BCA BUDGET SUBMISSION 2008–09

BUDGETING FOR PROSPERITY

THE BUSINESS COUNCIL OF AUSTRALIA

DOES THE BUDGET INVEST IN AUSTRALIA'S SOCIAL AND ECONOMIC PROSPERITY?

CONTENTS

THE BUDGET IS THE CORNERSTONE OF THE FEDERAL GOVERNMENT'S CONTRIBUTION TO ECONOMIC AND SOCIAL PROSPERITY. FUNDAMENTAL REVIEW AND REFORM OF THE BUDGET IS NOW NECESSARY.

EXECUTIVE SUMMARY

The Federal Budget: A Real Opportunity to Increase Prosperity

Each year, Australia's federal Budget and the expenditure and revenue-raising activities contained within it represent nearly 30 per cent of the Australian economy.

Over and above the scale of direct spending and taxing measures, the Budget has profound implications for almost every area of economic activity in which Australian businesses, households and investors engage. This makes the Budget the cornerstone of the federal government's contribution to current and future economic growth and social prosperity.

There is a real opportunity – and challenge – for the new federal government to undertake major fiscal reforms in this Budget. Inflation risks necessitate strong fiscal action in the short term, while the new government's longer-term reform agenda will require a reprioritisation of fiscal policies and goals. Leaving much-needed reforms to later in the electoral cycle will make them increasingly difficult to undertake in political terms.

A Changed Economy

As fundamental as the Budget is to Australia's economy, its processes and strategies have not been subject to major review or reform since the National Commission of Audit in 1996.

Since that time the Australian economy has changed substantially. Since 1996, the economy has expanded by more than 45 per cent. Individual opportunity and access to employment are at record highs, and skills shortages, rather than unemployment, are the key drivers of labour market trends. Communication technologies have accelerated capital flows and Australia's integration into the global economy, at the same time heightening the immediacy and impacts of global competition. The rise of new trading partners, especially China, has underpinned significant and long-term demand for Australia's resources.

These changes have seen Australia move to a supply-constrained economy. In other words, continuous, strong growth has transformed our economy from one where too much supply often competed for scarce demand, to one in which the key supply inputs of economic growth – labour, infrastructure and skills – are increasingly in short supply.

This has significant implications not only for business but for government activity and in particular, the federal Budget.

The Budget and Prosperity

As the BCA argued in its Budget Submission last year:

> 'Sustaining growth as the economy operates at close to full capacity means governments need to shift their thinking to better manage the supply side of the economy ... these challenges require governments and policymakers to depart from the paradigm of short-term approaches and 'just in time' fixes and adopt a mindset that involves more strategic decision making.'[1]

The opportunities and challenges for the new government in framing its first Budget have become even more pressing twelve months on as inflationary pressures have mounted, increasing upward pressure on interest rates. The BCA's analysis of recent federal budgets outlined in this submission reveals a growing misalignment with the strategic requirements of the economy and community.

As a result, the BCA considers that recent budgets – by focusing on policy settings that drive even greater demand and consumption in the short term – have fallen well short in contributing to the productive investments needed to underpin longer-term social and economic prosperity. Past budgets have increasingly focused on addressing key economic and social challenges with ever-higher spending allocations, instead of a strategic focus on quality policy assessment and outcomes.

This conclusion is consistent with a key theme advanced by the BCA, namely that while Australia's economy has expanded and changed significantly in recent years, the role and performance of government in sustaining growth, in areas such as federal–state relations, regulation, and fiscal policy, has not kept pace.

There is significant scope for the new federal government to reform the Budget to put spending on a more sustainable footing overall and to redirect government resources to better supporting growth in the long term. This, in turn, will help to ensure that future budgets enhance economic and social prosperity.

Given the size and influence of the federal Budget, and the growing disconnect between it and the current and future requirements of Australia's economy, fundamental review and reform of the Budget is now an economic reform imperative.

BCA Budget Submission: Objectives and Conclusions

The submission aims to outline the arguments for and the ways in which the structure of the Budget and the processes underpinning it can be strengthened to better support economic growth and social prosperity.

In particular, the submission highlights that:

- **There is an opportunity now to strategically invest in long-term economic and social prosperity.** Spending, buoyed by record revenue, has risen rapidly, but it has largely failed to be directed at meeting the needs of a capacity-constrained economy. As a consequence, a disconnect has emerged between recent federal budgets and the strategic investments required to sustain growth in the long term, as well as in addressing the long-term budget risks and challenges associated with an ageing population.
- **Fiscal policy can better contribute to sustaining economic and business activity.** This submission highlights the impacts of poorly targeted or excessive spending in recent budgets at a time in the economic cycle when costs to the economy of government activity 'crowding out' private sector investment and activity are much greater. As one symptom of this crowding out, the submission highlights the significant growth in federal public service employment at a time when business is facing a growing scarcity of labour, resulting in wage and other cost pressures.
- **The budget has become increasingly sensitive to variations in the business cycle.** Growth in federal spending has risen rapidly, financed largely from significant growth in company tax revenues. Of the $87 billion per annum that economic prosperity has delivered as windfall revenue to Canberra since 2002, all but $2 billion has been spent on income tax cuts and new spending. As a result, the Budget is now at risk of a marked and quick deterioration if business conditions turn down. The submission also questions the increasing reliance on business taxes at a time when Australia has no strategic plan to protect those revenues by keeping its business tax regime internationally competitive.
- **Accountability for policy priorities and outcomes can be strengthened.** Windfall revenue gains, from what has been the largest prosperity expansion in three decades, have weakened fiscal disciplines and the quality of budget reporting. Record revenues have increasingly allowed governments to frame budget decision making around the quantity of spending rather than quality of policy settings, in particular in key spending areas such as health, social security and defence.
- **Better returns can be achieved from investments in social prosperity.** The submission critiques current assumptions embedded in fiscal policy about the size and role of government, in particular in regard to social support spending, at a time when individual prosperity and employment growth on the whole is high, and the focus of current spending appears to have had little impact on improving levels of social prosperity, particularly for those facing the greatest and most entrenched disadvantage.
- **A new framework to address the fundamental issues of federal–state fiscal relations and reform is needed.** Given the importance of effective federal–state relations in addressing national reform issues, future budgets need to commit to systemic improvements to the effectiveness of revenue streams and revenue-sharing arrangements.

EXHIBIT 1

ACKNOWLEDGING THE BENEFITS OF PAST FISCAL REFORMS

It is important to acknowledge the fiscal reforms and achievements of the Howard Government, including the introduction of the Charter of Budget Honesty and the focus on reducing federal government net debt. By delivering persistent fiscal surpluses, the Howard Government eliminated net debt from a peak in the mid-1990s when net debt stood at nearly 20 per cent of GDP. This created a very solid foundation for fiscal policy in Australia, making its fiscal position strong relative to many other OECD countries.

The BCA's concern is that these 'disciplines' have tended to focus on headline outcomes and not the quality of decision making underpinning them, and that the strength and length of the economic and commodity cycle has meant that there has been little fiscal restraint in recent years. The BCA accepts that it is setting a high standard in critiquing what would be seen as sound fiscal outcomes in many other OECD countries. But if Australia is to sustain strong economic growth from here and manage well the significant longer-term challenges associated with population ageing and responding to climate change, fiscal policy must operate as effectively as possible.

Budget Reform: What's Required

The BCA's definition of sustaining prosperity beyond the short term is ensuring Australia becomes and remains a top-five tier economy among OECD countries by 2012.

To achieve this goal of becoming a 'top-five' economy, significant reform of government policy in areas such as infrastructure, regulation, education and fiscal policy is required. With the election of a new government, it is timely that the Budget – given its fundamental influence on economic activity – should now be the focus of reform.

