points of difference between the two projections are on economic growth and expenditure are highlighted in Table 2.1.

TABLE 2.1
FISCAL ASSUMPTIONS AND RECENT PERFORMANCE

	MYEFO projections to 2028–29	Intergenerational Report 2015	10-year historical average	2017–18 Result
Economic growth (Real GDP growth p.a.)	2019–20 to 2024–25: three per cent 2025–26 to 2028–29: 2.75 per cent	2.8 per cent	2.6 per cent	2.8 per cent
Tax Revenue (percentage of GDP)	23.9 per cent from 2025–26	23.9 per cent from 2020–21	21.5 per cent	22.6 per cent
Expenditure	Starting point: 24.5 per cent of GDP Growth: two per cent p.a. to 2021–22 and under 2.5 per cent p.a. from 2022–23 to 2028–29	Starting point: 25.9 per cent of GDP Growth: 3.1 per cent p.a.	Level: 25 per cent of GDP Growth: three per cent p.a.	Level: 24.5 per cent of GDP Growth: 1.1 per cent p.a.

Source: 2018–19 MYEFO and 2015 Intergenerational Report.

The MYEFO projections have the economy outperforming at three per cent growth over the next few years before returning to 2.75 per cent, which is more in line with the IGR's long term assumption of 2.8 per cent.

The IGR starts with the base of prevailing economic conditions in 2015, but uses trend growth rates over the long term based on population, participation and productivity. Given Australia's demographic headwinds, the only way for the economy to grow above trend on a prolonged basis over the decades considered in the IGR would be stronger sustained productivity growth. The IGR assumes 1.5 per cent annual productivity growth, which is broadly in line with Australia's experience over the last two decades, but higher than the sluggish performance in the last decade.

The biggest point of difference is on expenditure. The level of government expenditure has come down markedly since 2015, from 25.9 per cent to 24.5 per cent. This has been achieved through slower growth of payments driven in part by policy changes legislated since 2015 and expenditure restraint, which is projected to continue in the MYEFO projections.

The IGR starts from the higher level of expenditure in 2015 and grows at a higher rate that is in line with historical experience. It projects spending from the bottom-up, by assessing how spending per person is likely to evolve for different age groups based on current policy. It then uses the expected age structure of the population over time to calculate total spending.

We can confidently predict then that the starting point for the budget position in the 2020 IGR will be better. But whether this better starting position holds depends on how resilient current policy settings are to the changing demographics over the next 40 years. If the result is sustained periods

where expenditure growth outpaces economic growth (as is the case in the current IGR), then the budget will inevitably slip back into sustained deficit and associated debt, rendering current policy settings unsustainable over the long term.

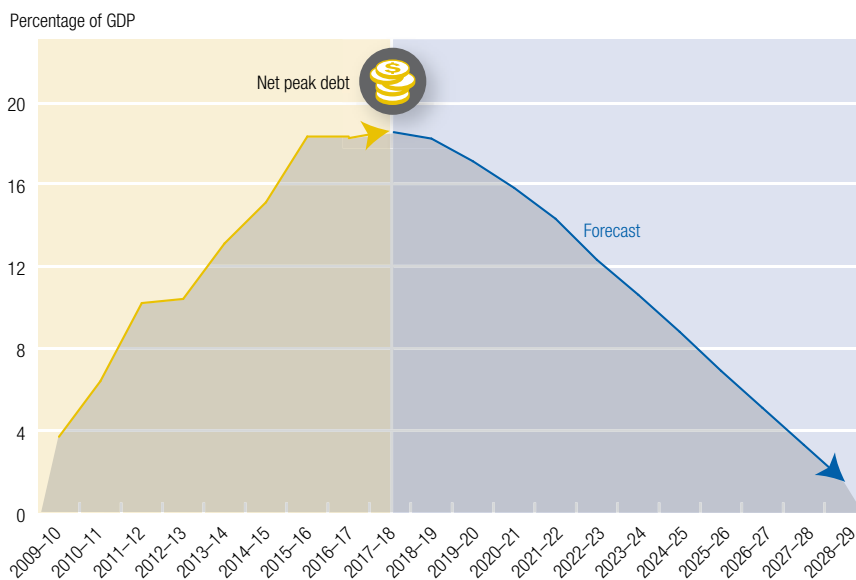
Debt reduction

Once the Commonwealth Budget emerges from deficit, the budget repair task will be to pay down debt as quickly as possible. It is important that rising debt interest does not constrain the spending choices available to Australian governments in future budgets.

It is important to put Australia's level of government debt into context. Australia's level of government debt as a percentage of GDP remains low compared to many other advanced economies. But this does not mean that Australia can be complacent. It has to keep government debt under control to retain flexibility to respond to global economic shocks, particularly in light of deteriorating global economic growth and the IMF's call for countries to build up fiscal buffers. In addition, it is important to note that Australian households do not have the same flexibility to respond, in light of Australia now having amongst the highest rates of household debt in the world.

It is also important to distinguish here between debt that is used to fund recurrent spending and debt that finances major infrastructure projects off budget that have a reasonable return. CEDA's concern is clearly with the former. Nearly two-thirds of the IGR's projected deficit of six per cent of GDP in 2054–55 is public debt interest, underlining the reinforcing spiral of debt and deficit when debt is left to accumulate without action over the long term.

FIGURE 2.2
NET DEBT (PERCENTAGE OF GDP)



Source: MYEFO 2018–19.

Sources of future fiscal pressure

Combining this outlook with the potential fiscal pressures outlined below, there is no room for budget complacency.

The potential risks to the economic outlook, funding gaps that will open up and demand for expenditure that enhances and maintains Australia's social compact suggest a careful balancing act for future governments. They will need to prioritise what matters to Australians and deliver it to those who need it most while making the budget more resilient to intergenerational pressures.

Slower economic growth

One of the most serious threats to the budget as evidenced over the last decade is the unanticipated or underestimated impacts of slower than expected economic growth, particularly on nominal GDP growth and revenues.

In 2017, the PBO modelled the fiscal impact over the medium term of temporary and permanent shocks to the economy. These scenarios are well within the realms of historical experience and would increase the headwinds for budget repair by 0.8 to 1.3 per cent of GDP. The impacts are far less severe than the scenario of a global economic shock leading to temporary fiscal stimulus.

Box 2.1

The impact of economic shocks on the budget

- Under a scenario in which non-mining investment in the economy grows slower than expected leading to temporarily slower GDP growth, this would lead to a cumulative negative impact on the underlying cash balance of about 0.8 per cent of GDP over a decade.
- Recent budgets have assumed that labour productivity will grow at 1.6 per cent annually, in line with its 30-year historical average. A permanent shock of labour productivity growing a quarter of a percentage point slower (in line with the last decade), would result in a cumulative negative impact on the underlying cash balance of about 1.3 per cent of GDP. The net debt incurred over the period would also be about 4.7 per cent of GDP higher.

Source: PBO, 2017–18 Budget medium-term projections: economic scenario analysis.

Health

Under the 'currently legislated' scenario in the 2015 IGR, Australian Government expenditure is projected to increase from 4.2 per cent of GDP today to 5.5 per cent by 2054–55. Contrary to popular belief, most of the projected increase (80 per cent) can be put down to non-demographic factors such as rising income, wage costs, increasing disease rates and technological change.

The projected increase in the level of expenditure implies that health costs for the Commonwealth Government will increase in real terms at an average annual rate of 3.6 per cent. If instead, Commonwealth Government health expenditure grew at a faster annual average rate then this will have significant and growing fiscal consequences. For example:

- If health costs grew at the same rate as they have over the last 10 years for the Commonwealth Government (4.5 per cent¹), then Australian Government health expenditure would represent 7.9 per cent of GDP in 2054–55.²
- If it grew at the rate at which it grew in the five years to 2011–12 (6.7 per cent³) before Commonwealth health expenditure growth began to slow, then Commonwealth Government health spending would balloon to 17.4 per cent of GDP by 2054–55.

This highlights that elevated rates of growth for health expenditure of this magnitude over the long term would lead to reduced spending in other areas, increased taxes and/or prolonged debt and deficit. While growth in Commonwealth health expenditure has been relatively subdued in the last five years with 2.4 per cent real growth on average⁴, returning to historically elevated rates over the long-term is likely to prove unsustainable.

This, of course, does not consider state government expenditure on health. If state governments were to increase their spending at the same rate they have over the last 10 years (4.6 per cent a year)⁵ then their spending would increase from 2.8 per cent of GDP to 5.4 per cent of GDP over the same period. Therefore, if both levels of government grew health expenditure at rates experienced over the last decade, they would be confronting a cumulative funding challenge equivalent to over six per cent of GDP compared to today.

There is little doubt that the community will continue to place a preference on increased spending on health as a proportion of GDP. While there is no determined optimum level of spending, to date Australia's increased expenditure on health has enhanced health and wellbeing, including through increased life expectancy. This contrasts with the recent experience of the United States. The future imperative is that this spending is planned and provisioned for and does not result in waste, including through the proliferation of unnecessary, dangerous or poor-quality care and procedures.

Aged care and age pension

Aged care is expected to be one of the fastest areas of expenditure growth over the next decade, doubling in nominal terms from \$18 billion to \$40 billion and growing in real terms at an average annual rate of 4.6 per cent.⁶ This is broadly in line with the trajectory for aged care spending envisaged in the 2015 IGR.

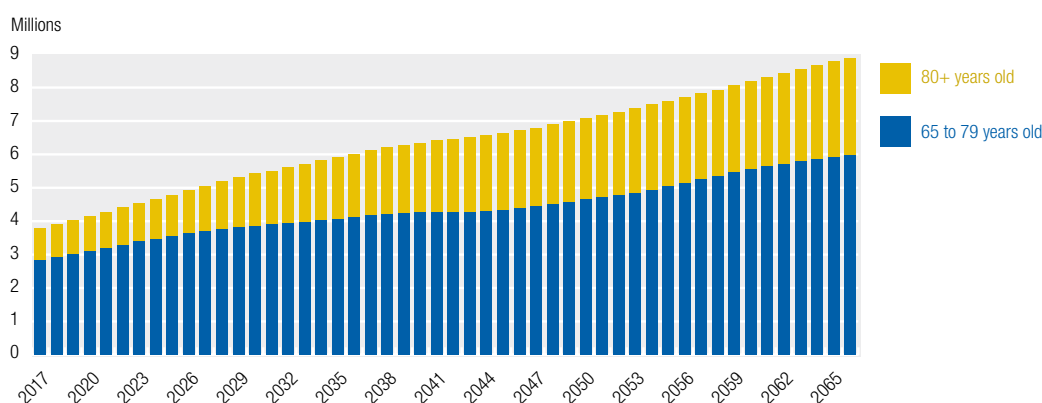
The pressures on aged care spending are only likely to intensify in the medium and longer term, based on community expectations, policy and demographics.