The federal Budget is one of the most important policy tools available to the new government. To enable the government to deliver its policy objectives and commitments effectively and in a manner consistent with sustained confidence and strong economic growth, greater fiscal discipline and a reprioritisation of spending is now required. To a large extent the government's first federal Budget will create the foundations for its broader reform agenda. How much is achieved in this first Budget will therefore set the tone and expectations for the government's broader reform agenda.

The BCA's overall recommendation is for the 2008–09 Budget to focus on restoring the underlying integrity of Australia's budgetary position through a comprehensive review of government expenditure and priorities, tighter spending controls (including a focus on explaining the objectives of, and justifications for, spending) and greater accountability for achieving policy outcomes.

Reforms undertaken to the expenditure side of the Budget will provide greater scope and flexibility for subsequent budgets to address revenue issues, deliver genuine improvements in prosperity for those most disadvantaged, and ensure that the 2008–09 Budget and subsequent budgets act as facilitators of, not barriers to, sustained economic growth. In particular, the BCA recommends that the government, through the 2008–09 Budget:

- Constrains growth in federal expenditure by:
  - Setting a target of zero year-on-year growth in real expenditure for the next three years. This would result in cumulative savings of over $32 billion over the three- year period through cutting current expenditure growth of 7.5 per cent this financial year to below 3 per cent in line with, or below, the rate of inflation.
  - Locking in these savings in the Budget's forward estimates to ensure a baseline of expenditure savings into the longer term.
- Subjects those areas where spending growth has been greatest – including health, family benefits and defence – to priority review to ensure future expenditure supports strategic objectives and outcomes.
- Commit to a review of all budget expenditure and revenue policies every five years using a framework similar to that used by the 1996 National Commission of Audit.
- Adopt a 'Charter of Budget Quality' that promotes greater transparency and ensures all new spending initiatives:
  - are subject to a rigorous process of cost–benefit analysis;
  - require clear policy objectives and targets, and timelines for achieving those targets; and
  - are subject to regular and transparent performance reviews.
  - The charter should also ensure that the Budget seeks to promote broader public understanding of fiscal priorities and the impact and effectiveness of policies through the development of a simpler, 'layman's' approach to the budget papers that includes simple headline indicators on how tax revenue has been spent, and how the government proposes to allocate each additional dollar of tax revenue.
- Expand its current agenda for reform of federal–state relations to incorporate a comprehensive review of intergovernmental fiscal arrangements as a priority for COAG in 2008.

ECONOMIC OVERVIEW AND KEY BUDGET TRENDS

Australia continues to experience an unparalleled run of economic growth.

In the past, periods of sustained economic success have been followed by declining competitiveness and living standards, because, as a nation, we have failed to lay the foundations necessary for ongoing growth and prosperity.

The Business Council of Australia considers that Australia's recent economic performance can and should be sustained and that we can do even better in the future (see Exhibit 2).

EXHIBIT 2

THE BUSINESS VISION FOR AUSTRALIA

In the fast-paced global economy of the 21st century, the rewards of staying ahead of the competition are great, as are the risks of falling behind. In such a world, standing still is the equivalent of going backwards.

Australia's recent economic performance should be a platform for the future, not a high-water mark. The BCA has set an aspirational goal for Australia to move into the top-five band of those countries with the world's highest living standards by 2012.

At present Australia ranks 7th among the OECD countries in terms of GDP per capita. This is a marked improvement on its ranking in 1990 of 17th – an achievement attributed to the benefits of reforms beginning in the 1980s that opened the domestic economy to global competition and equipped business with the capacity to meet that competition through the deregulation and liberalisation of domestic markets and institutions.

BCA research shows that a further lift in Australia's standing can be achieved through reforms, in areas such as federal–state relations, education, infrastructure, tax and business regulation, that will renew and update Australia's economy.

In an increasingly competitive global economy, this will not be easy, nor will the challenges become easier. The long period of growth has stretched Australia's productive capacity, thereby making further expansion all the more challenging. And in the longer term, Australia's capacity to grow will be constrained by an ageing population and strategies to address climate change.

Australia now represents a textbook case of a capacity-constrained economy. Domestic demand continues to outpace domestic production, employment is at record highs – as are skills shortages – and inflationary pressures are building (see Figure 1).

As the BCA's 2007–08 Budget Submission highlighted, to ensure strong growth can continue uninterrupted for longer, a concerted effort to better manage the supply side of the economy is needed. This, in turn, requires governments to focus more than ever on fiscal policies and reform agendas in areas such as infrastructure, education, skills and workforce participation that collectively enhance the nation's capacity to grow (see Exhibit 3).

Supply-side thinking and agendas are imperative because the positive and negative impacts of government policy and decision making become more accentuated and costly in an economy operating at full capacity.

'The best way to boost Australia's supply capacity – and hence our longer term prosperity – is through broad-based reform to both spending and taxes that is targeted at boosting participation and productivity (the supply side of the economy), therefore limiting any flow-on risks to prices and inflation.'

Access Economics Paper 1.

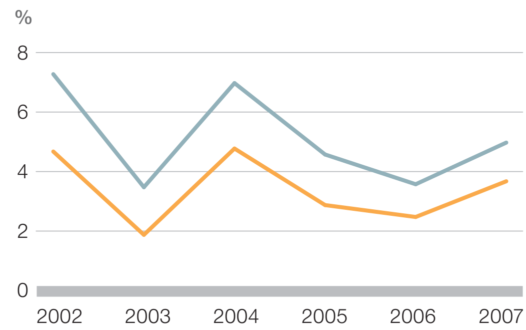
In a capacity-constrained economy, the basic tenets of good government become even more important, namely:

- Using resources efficiently and effectively and only where necessary.
- Undertaking activities in as streamlined a manner as possible to minimise the burden of administration and compliance.
- Being accountable for outcomes.
- Working effectively with other governments to avoid duplication and policy inconsistencies.

FIGURE 1

FULL TILT: RECENT ECONOMIC DEVELOPMENTS

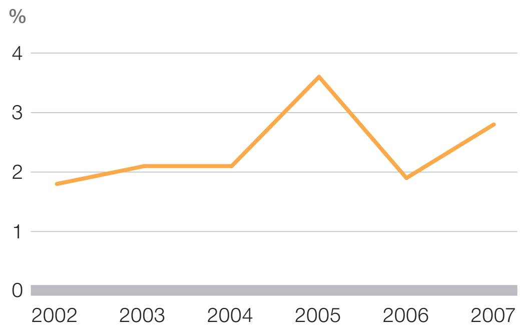
Excess domestic demand highlights a booming economy ...



GDP — Final demand

Source: ABS National Accounts; BCA calculations.

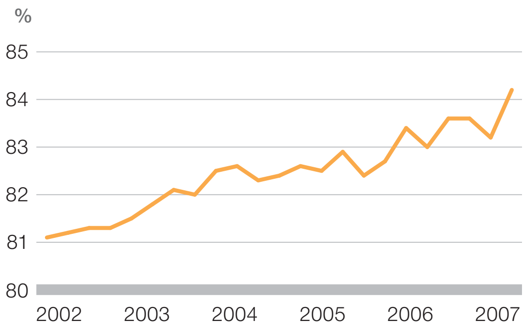
... which has led to substantial jobs growth ...



Growth in persons employed

Source: ABS Catalogue No. 6202.0.55.001, *Labour Force, Australia*, December 2007.

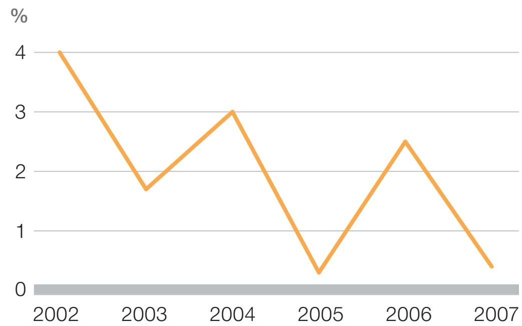
... and businesses operating at full capacity ...



Business capacity utillisation

Source: National Australia Bank Business Survey.

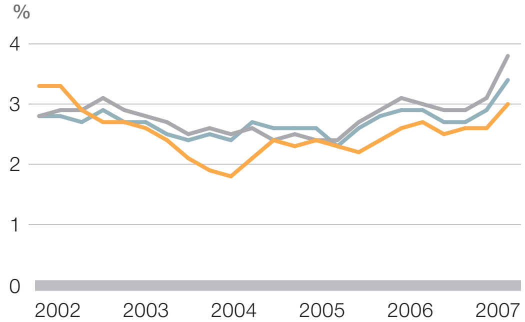
... while productivity growth declines ...



Labour productivity growth (hours worked measured)

Source: ABS Catalogue No. 5204.0, *Australian System of National Accounts*, 2006–07.

... all of which is putting upward pressure on inflation.



CPI excluding volatile items
RBA measure – weighted median
RBA measure – trimmed mean

Source: ABS Catalogue No. 6401.0, *Consumer Price Index*, December 2007.

EXHIBIT 3
GOVERNMENTS IN CAPACITY-CONSTRAINED ECONOMIES

'… we need to have an appreciation of the consequences of policy intervention in an economy operating at, or close to, full employment. Any government intervention will shift resources, including jobs, from one activity to another and impose a deadweight loss of efficiency on the economy.'[a]

'Government activities, directly or indirectly, affect the way in which private individuals and businesses perform. They compete with the private sector for resources. So governments need to ensure their activities are 'best practice', otherwise the whole economy suffers.'[b]

'Sustaining growth as the economy operates at close to full capacity means that the issues that the Australian economy now faces are different in nature to past challenges. The focus now must be on raising the longer-term capacity for growth, in other words on enhancing the supply side of our economy. This presents new challenges for governments, which tend to favour demand-side management. Even in regard to issues such as water, governments seem to find it far easier to seek to constrain demand rather than invest in new supply, despite the complete inadequacy of the former in terms of better managing water over the long term.'[c]

Sources: (a) Ken Henry, Secretary to the Treasury; (b) National Commission of Audit 1996; and (c) Business Council of Australia *Budget Submission 2007–08*, p. 4.

‘Doing things better is a prerequisite for stronger economic and employment growth. Australia must compete on world markets ... Private sector businesses and individuals must seek ‘best practice’ ways of operating to prosper. Governments should not be excluded from such pressures to perform’.

Source: National Commission of Audit, Report to the Commonwealth Government, June 1996.

A strong economy has delivered unprecedented growth in government revenues. The cumulative impact of upward revisions to revenues has delivered greater-than-forecast revenues to the federal government of $87 billion since 2002. In 2006–07, total revenues of the federal government stood at $278 billion, or 27 per cent of the total income generated by our economy. At the same time, strong economic and revenue growth has meant that governments have not experienced genuine budget pressures or constraints that might otherwise curtail inefficient and ineffective policy settings and interventions such as federal–state duplication and excessive regulation.

But a strong economy can only mask the true costs of these influences on broader economic activities for so long. Through its detailed research on key barriers to future growth, the BCA has concluded that the ability of business to invest, innovate, compete and grow to its potential is now being constrained by excessive and misdirected government intervention and reform inertia in areas including education, infrastructure, regulation, taxation and poor federal–state relations more broadly.

The federal Budget is a cornerstone of the government’s contribution to growth and prosperity. However, a detailed assessment of its structures and processes has not been undertaken since the National Commission of Audit of 1996.

The election of a new federal government provides a timely opportunity to review priorities and the effectiveness of current programs and policies, given the need to ensure that any call on scarce resources by governments is both necessary and effective.

The purpose of this submission is to examine the federal Budget and its role and performance in supporting economic and social prosperity in Australia. The submission draws heavily on four background research papers prepared by Access Economics for the BCA, incorporated as Appendixes 1 to 4:

- Paper 1: ‘The bang for our buck – is our federal budget doing the job?’
- Paper 2: ‘How at risk is the budget to the economy?’
- Paper 3: ‘Are we prepared for the intergenerational challenges ahead?’
- Paper 4: ‘How are the states faring?’

The Federal Tax Take: Government’s Growing Call on Resources

Government revenue continues to increase rapidly, both in absolute and in per capita terms, at a time when the economy – and critically, employment – have been surging. Total tax revenue has increased from $194.8 billion in 2002–03 to $245.2 billion – an increase of 25.9 per cent over that period.

Figure 2 highlights the growth in tax revenue relative to GDP. However, assessing the federal tax take as a share of GDP understates the significance of the overall increase. A more revealing figure shows the growth in federal tax revenue per person (see Figure 3).[2]

Access Economics calculates that federal revenue (including GST) rose relatively slowly from 1975–76 to 1992–93, with a net increase in real tax revenues per person of $1,019 over that 17-year period. In contrast, in the 14 years to 2006–07, real tax revenues per person are estimated to have risen by a further $5,123 to $12,153. This represents a sharp increase in the tax take.

Taxes impose a 'deadweight loss' on the economy.[3] Taxes change incentives (for example, incentives to work or invest) and alter the price and quantity of goods sold.

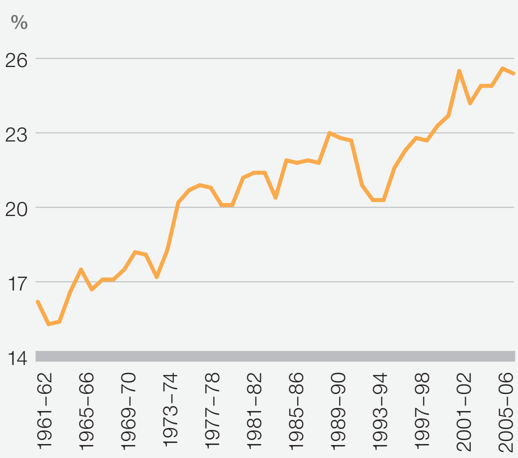
As a result, there is less economic activity than would otherwise be the case.

The average deadweight loss on the economy is generally estimated to be around 27.5 cents for every $1 of tax revenue raised.[4] This means that wherever and however possible, government should seek to minimise the tax take.[5]

The BCA's overall concern is that, in spite of rapid acceleration of tax revenue in recent years, fiscal policy has not been underpinned by a consideration or review of what an appropriate level of taxation should be in order to meet government objectives in an economy that has changed significantly over the past decade.

FIGURE 2

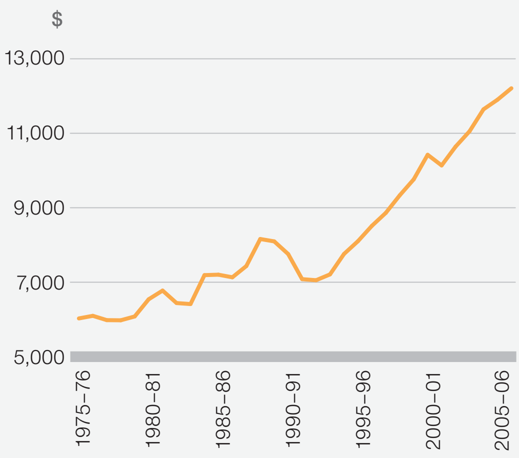
REVENUES AT RECORD LEVELS: FEDERAL TAXES INCLUDING GST (PER CENT OF GDP)



Source: Access Economics Paper 1. The chart is based on the ABS measure and therefore includes the GST as a federal tax.

FIGURE 3

HOW MUCH WE PAY: REAL FEDERAL TAX REVENUE PER PERSON (INCLUDING GST)



Source: Access Economics Paper 1.