In terms of demographics, 97 per cent of the people who are in residential aged care or receive the Australian Government's Home Care assistance are aged 65 plus.⁷ The average age of admission into Home Care is 80.

As evident in Figure 2.3, the number of Australians aged 65 and over will double by 2066, while the number of Australians aged 80 and over will triple.

CEDA's *Community Pulse 2018: the economic disconnect* underlined the importance that Australians place on government programs to assist the elderly. These expectations combined with the Royal Commission into Aged Care Quality and Safety will likely lead to increased resourcing of aged care to ensure adequate standards of service provision. If this does happen, it could place pressure on both government and non-government sources to increase funding beyond current trajectories.

FIGURE 2.3
PROJECTED POPULATION OF OLDER AUSTRALIANS (MILLIONS)



Source: ABS. *Population Projections, Australia 2017 (base) – 2066*. Catalogue No. 3222.0

As noted in the previous section, there has been less pressure on growth in the age pension following recent changes to the eligibility age and asset test taper rate. This sees the payment growing at a real rate of 2.2 per cent over the next decade.

Education

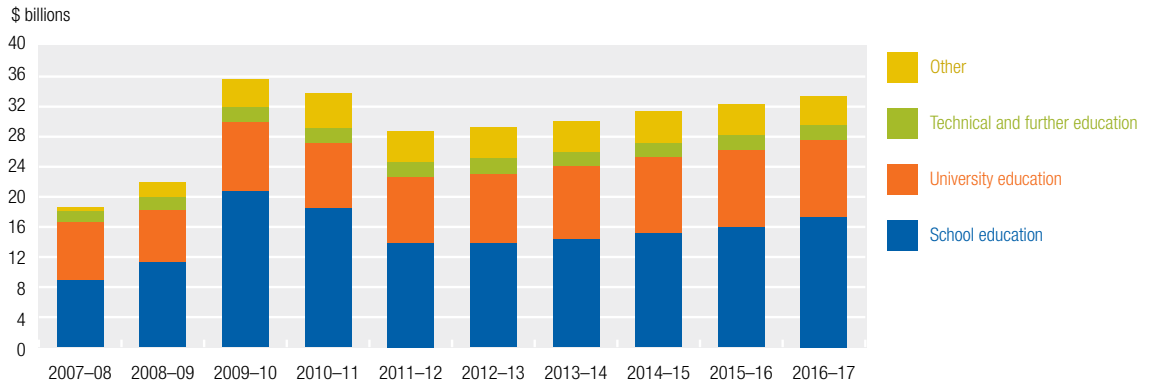
The key question for Commonwealth Government expenditure on education is whether the relatively subdued growth of recent years is sustainable. Expenditure on technical and further education has not increased in real terms over the last decade and the Commonwealth Government announced reductions in spending in the 2018–19 Budget as part of a revised funding agreement with the states. This comes despite recent projections suggesting that Australians will spend a third more time on education and training in the next two decades to keep up with technological change in modern workplaces.⁸

Universities have been subject to a 2.5 per cent efficiency dividend and recent reforms are set to see expenditure decrease in real terms over the forward estimates. The PBO estimates that the Commonwealth Grants Scheme, which subsidises higher education tuition will decrease at an average annual rate of 0.9 per cent to 2028–29.⁹

The story for schools funding has been different with the government retaining the principles of the Gonski model and funding increases above inflation

in the short term. Excluding the additional funding that it is providing for non-government schools, spending is set to increase in real terms at an annual average rate of 2.5 per cent.¹⁰

FIGURE 2.4
COMMONWEALTH GOVERNMENT SPENDING ON EDUCATION (\$B)



Source: ABS, *Government Finance Statistics, Education, Australia, 2016-17*, Catalogue No. 5518.0.55.001

Other social security payments

Other social security payments not already outlined appear to be relatively well contained over the next decade, except for child care, with the impact of the government's new child care subsidy taking effect.

In some cases, both recent expenditure growth and projected growth over the next decade are so low that there is a question of whether it is sustainable in the long term. Job seeker income support is a stark example of a payment where there is a strong case for increasing it, with a resulting cost to the budget.

FIGURE 2.5
GROWTH IN SELECTED PAYMENTS

	2017-18 (% of GDP)	2028-29 (% of GDP)	Annual real growth (%)
Child care	0.4	0.5	↑ 4.5
Carer income support	0.5	0.5	↑ 3
Parenting payments	0.3	0.3	↑ 1.3
Job seeker income support	0.6	0.5	↑ 0.7
Veterans support	0.3	0.2	↓ -4.4
Family tax benefit	1	0.8	↓ -0.4

Source: PBO, *2018-19 Budget Medium-Term Projections*.

Box 2.2

Adequacy of Newstart

The Henry Review of Taxation called for an increase to Newstart in 2010. The rate of Newstart is indexed to the Consumer Price Index, while pensions are generally indexed to average earnings.

Professor Peter Whiteford has shown that if this continues to 2050, as assumed in the most recent Intergenerational Report, by then a single unemployed person will receive a payment of 11 per cent of the average male wage compared to 20 per cent now. Therefore, it is inevitable that unemployment benefits will need to be adjusted to ensure that they are not an entry point to deep and persistent disadvantage and consequently an impediment to entering the labour market.

Over 76 per cent of Newstart recipients have been on the payment for over 12 months. The longer that people are on this low payment, the greater the levels of deprivation experienced resulting in greater economic costs and the likelihood of increased demands on other budget supports.

Deloitte Access Economics has estimated that increasing the level of Newstart by \$75 a week would cost the Commonwealth Government about \$3.3 billion a year – equivalent to 0.18 per cent of GDP. The same analysis shows that an increase would mostly benefit those Australians on the lowest incomes. This is substantially less than the \$135 a week increase that would be necessary to minimise poverty, according to recent modelling by the ANU Centre for Social Research and Methods.

Sources: Whiteford, P. 2014, Adequacy of social security benefits for working age households: a comparative assessment, ANU. Accessed from <http://csrcm.cass.anu.edu.au/sites/default/files/rsss/PeterWhiteford.pdf>

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Phillips, B., Gray, M. and Webster, R. 2018, 'Cut the pension, boost Newstart. What our algorithm says is the best way to get value for our welfare dollars', *The Conversation*, 13 December. Accessed from: <https://theconversation.com/cut-the-pension-boost-newstart-what-our-algorithm-says-is-the-best-way-to-get-value-for-our-welfare-dollars-108417>

Disability funding

The speed and nature of changes being brought about in disability support through the National Disability Insurance Scheme (NDIS) have been described as unprecedented as it aims to rollout a completely new service model to almost 500,000 participants by 2019–20. It will grow from about 0.4 per cent of GDP today to one per cent of GDP in 2028–29, reaching a level equivalent to what the Commonwealth Government spends on schools.¹¹

The experience of the NDIS to date illustrates the tension between meeting demand and getting the service delivery model right. According to the Productivity Commission there has been too much focus on quantity and not enough on quality, supporting infrastructure, market and workforce development in the rollout to date.¹² If this is not resolved over time, this

could result in cost pressure or quality of service concerns for participants. At the same time, the NDIS has been subject to considerable public scrutiny, adding further incentive for governments to get the rollout right and within budget.

Foreign aid

Official development assistance (ODA) has been a regular source of budget savings since 2012 by successive governments. This has seen foreign aid fall in real terms over the last five years.¹³ The most recent PBO projections see it falling in real terms by 0.6 per cent a year through to 2028–29.

The United Nations target under the Sustainable Development Goals is for ODA of 0.7 per cent of Gross National Income (GNI) and in 2013–14 there was a bipartisan commitment to reach 0.5 per cent of GNI. The government subsequently deferred the commitment indefinitely until the budget position improved. Australia currently spends about 0.22 per cent of GNI, placing it 17th in the OECD.¹⁴

If Australia was to increase its assistance back to previous levels of 0.33 per cent of GNI, just above the OECD average this would cost an additional \$2 billion a year in today's terms. Reaching the 0.5 per cent target would cost an additional \$5 billion a year in today's terms.

A number of former Foreign Ministers and international NGOs have highlighted the importance of Australian aid in its role as a 'good global citizen', pushing for an increase towards the UN target to come back on the agenda.¹⁵

Defence

Based on the Defence White Paper and government commitments, expenditure on defence will reach the targeted two per cent of GDP over the forward estimates period. The PBO also sees strong growth of 3.6 per cent a year in real terms until 2028–29.¹⁶

As with any significant ramp-up in spending, this will not come without its risks of further pressures for increased funding. Dr Marcus Hellyer of the Australian Strategic Policy Institute sums up these pressures:

"...the content and timing of Defence White Paper's investment program have not been revisited, despite changes (for the worse) in the strategic environment it was intended to address. Funding pressures are already emerging, with more to come in sustainment and personnel right at the time when a large share of the investment budget is being tied up in shipbuilding."¹⁷

National Broadband Network

The rollout of the National Broadband Network (NBN) is being funded through a \$29.5 billion equity investment and a \$19.5 billion loan from the Commonwealth Government. Equity contributions are funded from the issuance of government debt and therefore do impact the government's underlying cash balance through the cost of public debt interest. The PBO

estimates that interest costs will increase from \$730 million in 2019–20 to \$2.1 billion in 2026–27.¹⁸ These costs are partially offset by interest receipts from the loan component, which are greater than the costs of government borrowing for the loan.

There are a number of potential risks that could lead to a greater than expected impact on the budget over time:

- If the Commercial rate of return for NBN Co falls below 2.5 per cent then equity contributions could be treated as grants, impacting expenditure and the budget balance (on top of existing financing costs).
- If the sale price of NBN when it is privatised is less than the financing cost, then this will result in an ongoing cost to the budget.

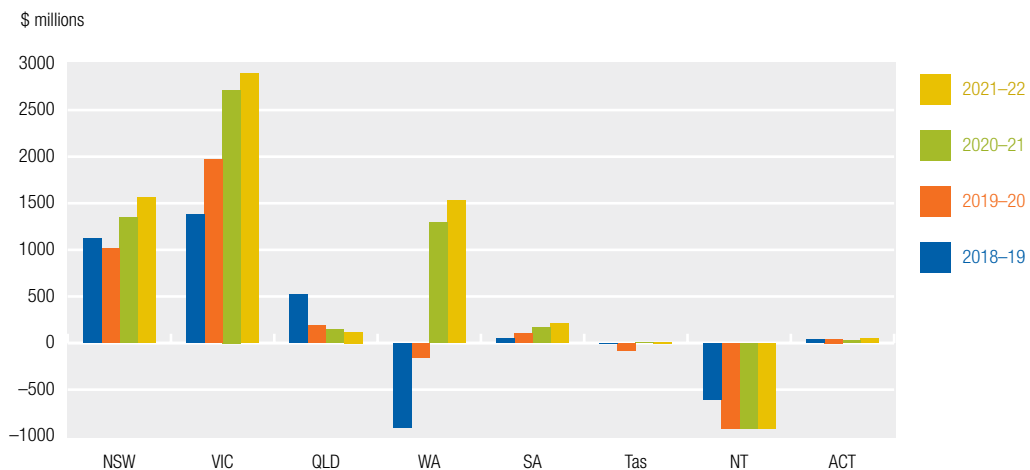
Credit Ratings Agency S&P has suggested that a write-down of NBN is inevitable but the government, on the advice of NBN, has stated that a write-down is not appropriate and that there is confidence that the government’s equity contribution will continue to be treated as equity rather than a grant.¹⁹

These issues highlight the need for constant scrutiny of major infrastructure projects financed off budget. As CEDA observed in 2016, while it is sometimes appropriate to finance such projects off budget, Commonwealth capital spending should be subjected to the same rigorous scrutiny as other forms of spending where possible. Major project spending should only be considered outside of the consensus cap on government spending to GDP where the project’s returns will demonstrably and substantially exceed its costs.

State government budgets

State government budgets are currently in reasonable shape, except for the Northern Territory, as highlighted in Figure 2.6. Western Australia is taking very deliberate steps to bring its budget back to surplus and pay down debt, despite a relatively slow economic recovery since the mining boom.

FIGURE 2.6
STATE AND TERRITORY NET OPERATING BALANCES (\$M)



Source: State and territory budget papers

Despite healthy balances now, there are risks in both the immediate and longer term. State governments remain highly dependent on revenues from stamp duty, which are vulnerable to the current downturn in property markets, particularly Sydney and Melbourne. Stamp duties on conveyances currently account for over a quarter of all state government tax revenue, with this figure closer to 30 per cent in New South Wales and Victoria.²⁰ In Victoria, the Treasurer has acknowledged that the budget position is predicated on a 'short and shallow' downturn in the property market.²¹

State and territory governments also face the same intergenerational spending pressures as the Commonwealth, particularly given that they are responsible for around 40 per cent of government spending on health. New South Wales intergenerational report finds that the state will confront a fiscal gap of 3.4 per cent of Gross State Product (GSP) or \$17 billion a year by 2056 based on current projections.²² Tasmania's Fiscal Sustainability report in 2016 found that the state would experience growing deficits and debt to 2029-30 if it continued on the path of recent expenditure trends.²³

The fiscal fundamentals of Australia's federation have not changed. States and territories raise about one-fifth as much tax revenue as the Commonwealth Government and receive over \$120 billion from the Commonwealth in the form of specific purpose payments and GST payments. It is therefore inevitable that state government fiscal pressures will ultimately be felt at the Commonwealth level. There are opportunities to both improve the transparency of these shared pressures as outlined further in this chapter and to address the efficiency of payments as discussed in Chapter 3.

Improving long-term budget transparency

Under the *Charter of Budget Honesty Act 1998* the next IGR must be publicly released within five years of the last report, making the next report due by March 2020. Almost 20 years since the first IGR, it is timely to review and adjust the reporting framework to ensure that the report remains relevant and effective in meeting its objective of assessing the long-term sustainability of current government policies over the next 40 years. In order to achieve this objective, the report must be as comprehensive, independent and frank as possible in outlining the long-term challenges for the budget.

Opportunities for improvement

When the IGR was introduced it was heralded as an important step in ensuring better understanding and scrutiny of the implications of long-term demographic trends and the ability of Federal budgets to withstand and respond to these pressures.

Over time, however, the quality of the IGR reports has diminished, and some have argued that the IGR could be improved and broadened to deliver a more robust assessment of the intergenerational equity and sustainability of fiscal policy. Based on this, a number of opportunities for improvement are outlined below.

Whole-of-federation

Only focusing on the Commonwealth Government's long-term budget position provides an incomplete picture of the fiscal and demographic challenges facing Australia. State government expenditure amounts to over 14 per cent of GDP, with almost half of this expenditure funded by transfers from the Commonwealth Government.²⁴

In a federation where state governments spend more than they earn from own-source revenue and spend this money in the fastest growing areas like health, the intergenerational report should provide a whole-of-federation assessment. One way or another, long-term fiscal trends in the states will impact on Commonwealth Government policy and its fiscal position. The sooner these trends are understood with clarity, the sooner that policy can adjust to avoid sudden increases in tax or reductions in expenditure.

A whole-of-federation intergenerational report could draw on the framework established by the Productivity Commission's *An Ageing Australia: Preparing for the Future* research paper in 2013 and the New South Wales Government's intergenerational report. It is also clear that the preparation of such a report would rely heavily on coordination through the existing Heads of Treasuries (HoTs) group, comprising of Secretaries of Commonwealth, state and territory Treasury departments.

Assessing intergenerational equity in the budget

While fiscal policy is required to have regard for financial effects on future generations, there is very limited analysis of how the budget is impacting on different generations over the long term. Fiscal strategies over the last decade have committed to budget balance or surplus on average over the medium term or economic cycle, which is one means of seeking to maintain intergenerational equity. However, after 11 consecutive deficits equivalent to 24 per cent of GDP, it now seems impossible for a government to achieve this feat. Assessing the precise implications of this across generations is likely to prove challenging but at least spelling out some of those implications and the policy choices that will be confronted by future governments must be a stronger focus of the report.

Adopting more rigorous scenario analysis

The 2015 Intergenerational Report included three 'scenarios' for the long-term budget position based on: (1) proposed policy, (2) currently legislated and (3) previous policy. The 2010 report also analysed two scenarios for the budget position with and without the then government's two per cent real spending growth cap.

While the projections of such scenarios may prove to be a useful political selling point for the government of the day, there are more informative approaches that could complement these scenarios in testing the long-term robustness of the budget under different economic and demographic conditions.

An alternative or complementary approach would be to undertake scenario analysis, that focuses on the areas of greatest uncertainty for the economy and develops a number of plausible future economic scenarios and how they could impact the budget position. This is different to the approach

in recent reports, which illustrate different rates of change for the budget, based on a single set of economic and demographic projections.

Recent budget performance has underlined the continuing capacity of the economy and its impact on the budget to produce both pleasant and unpleasant surprises for governments and forecasters. The imperative therefore is for fiscal policy to be adaptable and robust in the face of different economic conditions – something which can be tested through scenario analysis.

Emerging funding and revenue pressures

The Intergenerational Report could also analyse societal trends and community expectations for particular government supports and services that are not currently factored into budget forecasts. It would not necessarily need to quantify these pressures but simply provide increased foresight and transparency to assist long-term planning and provisioning.

For example, Commonwealth Government spending on mental health related services increased by an average annual rate of 3.5 per cent between 2011–12 and 2015–16 to reach \$3.1 billion.²⁵ In 2016–17, 2.4 million people received Medicare subsidised mental health services and over four million people received mental health related prescriptions.²⁶

While it is currently a relatively small proportion of expenditure, the prevalence of mental health issues is growing along with community expectations of better services and supports. At the same time the long-term costs of poor diagnosis and management are growing. The 2015 Intergenerational Report included considerable detail on fiscal trends in health and ageing, including expected growth of existing projects but it did not reference mental health. The previous report was also criticised for its limited reference to long-term climate change risks. This highlights the opportunity for future reports to look beyond the current structure of government programs and pressures already having a significant impact on the budget.

Responsibility for delivering the IGR

In addition to enhanced content, there is also a question of who is best placed to prepare the intergenerational report. Regardless of what content is produced, the report would benefit from being produced at greater arms-length from the government of the day. After all, intergenerational reports by their very nature will tend to reflect poorly on the current policies of the day – what is fine today may well be unsustainable in future decades. This is exactly what such reports are designed to do – make the long-term fiscal trade-offs more transparent to influence future policy-making and program design.

The most obvious place to transfer responsibility for preparing the IGR to enhance independence would be the PBO. There are a range of precedents and recent reports supporting such a move, including:

- Similar organisations in the United Kingdom (Office of Budget Responsibility) and the United States (Congressional Budget Office) undertaking such long-term budget projections.²⁷
- The PBO already undertakes regular analysis of the fiscal position of all governments in the federation with its *National Fiscal Outlook* reports and has also undertaken economic scenario analysis.
- The independent review of the PBO led by Dr Ian Watt AC noted that the PBO should build its capacity to analyse the underlying long-term drivers of the budget and that it would be well positioned to take responsibility for the next Intergenerational Report.²⁸
- The Productivity Commission and OECD have also supported moving responsibility for the intergenerational report to the PBO.

CEDA is mindful that changing responsibility for the report and enhancing its content would be an extensive undertaking and may be most sensibly completed through a transitional process across the 2020 and 2025 reports. Adopting any of the improvements canvassed here would require significant additional resourcing, but would deliver significant benefits for fiscal transparency.