EXHIBIT 4

INCREASING RELIANCE ON CORPORATE TAXES

Underlying the sharp growth in total federal tax revenues has been a substantial increase in the reliance on corporate taxes (see Figure 4). Since 2000, revenue from corporate taxes has risen from $27 billion to a projected $65 billion this financial year. Over this time, the share of corporate taxes in overall revenue has increased from 17.4 per cent in 2001–02 to 24.4 per cent in 2006–07, making it one of the fastest growing sources of revenue for the government. Much of this increase has helped fund tax cuts for wage earners, new and broadened social and community programs and some new infrastructure initiatives announced in recent budgets.

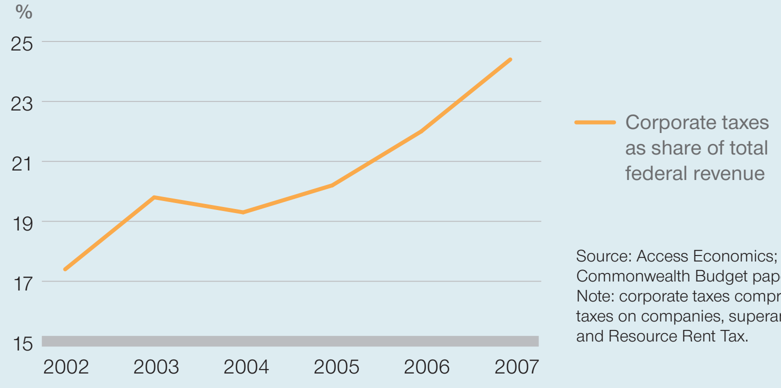
> 'The most cyclically sensitive heads of revenue in a classic slowdown are those most closely linked to profits and asset prices, such as company taxes.'
>
> Access Economics Paper 2.

The factors driving the growth in corporate taxes have received some attention in recent budget papers. However, the BCA considers that the implications of the rising reliance on corporate taxes in terms of ongoing tax competitiveness, the implications for private investment and the sustainability of this reliance have not been adequately addressed by government. This is particularly so given that many of our competitors and economic peers (such as the United States, Canada and the United Kingdom) have sought to reduce corporate tax rates and/or burdens in recent years.

As the BCA has consistently argued, Australia needs to put its business tax regime under 'permanent watch'; in other words, it requires ongoing review and adjustment in response to continuing changes in corporate tax rates and structures in those economies with which we directly compete for jobs and investment. Consideration needs to be given to the totality of the tax burden facing business, taking into account state as well as federal taxes. This is discussed further in Exhibit 9. Unfortunately, at this stage, no ongoing review or reform process exists to protect what is an increasingly critical, albeit highly cyclical, part of Australia's revenue base.

FIGURE 4

GOVERNMENT'S GROWING RELIANCE ON CORPORATE TAXES: IS IT SUSTAINABLE?



Source: Access Economics; Commonwealth Budget papers.
Note: corporate taxes comprise taxes on companies, superannuation and Resource Rent Tax.

Federal Government Spending: Where It All Goes

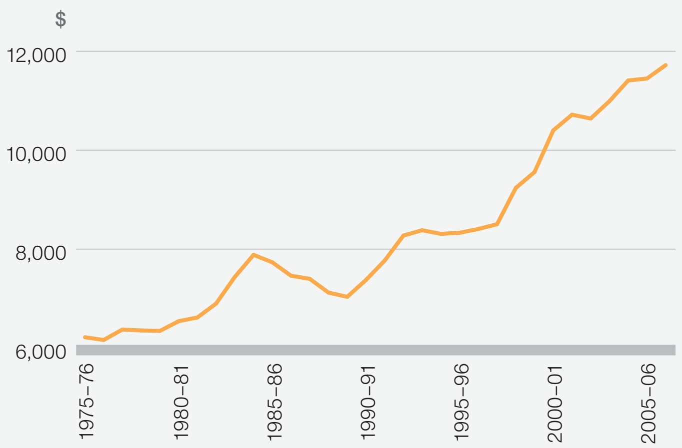
Not surprisingly, as federal government revenues have grown strongly, so too has spending. Based on the estimated level of federal spending in 2006–07, in just nine years underlying spending per person in today's dollars rose by $3,207 to a total of $11,716. This compares with an increase of $2,285 per person over the entire period from 1975–76 to 1997–98 (see Figure 5).

Some might argue that this is to be expected, asserting that a stronger economy means we can afford to spend more. But, as the economy surges and unemployment falls, it could equally be argued that overall there should be relatively less, not more, need for other forms of spending, namely income support via welfare and transfers and the provision of a safety net of basic services (e.g. housing, health care).[6]

And, while it may be appropriate for a 'wealthier' nation to invest relatively more per person in boosting social prosperity, such investment imposes broader (deadweight) costs and should be judged carefully in terms of the net contribution to social and economic prosperity. Just as much rigour is needed in boom times as in recessions.

FIGURE 5

SPIRALLING SPENDING: REAL FEDERAL GOVERNMENT EXPENDITURE PER PERSON



Source: Access Economics Paper 1.

EXHIBIT 5

WHERE HAS THE MONEY GONE?

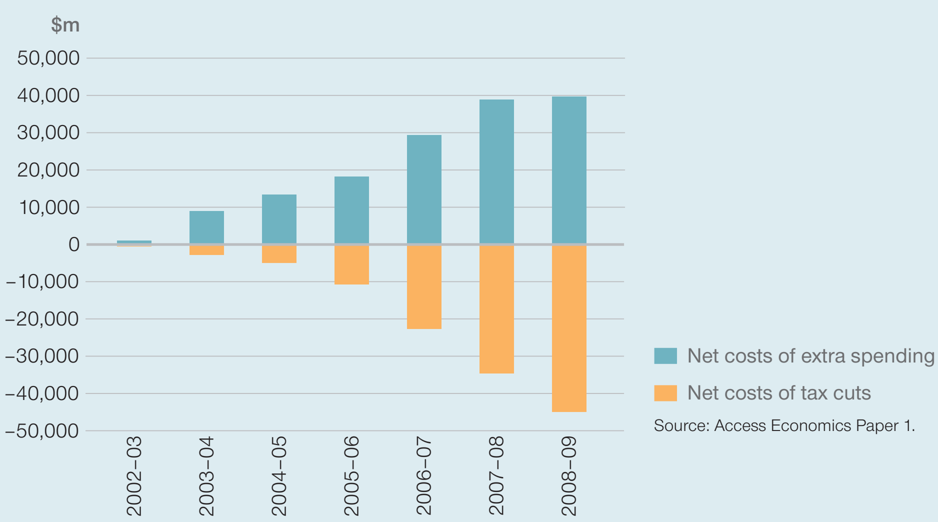
Big spenders: value for money?

New spending has been allocated in recent years nearly as quickly as new revenue has been generated. Spending increases over this time have been most notable in the areas of health, defence and social security and welfare (see Access Economics Paper 1, Section 4):

- Health spending has risen largely as a result of more expensive technologies and strong demand for health services. Despite significant expenditure growth, the effectiveness and sustainability of this spending is unclear.
- Rising defence spending is a reflection of the higher priority afforded to defence and national security in recent times, but is also a result of recent cost and project management problems.
- Social security and welfare spending are shown to have grown substantially. In fact real expenditure per capita has risen by an average 4.2% a year since as far back as 1961–62. Some recent policies such as the welfare-to-work reforms should help to alleviate this growth. But much of the recent growth, particularly in terms of non-means-tested benefits, is also indicative of the high degree of tax and expenditure churn in the federal Budget that is cycled through programs such as the family tax benefit scheme.
- Conversely, growth in education expenditure, a key investment to relieve capacity constraints and increase productivity, has been modest.

FIGURE 6

ANNUAL COSTS OF TAX CUTS AND EXTRA SPENDING SINCE 2002–03



Source: Access Economics Paper 1.

'As more and more unexpected revenue has poured into tax coffers in recent years, budget decisions increasingly smack of less strategic and well-targeted expenditure. In its place have been more 'middle-class welfare' and a raft of other 'policy on the run', including a significant proportion of 'permanent' cash handouts from a temporary base.'

Access Economics Paper 1.

Income tax cuts: strategic or not?

According to Access Economics, cumulative income tax cut decisions made by the previous government from mid-2002 to the present amounted to $45 billion.

To the extent that these tax cuts have reduced effective marginal tax rates and encouraged higher participation in the workforce, they represent an investment in economic growth. More could have been done towards this end, however. Tax cuts no doubt also curtailed government spending relative to what it might otherwise have been. But it also needs to be acknowledged that tax cuts have contributed to demand, to some extent at least offsetting the impact of higher interest rates, and exacerbated problems with supply constraints.

EXHIBIT 6

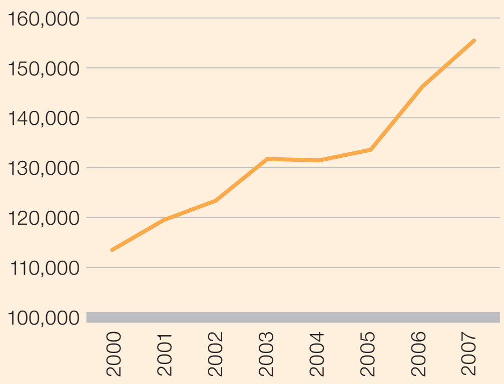
BIG GOVERNMENT GETTING BIGGER: THE RISE AND RISE OF PUBLIC SERVANT NUMBERS

As expenditure has grown through the expansion of government programs and other activities, so has the number of APS employees. The number of public servants in total has grown from 113,518 in 2000 to 155,482 in 2007. Australian Public Service (APS) employment growth has easily outstripped employment growth in the broader economy in recent years. In the last two years alone, APS employees have increased by 16.4 per cent. By comparison, jobs growth in the wider economy has been 4.7 per cent.

At a time when the private sector is struggling to identify sources of skilled labour, this is an example of government expenditure crowding out the private sector's capacity to access scarce resources. And, as Access Economics notes, this has occurred against a backdrop of falling unemployment and underemployment and a reduced need for government assistance for many.

FIGURE 7

THE NUMBER OF FEDERAL PUBLIC SERVANTS HAS RISEN DRAMATICALLY



Source: Australian Public Service Commission, Statistical Bulletin 2006–07, p. 12. Note: Australian Public Service staff are those employed under the Public Service Act as at 30 June in each period.

Implications for Future Budgets: Are We Locking in Largesse?

Recent rapid expenditure growth is set to continue because spending increases are embedded in the previous government's forward estimates for future budgets (see Table 1). This has created a momentum for expenditure growth that sets expectations and makes it more difficult to rein in future unnecessary spending.

The projections, as they currently stand, reveal that little if anything has been done to curb future increases in spending now despite the fact that population ageing will create additional fiscal pressures in the long term.[7] Expenditures are simply forecast to grow more or less in line with the growth in the economy. This is a complacent approach to managing government expenditure.

'Once put in place, extra spending is often difficult to roll back – a function of political pressure. Yet, despite that need for caution, the cost of new policies announced by the previous government rocketed over the past five and a half years ...'

Access Economics Paper 1.

TABLE 1

PROJECTED FEDERAL GOVERNMENT EXPENDITURE

	2007–08	2008–09	2009–10	2010–11
	Estimates		Projections	
Federal government expenditure ($b)	**235.8**	**248.7**	**259.4**	**269.5**
Per cent of GDP	21.0	20.8	20.8	20.8
Growth in spending on previous year (nominal)	7.5%	5.5%	4.3%	3.9%

Source: Pre-election Fiscal and Economic Outlook (PEFO) 2007 and BCA calculations. All estimates are based on Government Finance Statistics (GFS) standards, but with Goods and Services Tax (GST) revenue collected on behalf of the states and territories netted off expenses.

PAST SUCCESS MASKS EMERGING WEAKNESS: ASSESSING THE FEDERAL BUDGET

Limited Investment in Economic and Social Prosperity

See Access Economics Paper 1.

In order to contribute to economic and social prosperity, the Budget must be well structured in a cyclical sense and in terms of its capacity to address and respond to longer-term challenges. The BCA has concerns on both fronts.

Tax and spending decisions should be driven by clearly stated and assessed needs and objectives, not simply by a 'capacity to pay' as revenues increase. But experience suggests that when government revenues are surging, these disciplines are not adhered to; policy becomes less strategic, less well targeted and usually more 'political'.

As Access Economics Paper 1 highlights, the effectiveness of promoting long-term economic and social prosperity through tax and spending decisions made by the previous federal government, on the back of revenue growth which consistently exceeded forecasts, warrants careful assessment.

> 'Unless we can first identify the aims of policy, we cannot assess whether what we are already doing and policy proposals for change are either good, bad or indifferent ...'
>
> Access Economics Paper 1.

It is beyond the scope of the BCA to undertake an assessment of each and every decision and program in the federal Budget. However, overall the BCA has concerns about the stated aims, structure and processes of recent budgets and the extent to which they have been contributing to enhanced social and economic prosperity in Australia. Following is a summary of some of these concerns as they relate to the key budget policy objectives of investing in economic and social prosperity, and achieving greater simplicity and accountability.

EXHIBIT 7
A CHECKLIST FOR FEDERAL BUDGET POLICIES

In order to assess the activities of government, it is important to first understand the aims of those activities. In general terms, there are two primary 'roles' for government.

- Enhancing social prosperity by addressing issues of fairness or equity, including through the redistribution of income, the provision of a genuine safety net of income support and services (health care, housing, etc.), and policies to increase opportunity.
- Enhancing economic prosperity by addressing areas where a lack of government involvement would result in 'too little' or 'too much' of something being produced/consumed (so-called 'market failures'), in both the present day and in the future. Examples include education, police and defence, transport infrastructure, regulations to prevent pollution, etc.

How these roles are undertaken, the relative importance attached to them, and the priorities that fall within them, will differ across governments and communities and will change over time. But at any point in time, business and the wider community should be able to understand the government's priorities, understand how it is seeking to achieve them, and determine how well the government is performing those roles.

The expectations and objectives in fiscal terms can be summarised in the following policy checklist, which in turn can be used to guide an analysis of the federal Budget.

Investing in economic prosperity

- Is the policy likely to improve the effectiveness of government spending, expand workforce participation, or increase productivity?
- Is there a genuine reason for the government intervention?
- Is there a market failure?
- Is there an alternative to government intervention?
- Is government intervention/service delivery contestable?
- Has the policy been tested in a rigorous economic cost–benefit framework?
- What is the impact of the policy on the rest of the economy?
- Is the policy consistent with promoting the efficient operation of markets?
- Does it minimise the burden on individuals and companies?
- Does the policy minimise churn (the process whereby taxes are effectively returned to the same group of taxpayers via government outlays)?
- Is the policy consistent with, and complementary to, other policies (including in other jurisdictions)?
- Is the policy sustainable and/or flexible enough to adapt as society and markets change over time?

Investing in social prosperity

- Does the policy contribute to the provision of a genuine safety net for the least well-off?
- Does the policy assist access to a basic level of government services such as health and education?
- Are policies improving the equality of opportunity?
- Are policies contributing to improved fairness?
- Are the policies contributing to national security?
- Does the policy provide an incentive to participate in the workforce?

Simplicity and accountability

- Does the policy meet clearly defined goals?
- Are policy goals and progress against them monitored, assessed and made public?
- Is the ownership of the policy clearly defined by level of government?
- Does the policy reduce duplication and overlap between governments?
- Does the policy minimise the scope for cost-shifting across governments?
- Is the policy, and its application, as simple as possible and easily understood?
- Is the policy instrument the least-cost option for achieving the policy objective?
- Has the policy passed a regulatory impact statement?
- Has this process included appropriate consultation with key stakeholders?
- Has the policy been independently reviewed against best practice?
- Does the policy include a mechanism for regular and timely review and/or a 'sunset' clause?