Recommendation 2.1

The Parliamentary Budget Office should be tasked with preparing future intergenerational reports. The transition of new responsibility could be undertaken progressively across the 2020 and 2025 intergenerational reports.



Recommendation 2.2

The scope and content of future intergenerational reports should be enhanced to:

- take account of whole-of-federation intergenerational fiscal pressures, in close coordination with Heads of Treasuries (HoT).
- include greater analysis of intergenerational equity issues, more rigorous scenario analysis and analysis of newly emerging funding pressures (as opposed to pressures confined to existing government programs).

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three

Meeting the spending challenge

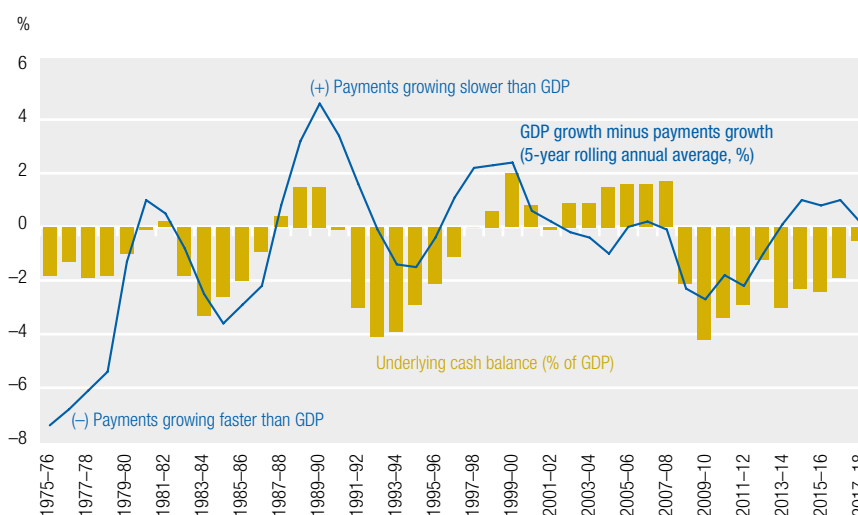
Expenditure discipline is core to having a sound fiscal strategy. Unfortunately Australia has had extended periods of expenditure growth outpacing the economy. Measures in this chapter outline areas where spending could be constrained or better targeted.

Instilling expenditure discipline across the board

Simple budget arithmetic suggests that it is unsustainable for spending growth to outpace GDP growth over an extended period. It is inevitable that payments growth will exceed GDP at the onset of a significant economic shock, including from the impact of short-term stimulus but this should not become persistent.

It is evident from Figure 3.1 that Australia has had substantial periods of expenditure growth outpacing the economy. But the quicker that the gap between GDP growth and payments growth was closed, the faster the budget position improved. Regardless of economic conditions, expenditure discipline should be a core component of a government's fiscal strategy if it is to repair a weak budget position or maintain budget balance over the medium term. It is also a necessary buffer against the impact of uncertain revenue forecasts.

FIGURE 3.1
GDP GROWTH, PAYMENTS GROWTH AND BUDGET BALANCE (PERCENTAGE, REAL)



Source: Commonwealth Budget Papers and ABS, *Australian System of National Accounts*, 2017–18, Catalogue No. 5204.0

Rules to constrain spending growth

Table 3.1 demonstrates that recent fiscal rules on expenditure have been associated with real payments growing slower than the economy. Even where these rules are not strictly met, they provide additional discipline and accountability for governments, with spending growth likely to be lower than what it would have been in absence of any rules.

Budget expert Barry Anderson has highlighted that compared to other fiscal rules, spending rules work best in good times, and they are more transparent, incontrovertible, credible and understandable.¹ For example, the rules above are much clearer and make governments more accountable than rules or ambitions for budget balance over the economic cycle, a cycle which does not correspond with electoral cycles.

TABLE 3.1
RECENT EXPENDITURE GROWTH RULES

Budget years	Spending rules in fiscal strategy	Real payments growth per annum	Change in payments to GDP	Real GDP growth per annum
2009–10 to 2013–14	<ul style="list-style-type: none"> • Hold real growth in spending to two per cent a year until the budget returns to surplus 	2.64 per cent	25.9 per cent down to 25.4 per cent	2.7 per cent
2014–15 to present	<ul style="list-style-type: none"> • Reduce ratio of payments to GDP • Offset new spending measures with spending reductions elsewhere 	1.03 per cent	25.4 per cent down to 24.5 per cent	2.6 per cent

Source: Commonwealth Budget Papers & ABS, *Australian System of National Accounts*, 2017–18, Catalogue No. 5204.0

Australia should, therefore maintain explicit rules for expenditure growth as part of this next stage of budget repair. Such rules should, of course, be cognisant of economic conditions and the impact of automatic stabilisers and the need for temporary stimulus in the event of an economic shock. There will also be cases where expenditure increases significantly in a year as a result of payments associated with structural reform – for example when the government introduced the GST.

It is also important to note that this does not prevent government from increasing spending at a rate greater than economic growth in some program areas, it will simply need to offset this with much slower growth in other areas of government expenditure.



Recommendation 3.1

Governments should adopt and maintain explicit rules to keep payments growth below GDP growth, as part of their fiscal strategy as long as economic circumstances permit.

A culture of evaluation

The lack of systematic policy and program evaluation in the Commonwealth Government was starkly illustrated by the Productivity Commission’s estimate that just 34 of 1000 Indigenous programs have been properly evaluated.² This is a shocking finding given the amount of spending directed to these programs coupled with the unsatisfactory outcomes continually delivered, as evidenced by the failure to achieve key policy targets outlined in the Prime Minister’s annual *Closing the Gap* report.

The health sector also provides many examples that suggest the focus on evaluation, and action in response to it, is inadequate. For example, the

Australian Atlas of Health Care Variations – details evidence of medical treatments that are of little or no value, and not cost effective. A culture of evaluation and response would be expected to deliver the outcome proposed by the Productivity Commission. That is, where there is clear evidence of a lack of efficacy or cost effectiveness, and the circumstances where this occurs can be reasonably specified, treatments should no longer receive public funding. To date such action has not been consistent across governments or the health sector.

There has also been a watering down of institutions to collect and report on data that would support better evaluation in the health system. The National Health Performance Authority previously had accountability for preparing comparative data on the performance of local hospital networks, public and private hospitals, primary health care and other health services organisations in accordance with the COAG Performance Accountability Framework. It was abolished as a budget saving measure in 2016. The reporting functions of the Authority were transferred to the Australian Institute of Health and Welfare, the Australian Commission on Safety and Quality in Health Care and the Department of Health. This has reduced ease of access and transparency, and therefore accountability in this all-important sector.

There is little argument in-principle that systematic policy and program evaluation should be standard procedure across government. But embedding the required culture, discipline and capabilities has proven difficult. Expecting governments (or for that matter other stakeholders) to better prioritise spending and resource allocation is impossible in the absence of an evaluation culture and enabling processes and practices.

CEDA does not consider the establishment of an independent organisation such as an Evaluator-General is enough in and of itself to turn around the current shortcomings in evaluation. Establishing a body to drive leadership in evaluation including using techniques like randomised trials as proposed by the Shadow Assistant Treasurer certainly has merit, but it will not be enough on its own to drive a change of approach across government. In this regard, the Productivity Commission notes that the NSW Government's Centre for Program Evaluation does not appear to have made in-roads into instilling a better evaluation culture in that state.³

It is necessary to integrate program evaluation into government decision-making processes if it is to stick as a business-as-usual discipline. This could be achieved using sunset clauses in the supporting legislation for policy and programs to ensure that an evaluation is conducted before that legislation is renewed. However, this would likely prove administratively burdensome and inefficient for legislative processes.

Alternatively, government could choose to integrate program evaluation requirements into the budget process. For example:

- Initial program funding could be dependent on the submission of an evaluation plan, including how data and evidence will be progressively collected to support an effective evaluation.
- Continued funding of programs could be subject to the successful completion of evaluations (every five years) and action to address any shortcomings identified.

The nature of the evaluation should be proportionate to the size and risks of the program, to ensure that efforts are well targeted. In order to drive transparency and accountability, such evaluations should be made public promptly after completion.

This approach would take the government back to the future, according to the Productivity Commission:

At the Commonwealth level in the decade to the mid-1990s, all budget funded programs were required (by statute) to be evaluated every three to five years, with evaluations integrated into the budget process. This period was associated with extensive evaluation activity (530 evaluation reports were published between 1993 and 1997) and there is at least qualitative evidence that evaluation findings made a substantial contribution to Cabinet debate and the development of policy options.⁴



Recommendation 3.2

To rebuild discipline in program evaluation, CEDA proposes that the Commonwealth Government legislate the regular review of all Commonwealth funded programs, with all programs to be reviewed at least every five years.

Evaluations should be conducted by the Department of Finance with the line department or agency responsible for the program. The legislation should require that all evaluations be made publicly available promptly after completion.

Opportunities for better value for money

As highlighted in previous sections, expenditure growth has been low by historical standards based in part on economic parameters but also on policy decisions. This suggests that future initiatives on the spending side of the budget will be harder won – for example, instruments like efficiency dividends cannot be increased indefinitely. Despite this, short-term opportunities remain to improve value for taxpayers' dollars. Two such opportunities to better target industry assistance and improve the value of Australia's pharmaceutical spend are outlined below.

The largest gains in future are likely to emerge from program redesign – that is fundamentally changing the way in which a service is delivered to improve value for money. The benefits of such reforms are likely to accrue over time and won't necessarily show up as savings in a four-year budgeting period. If they are well executed, then they will result in slower expenditure growth than otherwise would have been the case and better outcomes for the community.

The question for program redesign is where to start. Given the critical role of the states in the largest areas of service delivery expenditure, it is inevitable that COAG will need to play its part to facilitate reform. But this will require innovation, which is severely constrained by the current reliance on tied grants as part of Australia's federal financial relations.

The following section therefore provides a brief outline of two initial priorities that could be pursued to progress critical program redesign. That is, fixing part of Australia's federal financial relations as an enabler for better reform and initial priorities for redesigning Australia's health system.