Many of these goals are not mutually exclusive and the checklist is not exhaustive, but consideration of these key issues should ensure that the Budget contributes effectively to sustaining long-term growth and prosperity.

Source: Adapted from the checklist supplied in Access Economics Paper 1.

Out of Sync: The Budget and the Economic Cycle

See Access Economics Papers 1 and 2.

As argued, with economic activity so strong and many more people employed, the sheer volume of spending, the spending increases, and the targets of that spending, in recent years needs to be questioned. In Australia's case, additional spending has largely boosted demand rather than contributed to productive capacity, at a time when monetary policy is working in the opposite direction. This issue has been raised by the International Monetary Fund (IMF) and the Reserve Bank of Australia (see Exhibit 8).

A clear indicator of how well the Budget is operating relative to the economic cycle is to estimate what is known as a 'structural' budget balance, which adjusts the actual budget balance to take account of the strength of the economy. In simple terms, the structural budget balance shows the extent to which the budget balance looks better than it actually is because of high levels of economic activity. Access Economics has developed estimates of the structural federal budget balance taking into account the impact of the real and nominal economic cycles (that is, the impact of commodity prices). Based on these estimates, the federal Budget, despite record revenues, is in structural deficit. In fact, Access Economics estimates a structural deficit of around $11 billion, or around 1 per cent of GDP for 2008–09 (see Appendix 2, Paper 2: 'How at risk is the budget to the economy?').

In future budgets the proceeds of the commodity cycle should be reinvested in policies and programs that demonstrably lift capacity in areas relating to productivity and workforce participation.

> '... one policy accelerating and the other braking is almost the exact opposite of what is required in an economy with stretched housing prices and a large current account deficit amid a commodity boom.'
>
> Access Economics Paper 2.

EXHIBIT 8
WORDS OF WARNING ON BUDGET STIMULUS

In the latest Article IV Report on Australia, the IMF cautioned that: 'Although the government's management of additional revenue resulting from the terms of trade boom has been prudent, the main concern in the near term is to avoid additional stimulus to the economy.'

The IMF specifically stated that the Australian Government should save any further extra revenue surprises, rather than blowing them on an over-stretched economy: 'Staff suggested that this year's expenditure be kept to the current budget plan, even if revenues run ahead of projections.'

The Reserve Bank of Australia said in its November 2007 monetary policy statement that: 'Domestic demand has continued to grow strongly, with consumption, business investment and public spending all making significant contributions.'

The Budget and the Business Cycle

See Access Economics Paper 2.

In addition to concerns about the appropriateness of the cyclical stance of the federal Budget, the analysis undertaken by Access Economics highlights the vulnerability of the Budget to economic and commodity price cycles in the future (see Appendix 2).

Specifically, this research shows that Australia's tax base has become more sensitive to the business cycle, in large part as a result of the growing reliance on company taxes. But at the same time, spending remains significantly less sensitive to the business/economic cycle. According to Access Economics, virtually all of the revenue side of the federal Budget is sensitive to the economy, whereas little more than one in every $25 on the spending side is similarly sensitive.

As a result, if and when growth slows, for example as a result of weaker commodity prices and income growth, the federal Budget will deteriorate markedly and quickly, unless offsetting decisions are made to curtail spending or raise taxes. Given the political difficulties of cutting spending, the likely fallbacks are higher taxes (which in turn would weigh against competitiveness and longer-term growth prospects) or larger fiscal deficits. A significant increase in government borrowing to fund recurrent spending would have negative consequences for interest rates and the value of the Australian dollar given Australia's high foreign debt and the current account deficit.

Australia's federal fiscal position is not as strong as it seems. A strong domestic economy and commodity price boom have provided cover for growing government intervention in the economy and masked a deterioration in the structural, or underlying, integrity of the federal Budget.

'As a simple rule of thumb, taxes respond notably to swings in the economy, whereas spending does not. It is in that dichotomy that fiscal risks lurk.'

Access Economics Paper 2.

Intergenerational Risks and Weaknesses

See Access Economics Paper 3.

Looking even further ahead, while Australia is currently better placed than many OECD countries to manage the fiscal impacts of population ageing, there are still significant weaknesses in its longer-term budget outlook.

Two Intergenerational Reports have now been published. These reports highlight the longer-term outlook for Australia's federal Budget taking into account the impacts of population ageing. Both point to a significant deterioration in the federal Budget by the middle of this century. The second Intergenerational Report (IGR2) concluded that, on a 'no-policy change' basis, the federal Budget would be in deficit by around 3½ per cent of GDP by 2047–48.

There are a number of reasons to believe that these estimates may be overly optimistic.

Most importantly, the Intergenerational Reports assume that trend productivity growth will be sustained. However, trend productivity growth has been boosted by the impact of past economic reforms. In the absence of a reinvigorated national reform agenda, there are significant downside risks to Australia's future productivity performance.[8]

On the spending side, one of the main sources of the deterioration in the federal fiscal position over the longer term is health spending. New technologies and medications, coupled with rising living standards and policy decisions that have increased access to care, have contributed to higher expectations regarding the amount and quality of health care. These factors reinforce one another in contributing to higher spending by governments on health.

On the tax side, it is important to note that the Intergenerational Reports assume that revenues will remain a constant share of national income over the long term. However, the elimination of indexation of the petrol excise, and changes to the taxation of superannuation (including the abolition of benefits taxes) are likely to result in a revenue 'gap' and hence a larger deficit emerging in the future.[9] This serves to highlight the longer-term vulnerability of the budget outlook and the need to impose greater spending discipline sooner rather than later.

'Access Economics is of the view that the long-term assumptions of the second IGR may be too optimistic – leaving policymakers and the public too sanguine with respect to the longer-term challenges facing fiscal policy'.

Access Economics Paper 3.

Federal–State Relations and Fiscal Reform

See Access Economics Paper 4.

In late 2006, the BCA released a comprehensive report, *Reshaping Australia's Federation: A New Contract for Federal–State Relations*, on the need to improve federal–state relations to reduce duplication and ensure governments work cooperatively to address issues of national importance. The BCA welcomes undertakings by the new federal government to fundamentally review and reform federal–state relations, and its commitment to utilise the Council of Australian Governments (COAG) more strategically to improve relations and progress national reform. Improved fiscal relations between federal and state governments are increasingly important in a capacity-constrained economy because:

- Duplication by governments wastes resources and reduces accountability for policy outcomes. The closer the economy is to capacity, the more costly this becomes.
- Governments need to focus on enhancing the capacity of the economy to grow through supply-side policies. Education, health and infrastructure are all vital to increasing participation and productivity, and are all areas characterised by a high degree of overlap and duplication in spending and responsibilities across federal and state jurisdictions. COAG's commitment to reform specific purpose payments (SPPs) to focus more on outputs and outcomes is a welcome step forward.

With federal and state governments now seeking to enhance federal–state relations, the federal Budget will need to quickly reflect agreements reached through COAG and pave the way for progress towards improving the allocation of funding, roles and responsibilities across federal, state and local jurisdictions to avoid duplication and ensure those best placed to deliver services are charged with that responsibility. As part of the broader review of federal–state relations, an assessment of resource requirements of the states should be made in line with the changes in the allocation of responsibilities and taking into account the economic and social prosperity decision making framework outlined in the submission.

> 'With this surge in prosperity, the pressures on the one of the oldest federations in the world have become more acute, exposing inefficiencies in Commonwealth–State relations as a weakness.'
>
> Access Economics Paper 4.

In addition, immediate steps should be taken to reform federal payments to the states to improve simplicity and accountability, reduce administrative costs and reward innovation and efficiency in service delivery.

These steps would provide the foundation for a broader review of federal–state fiscal relations focusing on the overall effectiveness of current revenue streams and revenue-sharing arrangements, namely:

- the amount of revenue raised;
- the operating costs of individual taxes relative to the revenue raised;
- the administrative burden on both government and business of individual taxes; and
- the sustainability of current arrangements.

EXHIBIT 9

FIXING FISCAL FEDERALISM

See Access Economics Paper 4.

Revenue Distribution

The federal Budget remains the conduit through which money is channelled through the federal government to the states. In the 2006–07 Budget, total payments to the states amounted to around $68 billion. A growing share of payments to the states is now made up of revenues from the GST, which the states can largely use as they choose. However, payments with conditions attached to them by the federal government – so-called specific purpose payments – remain substantial, particularly in the areas of health and education. While SPPs are intended to be used to pursue national objectives consistently across states and territories, they have a number of significant weaknesses, including that they are:

- Focused on inputs and processes, not outcomes.
- Bureaucratic and administratively cumbersome.
- A barrier to innovation and efficiency in service delivery.
- A source of dispute and tension – not an effective tool for collaboration and partnership.
- Sometimes used to address issues that have little to do with core national policy objectives.

The use of SPPs should be confined to areas where there is a clear and significant national policy objective, and consideration should be given to how their effectiveness can be improved, especially through a greater focus on outcomes, simplicity, and flexibility.

More fundamentally, there needs to be a better understanding of the sources and magnitude of total funding for service delivery in key areas such as health and education. This should be coupled with a clearer allocation of responsibilities in these areas across jurisdictions, as the BCA has previously argued. Access Economics, in its research for the BCA, also discusses a range of limitations with the existing Commonwealth Grants Commission processes, that is, the way in which grants, including the relative distribution of GST revenues, are made across the states and territories.

A key concern raised is that the system implicitly rewards states and territories for not lifting their performance in service delivery. Given the scale of grants, it is important to ensure that the system of allocation rewards efficiency, innovation and best practice in service delivery and that the benefits of addressing fiscal imbalances between states continues to exceed the costs of doing so.

Tax Tensions

In large part the fiscal tensions that exist across state and federal jurisdictions stem from the imbalance between spending responsibilities and the capacity to raise revenue, with the federal Budget raising by far the bulk of revenues in Australia.

Access Economics argues that this tension has been exacerbated by the current economic cycle, which has seen federal revenues rising strongly while demand for infrastructure, education and health spending has increased at the state level. As a result the states have been 'forced' to run deficits and borrow to fund new initiatives. It is important to note, however, that the states have also benefited from revenue windfalls in recent years, in particular those associated with booming property prices.

While the states have also pointed to spending pressures, significant gains can and should be made through more efficient use of existing resources, including through greater attention being paid to outcomes, better prioritisation, and improved long-term planning, including across jurisdictions.

More generally, the longer-term sustainability of the current tax arrangements, particularly business taxes, across state and federal jurisdictions, warrants major examination.

The BCA 2007 report, *Tax Nation: Business Taxes and the Federal–State Divide*, found that businesses operating across states in Australia bear or collect up to 56 separate taxes. The system is complex, opaque and costly to administer, particularly as one federal tax – on corporate incomes – accounts for two-thirds of total business taxes collected. As fiscal pressures associated with population ageing mount, there will be a tendency for governments at all levels to raise more revenue. The lack of transparency and complexity of the current system creates easier opportunities for governments to raise revenue. The risk is that the current system and any additional burdens imposed through it will weigh on competitiveness and economic prosperity.

Social Prosperity: Over-Investing for Limited Returns

See Access Economics Paper 1.

The previous federal government undertook substantial and growing 'investments' in social prosperity as evidenced by sustained growth in real spending per person on social security and welfare.

The fact that social security and welfare spending per person in Australia has been rising at a time when unemployment has fallen sharply, however, raises questions about how well that money is being 'invested' (see Figure 8).[10]

Evidence suggests that the structure of government tax and spending does contribute to a redistribution from wealthier households to poorer households and from those with a greater capacity to provide for themselves to others over a lifetime (namely from single working individuals to families and the aged).[11]

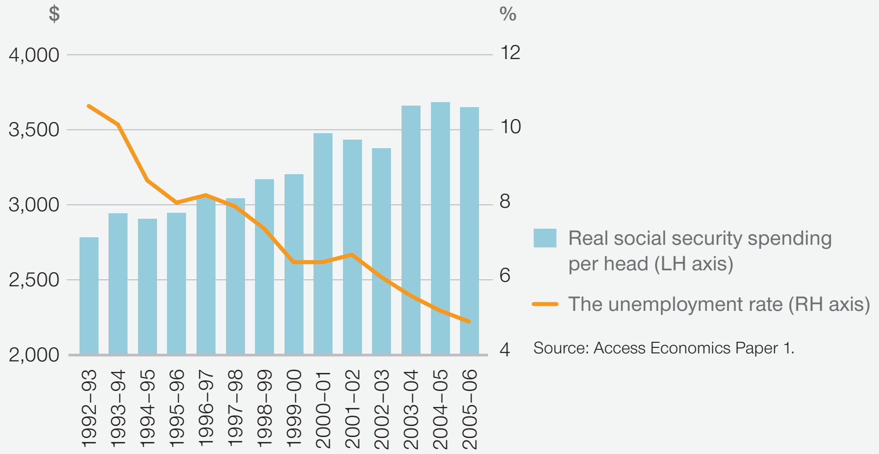
However, as Access Economics notes, levels of social prosperity, as measured by aggregate income equality, have at best remained static in the face of ever-increasing federal spending (see Figure 9).

While inequality might have risen without such government 'investment', there does not appear to have been a big impact on equality (in terms of this measure at least) relative to the magnitude of spending.[12] One reason for this is that a significant share of spending is simply being 'churned', that is, collected by governments and then handed back in the form of spending and benefits. The Centre for Independent Studies has estimated that around half of all welfare spending in Australia is churned.[13]

The extent to which middle and higher income families receive significant benefits from the government is confirmed by other research. For example, it has been found that

FIGURE 8

OUT OF SYNC: JOBS GROW, BUT SO DOES SOCIAL SECURITY



Source: Access Economics Paper 1.

middle income households receive benefit payments worth around three-quarters of that paid to the poorest households.[14] The reality is that much of the redistribution from wealthier households and income earners to those less well-off is achieved through taxation and not through government spending.

Looking after the less well-off in our society is an important objective. But churning money from middle and upper income households back to those same households is a costly exercise with highly questionable benefits. Reducing this churn would lower tax burdens, free up resources otherwise spent on administration, compliance and enforcement of the welfare state, and could provide for more, rather than less, spending being directed to those most in need and to enhancing social prosperity more broadly.[15]

As the BCA noted in its 2006 publication, *Engaging our Potential: The Economic and Social Necessity of Increasing Workforce Participation*, nearly 3 million people of working age and not in education are not participants in the labour force. Within this group are large pockets of significant, sustained and entrenched disadvantage, groups for whom participation and education remain well below that achieved in mainstream society. As an example, workforce and education participation rates for Indigenous Australians remain significantly lower than for the non-Indigenous population. On these measures there is still a long way to go. The best way to improve social prosperity over the long term is to invest in higher participation in employment and education and to reduce the disincentives created by taxes and/or poorly targeted and structured benefit payments (including middle-class welfare).[16]

FIGURE 9

TAX CHURNS ... WHILE FAIRNESS FLATLINES

Source: Access Economics Paper 1.
Note: the Gini coefficient is a measure of income dispersion ranging from zero per cent in an economy where incomes are shared equally, to 100 per cent in an economy where all incomes are in the hands of one person.

The Federal Budget: Failing the Accountability Test

See Access Economics Papers 1 and 4.

One of the biggest challenges to ensuring the simplicity of government tax and spending decisions and accountability for those decisions in Australia is the duplication and overlap that exists in responsibilities across federal, state and local jurisdictions.