Better targeting industry assistance

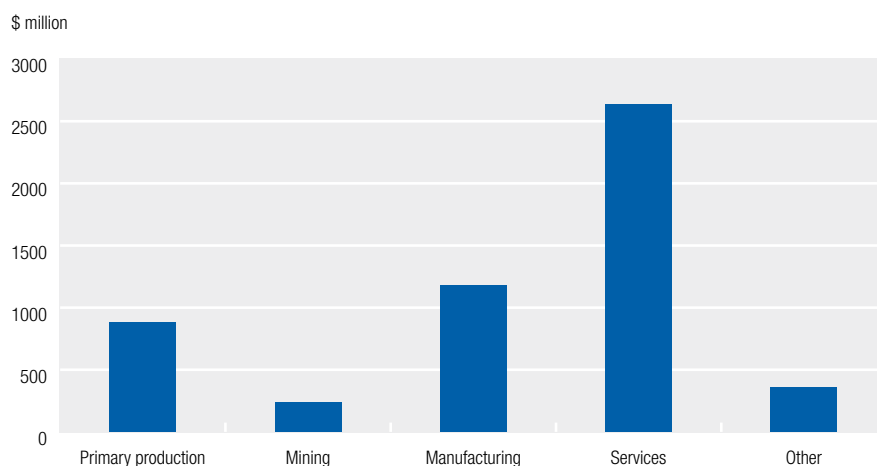
As highlighted in CEDA's 2016 report, there is ample opportunity to reduce budgetary assistance to industry. In 2016–17, the Commonwealth Government provided \$5.3 billion in budgetary assistance to industry.⁵ At a time when the public service and higher education sectors have had efficiency dividends to contribute to budget repair, it seems reasonable for industry to play its part.

Most subsidies now go to the services sector and it is difficult to assess the effectiveness of these subsidies given there is limited evaluation of the programs underpinning them. The government should seek to apply the principles of means testing and additionality to all budgetary assistance to industry. This would ensure that payments are incentivising:

- those companies who genuinely require assistance ('capacity test');
- activities with an economic benefit that a company would not otherwise undertake ('additionality test').

This could be achieved through some form of profitability test. In the first instance the government could target a 10 per cent reduction in budgetary assistance spread as broadly as possible. This is unlikely to cause unmanageable hardship or reduce economic output.

FIGURE 3.2
INDUSTRY ASSISTANCE BUDGETARY OUTLAYS (\$M, 2016–17)



Source: Productivity Commission, *Trade & Assistance Review 2016–17*.



Recommendation 3.3

The government should increasingly restrict access to budgetary assistance to industry to those firms who genuinely require assistance and would not undertake the subsidised activity without it.

Lower Pharmaceutical Benefits Scheme prices

The 2017–18 Budget contained \$1.8 billion in savings over five years under the ‘cheaper medicines’ measure. This expands existing statutory price reductions for PBS-listed medicines.

The government has also until recently reported savings under its price disclosure arrangements in which pharmaceutical companies submit sales information to the government so that it can adjust prices particularly where medicines come down in price due to competition. Over the last two years the government has experienced a \$1.7 billion shortfall against its savings targets for price disclosure and appears to have reduced transparency of achieved savings.⁶ The government should reinstate this transparency measure and accelerate efforts to realise greater savings, including through greater use of international benchmarking in price negotiations.⁷



Recommendation 3.4

The Commonwealth Health Department should reinstate reporting against PBS price disclosure savings targets and accelerate further savings including through greater use of international benchmarking in price negotiations.

Re-fixing federal financial relations

The proliferation of tied grants is one area of fiscal policy that has not received the attention it deserves in recent years. Apart from general revenue assistance through the distribution of the GST, most other grants to the states are payments for specific purposes, with various levels of conditions attached (i.e. tied grants).

At the end of 2008, the Council of Australian Governments (COAG) ushered in “the most significant reform of Australia’s federal financial relations in decades”.⁸ It saw a new intergovernmental agreement (IGA) on federal financial relations designed to reduce Commonwealth prescriptions on service delivery by the states and rationalise the number of tied grants to the states. The intention was to focus on outcomes and facilitate more tailored local solutions.

In the early years of the new IGA there was significant progress, including the consolidation of 90 funding agreements into six national agreements in fundamental areas like health and education.

There were also new National Partnership Agreements, which were aimed at facilitating specific reforms – e.g. achieving more consistent national regulatory outcomes.

Today, there is broad consensus that the implementation of the revised arrangements has fallen short of the original ambition. There has been a proliferation of funding agreements, continuing prescriptions on service delivery and associated administrative burden across governments.

Based on CEDA’s analysis of the current list of agreements⁹, there are currently:

- two national specific purpose payments
- five national agreements
- 76 National Partnership, project and other agreements in place.

The 76 agreements identified include a wide array of projects and programs – hospital expansions, occasional care, wireless internet on trains, sporting stadiums and legal assistance. The implementation of the revised intergovernmental agreement has unravelled. For example¹⁰:

- The current approach sees states and territories increasingly accountable to the Commonwealth Government for funding and performance, rather than both levels of government being accountable to the public for outcomes delivered.
- There is continued blurring of responsibility for policy, funding and service delivery undermining accountability and transparency to the public.
- It inhibits innovation and tailoring policy responses to local circumstances – e.g. Commonwealth Government ultimatums that it will only fund a specific project that is not the preferred option at the state level.
- The stability and predictability of state and territory government finances is undermined by continual negotiations and changes to funding conditions.

The Commonwealth Government's unilateral proposal to revise indexation arrangements for school and hospital funding in the 2014–15 Budget, reducing payments by \$80 billion over 10 years is a prime example of the revised intergovernmental agreement failing to be adhered to in practice. While it did not proceed, it undermined revenue predictability and goodwill for pursuing cooperative reforms with states and territories.

As a precursor to pursuing more fundamental redesign of the health system, COAG should re-commit to the original ambitions and objectives of the Intergovernmental Agreement on Federal Financial Relations.

As a first step, the number of funding agreements should be consolidated and agreements that are being re-negotiated should be assessed for their alignment to the IGA's principles and the capacity to support innovation in service delivery.



Recommendation 3.5

COAG should re-commit to the original ambitions and objectives of the Intergovernmental Agreement on Federal Financial Relations.

As a first step, the number of funding agreements should be consolidated and agreements that are being renegotiated should be assessed for their alignment to the IGA's principles and the capacity to support innovation in service delivery.

Redesigning the health system

In health there is a pattern similar around the world, population ageing and emerging health trends – increasing health risk factors, preventable diseases and escalating mental illness – are colliding with expectations of better care and systems already unable to keep up.

System inefficiencies

In Australia, increasing expectations for better health come with a further expectation that adds to the challenge.

The unwavering message from CEDA's *Community Pulse* survey is that access to affordable basic healthcare and chronic disease services are top priorities for the community, and they prioritise the role of government in providing these.

All of this occurs against the backdrop of known system inefficiencies and limitations. These include:

- clinical interventions that are excessive, unnecessary or provide limited benefits;
- preventable adverse events in hospitals, which add six to 10 per cent to the costs of the hospital system, according to the Australian Commission on Safety and Quality in Health Care;
- a fragmented system where different sectors do not connect seamlessly to provide the best and most efficient level of care; and
- a lack of data and transparency on the performance of health providers, including backsliding on previous reform efforts as noted above.

The system also remains skewed to acute care, even though chronic health conditions are the more pressing issue. Australians spend a longer proportion of their lives in ill health and have a higher incidence of multiple chronic illnesses compared with other OECD countries.

How well these issues are addressed will have significant bearing on how we assess whether in years to come we have made progress in improving the lives of Australians.

Getting health system redesign right should also contribute to more sustainable government budgets. With Governments collectively spending \$124 billion on health, programs of continual improvement cannot be put off if we are to make government budgets robust in the future.

Changes to make the system work better and slow expenditure growth will provide significant fiscal dividends in the long run. For example, if Australian Government health spending grew at 3.1 per cent a year rather than the 3.6 per cent envisaged in the Intergenerational Report, spending on health would be one per cent of GDP less in 2054–55 or around \$18 billion in today's terms. The Productivity Commission estimates that health reform could save \$140 billion over 20 years.¹¹

Drawing on recent inquiries such as the Productivity Commission's 5-year productivity review, it is time for COAG to put a serious program of reform for the health system back on the table.

Such a program could include:

- Taking immediate steps to improve information and transparency in the system. We need to understand better how the system is performing by sharing information and using it to improve. Initial steps could include:
 - publishing institution-level hospital and health agency performance data for *all* indicators in the National Health Performance Authority's Performance and Accountability Framework 2012;
 - mandating hospitals to report data into clinical quality registries under the National Safety and Quality Health Service Standards;
 - sharing existing hospital cost data across public hospitals, including condition-level data to identify and address poor performance.
- De-funding proven low value health interventions, including appropriate information and awareness campaigns.

- Developing an architecture for patient-centred care, including better information, reporting and feedback loops on customer experience and outcomes.
- Providing greater autonomy and reallocating some funding to Primary Health Networks (PHNs) and Local Hospital Networks (LHN) to deliver better integrated care to address chronic conditions and reduce the need for hospitalisation.



Recommendation 3.6

COAG should put a serious program of health system reform back on the table.

Useful starting points for such a program would include developing an architecture for patient-centred care, boosting performance information and transparency, defunding low-value health interventions and enhancing integrated care through Primary Health Networks and Local Hospital Networks.

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four

Shoring up Australia's tax base

Shoring up the long term tax base will be vital for achieving long-term budget balance. Key areas identified in this chapter can deliver meaningful improvements.

While the government's fiscal strategy focuses on the quantity of tax through the 23.9 per cent of GDP tax cap, the quality of the Commonwealth Government's tax base is just as important.

Reconfiguring and shoring up the Commonwealth Government tax base in the years ahead will be central to achieving long-term budget balance. It will ensure that there is enough revenue to fund the services and supports that the community expects, while minimising the drag on the economy from the most inefficient taxes.

At this stage, there is no need to rush through tax changes with the singular purpose of 'revenue raising'. Any tax changes should be cognisant of the principles of tax design and their contribution to a more coherent and effective tax system in the future. The principles of tax design are well known and include simplicity, equity, revenue adequacy and efficiency. As the Henry Tax Review highlighted, a key priority for Australia's tax system is to reduce reliance on the taxes that have the most damaging effect on decisions to save, invest, innovate and work.

Any tax proposal, including those being canvassed at present, will carry risks and the potential for unintended consequences. This need not lead to inaction. The Commonwealth Government has the capacity to progressively implement careful changes with well crafted transitions for the community, in pursuit of a more coherent tax system in the future.

CEDA has sought to be pragmatic in assessing the future options to change the Commonwealth tax base in both the short and long term.

Short-term options to shore up the tax base

With a current tax to GDP cap of 23.9 per cent, and revenue projected to be 23.8 per cent at the end of the forward estimates, there may be limited opportunities to undertake further fiscal consolidation through tax increases under current policy settings.

CEDA supports the principle of placing discipline on the size of government through tax and spending caps. The current tax cap of 23.9 per cent is consistent with the ceilings adopted by current and previous governments. It is the ceiling that has been used by Treasurers Costello, Swan, Hockey, Morrison and Frydenberg. It also underpinned the projections in the most recent IGR.

If current tax revenue projections do not eventuate, there is ongoing erosion in consumption tax bases as anticipated by the PBO or there is a need to fund further personal income tax relief then there are several options canvassed here that could be implemented to shore up the tax base. If a future government decided to increase the tax to GDP cap, then this would only further reinforce the importance of the efficiency of tax bases involved.

In many cases, these are options that are well within the bounds of current economic debate in the lead-up to the election. CEDA's preference is that the Commonwealth Government focuses on proposals that align with broader principles of good tax design. Australia should seek to have a more coherent tax system in the future and reduce economic distortions.

To this end, the following options should be given priority in any future decisions to shore up the tax base:

- limiting work-related expense deductions in order to broaden the personal tax base and simplify administration and compliance;
- reducing the capital gains tax discount, to take account of the changed inflationary environment and reduce the distortionary impact it has across different asset classes, particularly housing;
- moving to more uniform volumetric taxation of alcohol, simplifying the system, broadening a relatively efficient consumption tax base and better targeting the social costs of alcohol use;
- removing dividend imputation refundability to address revenue adequacy and sustainability concerns emerging from the growing budget impact this will have as more Australians enter concessional tax treatment in retirement.

The limiting of negative gearing is considered to be a lower priority than reducing the capital gains tax discount and reinstatement of the budget repair levy is considered to be undesirable based on past experience. However, both of these options are still canvassed in further detail below.

Work-related expense deductions

Description

Work-related expense deductions seek to provide equity between those employees who incur expenses during their employment and those who don't. Claims include car expenses and uniforms. Around 64 per cent of individual taxpayers claimed work-related expenses in 2015–16, with total expenses claimed of almost \$22 billion.¹ Treasury has noted that Australia has relatively generous arrangements for work-related expense deductions.² For example, New Zealand abolished work-related expenses in the late 1980s to fund income tax relief.

Fiscal impact

The Tax Commissioner has noted that over-claiming of work-related expenses may result in \$2.5 billion in foregone personal tax revenue each year.³ Based on CEDA analysis of 2015–16 ATO statistics, the total revenue foregone from work-related expense deductions could be in the order of \$7 billion a year.⁴

Economic impact

John Freebairn notes that the current ad-hoc and incomplete list of allowable deductions creates distortions that do not really meet the equity objective of the deduction.⁵ Limiting these deductions, including through increased ATO compliance, would therefore reduce these distortions. It would also limit the need for individuals to use tax agents to manage their tax affairs.

Re-instating the budget repair levy

Description

In the 2014–15 Budget, the government introduced a temporary budget repair levy of two per cent on all income earned over \$180,000 for 2014–15, 2015–16 and 2016–17. The ALP has signalled that it will reinstate this levy if it wins government at the next election.

Fiscal impact

The levy raised around \$1.4 billion a year when it was in place.⁶ Rather than being hypothecated, levies in the Commonwealth Budget are often directed into consolidated revenue (eg. Medicare and the flood levy in 2011–12).

While the levy is a more transparent way of raising taxes for budget repair than bracket creep, it is unclear that it will meet its purpose. Delivering “budget repair” has proven far more uncertain and elusive than delivering Medicare or flood assistance. For example, the deficit increased while the levy was in place between 2014–15 and 2015–16 from 2.3 to 2.4 per cent of GDP. It was, therefore, a levy that lacked accountability.

Economic impact

The levy is tightly targeted at those on higher incomes – that is, the 416,000 odd taxpayers with taxable incomes more than \$180,000. Compared to many other advanced economies, Australia has a high top tax rate and low top tax threshold and the levy reinforces this.⁷

The extent to which the high top tax rate impacts on decisions to work more or attracting global talent is contested. Empirical analysis suggests that higher income earners’ labour supply tends to be less responsive to tax rates.⁸ At the same time, there has been some evidence that highly skilled labour is globally mobile and potentially more responsive to tax considerations.⁹ However, in Australia’s case this has been disputed with recent data showing strong growth in millionaires migrating to Australia.¹⁰ What is more likely is that Australia’s relatively low threshold and high rate increases incentives for tax planning and reducing taxable income.

Reducing the capital gains tax discount

Description

The 50 per cent capital gains tax discount is based on the principle that capital gains should be taxed at a concessional rate compared to ordinary income, to encourage saving.

CEDA strongly supports the general principle that capital gains should be taxed at a concessional rate. However, as concluded in CEDA's 2017 *Housing Australia* research, over time excessively generous capital gains taxation has encouraged the flight to property and other assets. This has led to over-investment in property and contributed to housing affordability concerns.

Part of this excessive generosity has occurred because inflation has been lower than expected when the discount was introduced in the late 1990s. In other words, people have realised much larger real gains on investments than what was envisaged when the discount was set. As the Reserve Bank of Australia notes:

...the switch in 1999 from calculating CGT at the full marginal rate on the real gain to calculating it as half the taxpayer's marginal rate on the nominal gain resulted in capital gain-producing assets being more attractive than income-producing assets for some combinations of tax rates, gross returns and inflation.¹⁶

A range of proposed reductions have been canvassed in the policy debate over the last decade. The two most notable are the Henry Review's proposal for a 40 per cent discount and the ALP's proposal to move to a 25 per cent discount. The latter proposes to grandfather purchases before a yet to be determined date.

Fiscal impact

There is considerable uncertainty around the revenue gains that would be realised by reducing the capital gains tax. The ALP's proposal will also take some time to have an impact, given it grandfathers existing assets. Based on estimates from the PBO, in conjunction with changes to negative gearing reducing the capital gains tax discount could raise up to \$32 billion over a decade.¹⁷

Economic impact

Reducing the capital gains tax discount will reduce but not fully address the distortionary impact of different tax rates across different types of savings. For example, interest on bank savings are still taxed at an individual's full marginal tax rate.

The main concern presented in opposition to reducing capital gains tax discounts is the impact that it would have on the property market, by reducing investment and acting as a further dampener on prices and consumer sentiment through the wealth effect. On the other side of the argument, the recent correction in housing prices points to the myriad of other factors that have a much larger impact on the housing market, including supply, lending practices and interest rates.

If the objective is to address housing affordability, then it is inevitable that prices will either need to fall or experience slower growth depending on prevailing market conditions. Tax changes may assist but they will not obviate the need for the bigger affordability drivers like housing supply and planning laws to change.

It is important not to understate or dismiss the impacts that tax changes could have on the property market – they should be well understood, with plans made to minimise unintended consequences. It is worth noting that the Henry Review proposed transitional relief to minimise disruption if the discount is reduced, with a five-year phase-in and grandfathering provisions.¹⁸

Establishing the distributional impact on individuals is not straightforward. The ATO's latest tax statistics show that around 79 per cent of estimated tax on net capital gains in 2015–16 were paid by people in the top tax bracket. Around half of all tax on net gains were paid by people with a taxable income of \$1 million or more.

However, this simple analysis is likely to be misleading given that most people will have high taxable incomes in the year that they pay capital gains tax. Removing these one-off capital gains is likely to reduce many individuals' taxable incomes substantially and increase the number of people at lower tax brackets who are paying capital gains tax.

Individual taxable income may still not be a reliable indicator of income distribution with many individuals receiving tax free income in retirement or living in households with high combined incomes. However, even taking account of all these factors the best available analysis suggests that most of the benefits of the capital gains tax discount fall to higher incomes.¹⁹

Limit negative gearing

Description

Negative gearing generally refers to interest deductibility for rental properties, although it applies to all investments. Investors make an investment that loses money in the short-term due to financing and other costs, with a view to making a return on their investment over the longer term. The losses are then deducted from their wage income to lower their taxable income.

The Federal Opposition are proposing to limit negative gearing (against wage income) to newly constructed properties from a yet to be determined date. Investments made before this date will be grandfathered.

In addition, losses from new investments in shares and existing properties will be allowed to be written off against investment income. This means the loss is simply carried forward to reduce taxable income when the capital gain is realised.

The proposal is based on concerns about the upper hand that negative gearing gives investors over first home buyers, reducing housing affordability and reducing tax revenue. Other proposals that have been canvassed in policy debate include limiting the number of properties, placing a cap on deductions or only allowing interest to be deducted against rental income rather than wage or other investment income.

Fiscal impact

The revenue impact of limiting negative gearing to new properties has been estimated between \$3.4 billion and \$3.9 billion per year in the longer term.²⁰ Proposals to cap losses at \$10,000 and \$50,000 have previously been estimated to raise an additional \$1 billion and \$300 million in revenue respectively.²¹

Economic impact

The relative impact of negative gearing on investor behaviour and the property market vis-à-vis the capital gains tax discount is likely to be less. After all, ultimately investors are not seeking losses but rather the capital gain that is realised by the investment. Without a sufficient after-tax return (assisted by the 50 per cent CGT discount), there is little incentive to absorb losses simply to reduce taxable income in the short-term.

Some are concerned that limiting negative gearing would lower supply in the rental market and place upward pressure on prices. There are a number of factors to consider in assessing the impact on the housing market. It should be expected that demand will increase for new homes, with investors now potentially crowding out owner-occupiers and placing upward pressure on prices for new homes in the short-term until supply responds. The stock of rental accommodation available in existing dwellings would decline but presumably owner-occupiers will enjoy a more favourable market for existing dwellings. In its recent Sydney and Melbourne housing market update, KPMG Economics concludes that:

These policies could have some impact on investment in dwellings for rental purposes, especially in the short term as it will take time for the developer market to produce new dwelling stock for tax approved investments. Overall, the policies proposed are sound, but their introduction would need to be managed carefully.²²

The Henry Review found that changes to the taxation of rental properties could have an adverse impact on the housing market in the short to medium term. In particular, it found that in a market already facing supply constraints, changes could place pressure on the affordability of rental accommodation.²³

The Hawke Government abolished negative gearing for property investment in 1986, prior to its reintroduction in 1988. Growth in rents during this period were largely unchanged, except for Sydney and Perth where rental vacancy rates were abnormally low before negative gearing was abolished.²⁴ The housing market has obviously changed materially since this time so it is difficult to draw direct parallels on the likely impact of limiting negative gearing at this time.

Another argument levelled against changes to negative gearing is that interest deductibility is a sound and common principle of modern tax systems and should be retained. However, it is important to note that the proposal being put forward by the Federal Opposition does retain interest deductibility, it simply restricts its application across different assets and against different income.

Similar to the capital gains tax discount, it is difficult to obtain a full picture of the distributional impact when taxable incomes reported by the ATO already take into account deductions. While people on a range of incomes utilise negative gearing, the majority of the benefits of negative gearing accrue to higher income earners.²⁵

The Federal Opposition proposal does introduce new distortions and complexity in the tax treatment of different assets – shares and existing housing vs newly constructed housing. It takes a small step towards a dual income system, where labour and investment income are taxed separately but, in the process, introduces a further distinction in the concessional treatment of different assets. Australia should examine the application of a dual income system approach more broadly, with a view to achieving greater consistency in the concessional treatment of investment income. This could also assist in achieving greater equity and sustainability of the tax base.

On balance, CEDA considers that the case for reducing the capital gains tax discount is probably stronger than the case for limiting negative gearing.

Changing alcohol taxation

Description

The taxation of alcohol contributed around \$5.5 billion of revenue to the Commonwealth Budget in 2017–18.²⁶ Alcohol is taxed according to multiple rates and in different manners. Beer and spirits are taxed on their alcohol content based on volume through excise. Wine is taxed at a rate of 29 per cent of its wholesale value. Table 4.1 highlights just how complex and varied the effective tax regime for alcohol is and the higher effective tax rate for beer compared to wine.

TABLE 4.1
EFFECTIVE RATES OF EXCISE

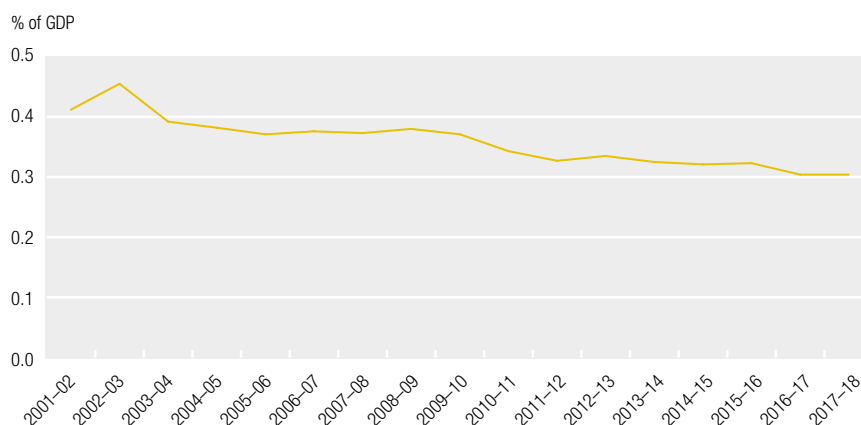
Alcohol type	Effective excise rate, \$ per litre of pure alcohol
Non-commercial beer, low-strength	1.76
Non-commercial beer, mid- to full-strength	2.59
Non-commercial beer, low-strength	1.76
Non-commercial beer, mid- to full-strength	2.59
Draught beer, full-strength	26.14
Packaged beer, low-strength	24.97
Packaged beer, mid-strength	32.36
Packaged beer, full-strength	37.11
Brandy	76.25
Spirits	81.65

Ready-to-drink beverages	81.65
Wine, \$15 cask (4L)	3.09
Wine, \$7 bottle	8.23
Wine, \$15 bottle	17.64
Wine, \$40 bottle	47.05

Source: PBO.

As Figure 4.2 shows, the alcohol tax base is eroding due to a decrease in consumption per capita and a switch in consumer preference from beer to wine. The most sensible option to increase the efficiency and robustness of the tax base would be to move to a more uniform volumetric basis for taxing alcohol.

FIGURE 4.2
ALCOHOL TAXATION (PERCENTAGE OF GDP)



Source: PBO and *Final Budget Outcome 2017-18*.

Fiscal impact

Previous research has suggested that bringing wine, fortified wine and cider into line with the rate of excise for low-strength beer would raise an additional \$1.3 billion in tax.²⁷

Economic impact

A key finding of the Henry Tax Review was that:

A common alcohol tax that does not discriminate between beverage types would remove production and consumption biases from the alcohol taxation system, reduce compliance and administration costs, and better target the spillover costs of alcohol consumption.²⁸

Therefore, in addition to simplifying and increasing the efficiency of the tax base, volumetric taxation would better address the social harm aspects of alcohol.

Dividend imputation refundability

Description

Dividend imputation was introduced in Australia in 1987 to ensure that company profits are not subject to double taxation. Shareholders receive a credit for company tax already paid, paying a rate of tax equal to their marginal tax rate minus the company tax rate.

In 2001, the government at the time introduced refundability so that individuals and superannuation funds could claim a refund from the ATO where the value of imputation credits exceeded their tax owing. In other words, where their marginal tax rate was less than the company tax rate, they would receive a refund including where their marginal tax rate is already zero.

At the time, the government noted that this change "...would ensure that the imputation system operates as it should, imposing overall tax on distributed profits at the marginal tax rates of resident individual taxpayers."²⁹ At the time, the government emphasised that this would be a major benefit for low-income earners, including self-funded retirees who didn't have sufficient taxable income to absorb franking credits.³⁰

The ALP is now proposing to remove refundability of dividend imputation except for pensioners, charities and not-for-profits.

Fiscal impact

The PBO has estimated that the ALP's proposal to remove refundability would raise \$5.2 billion in 2020–21.³¹

Economic impact

It is perhaps unsurprising that proposals to change this seeming 'quirk' of the tax system have proven contentious.

Contrary to some arguments being made, refundability is fully consistent with an imputation system. The company tax forms a pre-payment of the shareholder's tax, with the final tax obligation being paid at their marginal tax rate minus the company tax rate. It does, however, mean that the practical effect is that no tax is paid on part of a company's profit and individual shareholders with no tax liabilities to absorb a franking credit receive a refund from the ATO. While Australia is an international outlier in providing this refund, this should be unsurprising given it is already an outlier more generally in having an imputation system.

The proposal would have an economic impact, both for companies and individuals.

The proposal will reduce investor demand for high dividend paying companies, with the potential for a small increase in the cost of equity particularly for those companies without ready access to international capital.³² Given the small size of investors affected relative to the overall market, these impacts are likely to be small.

Removing the tax credit may help to dampen incentives for ex-dividend arbitrage on the share market.³³ That is, there is evidence that short-term investment activity ramps up before the ex-dividend date for stocks to capture the dividend and tax credit with this activity concentrated in stocks distributing tax credits.

PBO analysis shows that self-managed super funds would be most impacted by the policy, responsible for 60 per cent of the additional revenue that would be raised from this measure. More than half of excess franking credits go to accounts with balances more than \$2.4 million.³⁴ The ALP has proposed to guarantee that pensioners will be exempt from the proposal. That is, under the current pension assets test, homeowners with less than \$564,000 in assets (excluding the home) and less than \$771,000 for those who don't own a home.³⁵ Therefore, while this tax change is well targeted, it will not just impact high-wealth individuals.

Individuals affected will likely shift their allocation of assets. There is the possibility of taking on higher risks to achieve the same rate of return. At the same time, it could also lead to better diversification across international stocks and other assets. There have been suggestions that it will lead to a move out of self-managed super funds, which will no longer be able to claim the credit and into industry and retail superannuation funds who can still absorb franking credits.

The strongest arguments in favour of removing refundable dividend imputation credits appear to be based on revenue adequacy and sustainability. Australia will have an increasing number of Australians of retirement age – almost four million this year climbing to seven million by 2050 based on current projections. The PBO notes that making franking credits refundable was estimated to cost \$550 million in 2001-02 (0.08 per cent of GDP) when the policy was announced and in 2014-15 \$4.9 billion of franking credits were refunded (0.3 per cent of GDP).³⁶

As more and more Australians benefit from concessional tax superannuation in retirement, there is a case for limiting other tax concessions to protect the revenue base. In absence of an appetite to increase the consumption tax base or change the taxation of superannuation, it is inevitable that measures like this will become necessary to shore up the tax base.

The cost of this may be a 'less pure' imputation system but it is worth remembering that this is the system that Australia had before the 2001 changes. As noted above the 2001 changes cited the resulting benefits to low-income earners. It is unclear whether the government at the time envisaged the situation today where people with low *taxable* incomes (based on concessional superannuation tax arrangements), but higher actual income streams and wealth enjoy the greatest benefit from refundable credits. To ease the impact of removing refundable credits one option (in addition to the Pensioner exemption) would be to phase-in the change over a transition period but this would also add complexity and reduce revenue gains.



Recommendation 4.1

To the extent that there is a need to increase taxes to address a revenue shortfall or fund tax relief, proposals should align with broader principles of good tax design, including simplicity, equity, revenue adequacy and efficiency.

Limiting work-related deductions, increasing full volumetric taxation of alcohol, reducing the capital gains tax discount and removing dividend imputation refundability would move Australia's tax system in this direction.

There is time to progressively implement careful changes with well-crafted transitions for the community, to limit any unintended consequences.

Longer-term priorities for tax reform

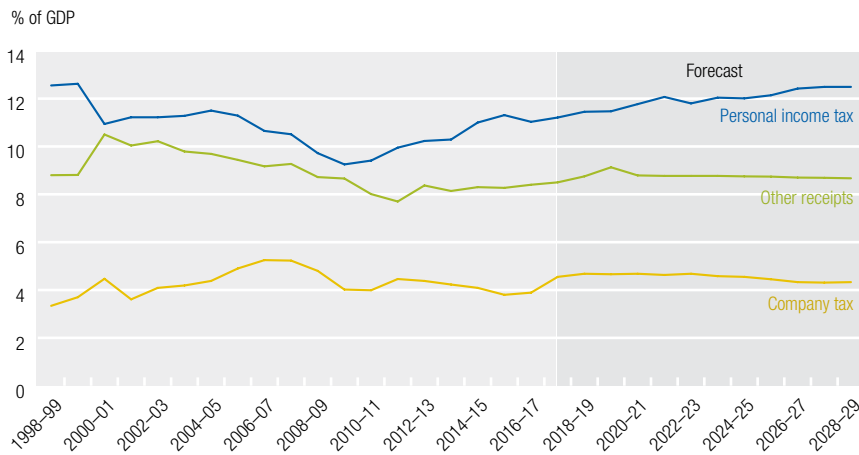
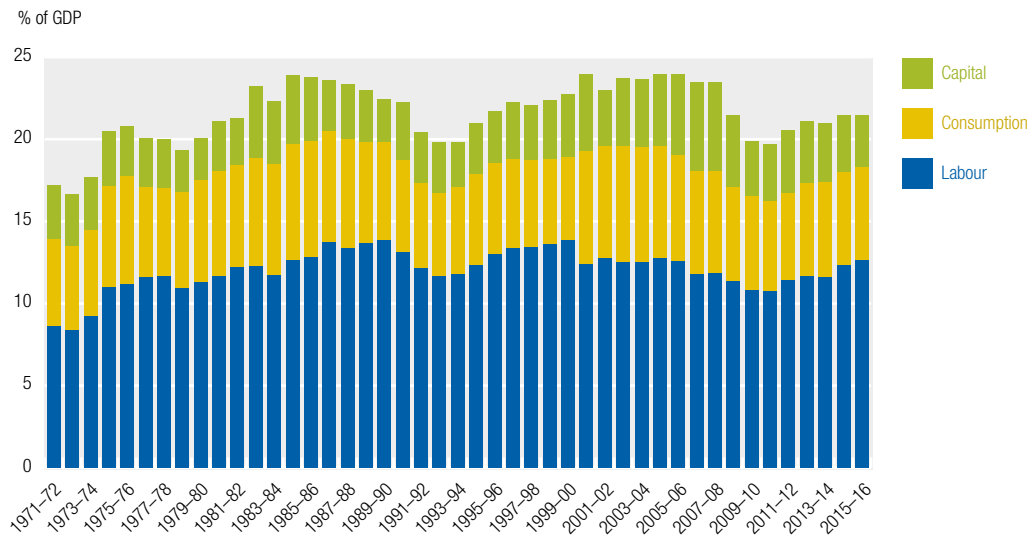
Comprehensive tax reform has evaded Australia over the last decade with the failure of politics, the budget and economy to align in a way that produced sufficient appetite and a workable plan for reform. Despite this there are realistic opportunities for governments to implement sound tax reforms over the course of future budgets to begin to address the greatest weaknesses of Australia's tax system.

Australia is much more reliant on tax bases that are volatile and have medium to high economic costs such as taxes on labour and capital than other advanced economies.³⁷ This is particularly so now, with surging personal income and company tax receipts driving budget improvement. At the same time, tax bases on consumption (including the GST), which have a lower economic cost are narrowing.³⁸

The government has taken steps to lower the burden of personal income tax by reducing the impact of bracket creep through its personal income tax plan, to be fully implemented by 2024. Despite this, personal income tax is still expected to increase as a proportion of GDP over the next decade. All income quintiles will still have increasing average tax rates as a result of bracket creep, with income earners in the second and third quintiles hardest hit. Future personal income tax relief should target these income earners.

Various attempts to reduce the rate of corporate tax have also failed across the last decade. Arguably the greatest failure of both the Business Tax Working Group in 2012 and the government's most recent enterprise tax plan was an inability to generate ideas that vary tax bases in favour of investment, productivity and economic activity.

FIGURE 4.3
COMMONWEALTH TAX BASES (% OF GDP)



Source: PBO, 2018.

While Australia's relatively high statutory corporate tax rate among advanced economies has been well publicised, recent OECD analysis also shows that Australia has high effective tax rates. These are forward looking indicators of the 'incentives delivered by corporate tax systems' to expand existing investments (marginal) and discrete investment decisions between alternative projects (average).⁴⁰ They take into account both the statutory rate and other allowances for investment. In both cases, Australia is ranked in the top 10 for highest effective tax rate out of 74 jurisdictions.

This suggests that in the absence of a workable agreed plan to reduce Australia's corporate tax rate, a stopgap is urgently needed to improve incentives for new investment in Australia. This could take the form of more generous investment allowances in the tax system.

Recent proposals for a corporate rent tax in Australia received a lukewarm political reception and there were concerns from business about the practical application of such a tax. Despite this, such proposals warrant continued examination in addition to a simple statutory corporate tax rate reduction.

CEDA is not suggesting that governments should give up on comprehensive tax reform. But history suggests that executing it successfully requires an alignment of the right economic conditions, political conditions and budget capacity. In the meantime, there are iterative reforms that the Commonwealth Government can undertake to limit the harm of our most inefficient taxes.



Recommendation 4.2

As the budget position improves and there is fiscal capacity to do so, the Commonwealth Government should take steps to reduce the negative economic impacts of taxes on labour and capital. It can do this by:

- Continuing to address bracket creep through further targeted personal income tax relief focused on middle income earners most impacted by increasing average tax rates.
- Providing more generous allowances for new investment in the corporate tax system, in absence of an agreed plan for reducing the current corporate tax rate. This is increasingly urgent in light of the Australia's relatively unfavourable effective corporate tax rates recently reported by the OECD.

Endnotes





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Appendix 1

status of 2016 CEDA measures

KEY

	Implemented by government
	Not implemented or adopted
	Partially implemented by government
	Adopted as policy in some form by Opposition

Measure	Status	Comment
Revenue measures		
Progressive superannuation contributions tax (15 per cent discount).		This has not been adopted as policy by either of the major political parties.
Halve the capital gains tax (CGT) discount.		The ALP has proposed to reduce the capital gains tax discount to 25 per cent, while grandfathering existing assets.
Cut the fuel tax credit scheme by half.		Both federal political parties have committed to not adjusting the current fuel tax credits scheme.
Marginal tax on superannuation contributions above \$10,000.		The Government did not go this far but it did reduce the annual cap on concessional (before-tax) superannuation contributions to \$25,000 in the 2016–17 Budget. Along with lowering the threshold at which high-income earners pay additional contributions tax, this measure was estimated to increase revenue by \$2.3 billion across the forward estimates.
Raise taxes on luxury cars, alcohol and tobacco by either 15 or 20 per cent.		The Government increased tobacco excise and excise equivalent customs duties through four annual increases of 12.5 per cent per year from 2017 until 2020. This raised \$4.7 billion across the forward estimates in the 2016–17 Budget.

Reduce the capital gains tax discount by 75 per cent.		The ALP has proposed to reduce the capital gains tax discount to 25 per cent, while grandfathering existing assets.
Reduce industry tax concessions across the board by 25 per cent.		Industry tax concessions have increased since 2015 according to the most recent PC Trade and Assistance Review.
Continue the budget repair levy.		The budget repair levy ended in 2016–17. The ALP has proposed reinstating it if it forms government.
Reduce work-related deductions.		There have been no changes to work-related tax deductions, although the ATO has intensified its scrutiny of these deductions.
Increase petrol tax by 10 cents per litre.		There have been no increases over and above indexation.
Lift capital gains on superannuation fund earnings to 15 per cent.		This has not been adopted as policy by either of the major political parties.
Removal of Private Health Insurance (PHI) rebate exemption.		This has not been adopted as policy by either of the major political parties.
Remove negative gearing on all types of assets purchased after December 2015.		The ALP has committed to limit negative gearing to new housing from a yet-to-be-determined date after the next election.
Reduce Capital Gains Tax Discount to 40 per cent with no grandfathering		The ALP has proposed to reduce the capital gains tax discount to 25 per cent, while grandfathering existing assets.
Expenditure measures		
Lower Pharmaceutical Benefits Scheme (PBS) drug prices.		The 2017–18 Budget contained \$1.8 billion in savings over five years under the 'cheaper medicines' measure. This will expand existing statutory price reductions for PBS-listed medicines.
Reduce budgetary assistance to industry by 10 per cent.		Budgetary assistance has increased since 2015 according to the most recent PC Trade and Assistance Review.
Improve public sector efficiency through an increase in the efficiency dividend and a reduction in Commonwealth activity.		The efficiency dividend was maintained at 2.5 per cent from 2015–16, reduced to two per cent from 2018–19. It will be reduced to 1.5 per cent in 2019–20.
Improved cost-effectiveness of Medicare Benefits Schedule (MBS) treatments.		The government's MBS Review Taskforce, which was established in 2015 has been undertaking a comprehensive review of MBS items. The Review has achieved savings but these are being re-invested in Medicare.
Cut the Private Health Insurance (PHI) rebate by 25 per cent.		Neither of the major parties have a policy to reduce the private health insurance rebate at the current time.
Higher education efficiency dividend.		The Government implemented a 2.5 per cent higher education efficiency dividend taking effect in 2018 and 2019. This is estimated to have raised \$384.2 million.

Endnotes

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