At the federal level alone, however, the BCA considers that the accountability for policies and transparency of the Budget can and should be improved.

Each year the key focus of the Budget is on the scale of new policies. What seems to matter most is the magnitude of new tax and spending decisions, with relatively less focus on the longer-term impacts and policy outcomes intended or achieved.

In addition, because the focus is on policies being announced in the annual budget, it can be difficult to determine the cumulative impact of policy decisions, even when successive policies are targeted at similar groups or objectives. There is little scrutiny of the effectiveness of the ongoing spending base, which is taken as 'given'. The plethora of benefits that are now potentially available to families means that calculating the net impact of tax and spending decisions and how these impact on incentives to work or otherwise, for example, is overly complex and requires significant expertise.

This lack of transparency and accountability is further complicated by the fact that policies are often 're-announced' or 're-badged' in an effort to bolster the perceived significance of government actions. This too means that determining the 'net' impact of policies and whether, in total, they are producing the results intended or desired is not easy.

> '... the Australian Government budget process is not adequately geared to provide a comprehensive review of the effectiveness of government spending as a whole.'
>
> Access Economics Paper 1.

CONCLUSION AND RECOMMENDATIONS

The discussion and analysis in this submission highlights a number of important areas in which the federal Budget can and should be strengthened. The Budget and the broader reform agenda that it supports must better address the priorities and requirements of a capacity-constrained economy. The Budget remains heavily geared to past challenges and policy frameworks. There is now a need and opportunity to restructure fiscal policies and processes to ensure that government actions are targeted effectively and support – rather than hinder – future growth and prosperity.

Strong economic growth and revenue flows have allowed governments to replace the quality of policy assessment and outcomes with quantity of spending. In many ways, allocating revenue in increasingly larger amounts has become the default strategy that governments have employed to address economic and social issues that require more complex response strategies.

While Australia appears, on the surface, to be in a sound fiscal position, headline numbers mask a structural deterioration that has left fiscal policy increasingly sensitive to fluctuations, pressures and changes in economic growth, here and internationally.

As this submission argues, there is a major disconnect between the focus of recent budgets and the longer-term needs of the economy.

> ‘Australia leads the world on many public policy fronts – many programs successful in Australia have been copied across the globe – but there is a long way to go in terms of implementing best practice federal expenditure policy.’
>
> Access Economics Paper 1.

The 2008–09 Budget presents a real opportunity to implement reforms to ensure that federal fiscal policy better supports economic and social prosperity over the long term.

FEDERAL BUDGET 2008–09: BCA RECOMMENDATIONS

The BCA recommends that the 2008–09 Budget incorporate a series of structural reforms aimed at:

1. Streamlining expenditure to provide the conditions in future budgets to effectively address revenue issues.
2. Restoring greater budget accountability and disciplines.
3. Making significant reform of fiscal relations a priority of the federal government's push to reform federal–state relations more broadly.

1 Major review and streamlining of expenditure

- Constrain the growth in federal expenditure by:
  - Setting a target of zero year-on-year growth in real expenditure for the next three years. This would result in cumulative savings of over $32 billion over the three-year-period through cutting current expenditure growth of 7.5 per cent this financial year to below 3 per cent in line with, or below, the rate of inflation.
  - Lock these savings into the Budget's forward estimates to ensure a baseline of expenditure savings into the longer term.

Table 2 demonstrates the cumulative result of the BCA's proposed expenditure targets on overall spending.

TABLE 2

EXPENDITURE OUTCOMES FROM A ZERO REAL EXPENDITURE GROWTH LIMIT

	2007–08	2008–09	2009–10	2010–11
	Estimates		Projections	
Total expenses – general government sector ($b)	**235.8**	**242.3**	**248.4**	**254.6**
Per cent of GDP	21.0%	20.3%	19.7%	19.2%
Cumulative savings ($b)	0	6.4	17.4	32.2
Growth in spending on previous year (nominal)	7.5%	2.75%	2.50%	2.50%

Source: Pre-election Economic and Fiscal Outlook 2007 and BCA calculations. BCA calculations are based on Consumer Price Index forecasts provided by Treasury in PEFO 2007. All estimates and projections are based on Government Finance Statistics (GFS) standards, but with Goods and Services Tax (GST) revenue collected on behalf of the states and territories netted off expenses.

- In relation to specific measures, the government should:
  - Immediately review the largest areas of expenditure in terms of their effectiveness in enhancing economic and social prosperity.
  - Attention should be focused on developing strategies and introducing greater fiscal rigour to areas where spending is growing or projected to grow, such as health, education and defence, to assess whether funding supports outcomes and is being effectively targeted.
  - Programs aimed at providing assistance to business should also be reviewed to ensure that they contribute to economic growth rather than distorting the allocation of scarce resources.
  - Develop strategies to ensure social security and welfare is better targeted to those people genuinely in need.

2 Enhance budget accountability

To support improved tax and spending outcomes, budget processes and reporting need to be strengthened. In this regard the federal government should commit to a 'Charter of Budget Quality'. The charter should:

- Ensure all new spending initiatives:
  - are subject to a rigorous process of cost–benefit analysis, including that the least-cost policy option has been applied to achieve the policy objective;
  - require the specification of clear policy objectives and targets, and timelines for achieving those targets;
  - are subject to regular and transparent performance reviews.
- Commit to legislate for a review of all expenditure and revenue policies every five years using a framework similar to that adopted in the 1996 National Commission of Audit.
- Improve budget reporting to genuinely enhance understanding of fiscal priorities, the government's call on resources, and the impact and effectiveness of policies. In particular:
  - A simpler and more consolidated approach to the budget papers should be adopted.

- A series of simple headline indicators should be developed and reported to enable a better understanding of how a dollar of tax revenue is spent on average, and how the government is proposing to spend each additional dollar of tax revenue through new policy decisions.
- Budget papers should include a clear discussion of key program outcomes and how these compare with stated objectives and targets.
- An immediate priority should be assessing and reporting on the objectives of social welfare spending, the rationale for government intervention, and the extent to which improved outcomes are being achieved particularly for key groups facing significant disadvantage.
- Budget papers should include a clear discussion of the expected impact of spending and tax decisions on participation and productivity outcomes, the economy as a whole, and an assessment of whether and how significantly they will impact on the conclusions of the most recent Intergenerational Report.
- Budget papers should include estimates of the structural budget balance, taking account of real and nominal economic cycles.

3 Reform federal–state fiscal relations

Acknowledging recent commitments to reforming special purpose payments, the BCA recommends the Budget incorporate a commitment for a thorough and comprehensive review of federal–state fiscal arrangements. This review should be made a priority for COAG's 2008 national reform agenda.

Any review should focus on:

- Improving the allocation of responsibilities across jurisdictions to avoid duplication and to ensure those best placed to deliver services are charged with that responsibility.
- Reassessing the resource requirements of the states in line with the changes in the allocation of responsibilities.
- Structuring payments to the states so as to:
  - improve simplicity and accountability;
  - reduce administrative costs;
  - reward innovation and efficiency in service delivery;
  - remove duplication and overlap across governments; and
  - maximise social and economic prosperity.
- Reviewing the effectiveness of current revenue streams and revenue-sharing arrangements, focusing on:
  - the amount of revenue raised;
  - the operating costs of individual taxes relative to the revenue raised;
  - the administrative burden on both government and business of individual taxes; and
  - the sustainability of current arrangements.

NOTES

1 *BCA Budget Submission 2007–08, Passing on Prosperity: Raising the High Bar on Reform*, Business Council of Australia, Melbourne, January 2007.

2 Throughout this submission the 'per person' calculations are based on total population. The figures are in today's dollars.

3 'Deadweight loss' is a concept that reflects lost economic value. It arises when economic behaviour is altered in response to taxes, resulting in production and consumption in different quantities to what would have occurred if the tax did not exist. The deadweight loss is therefore a loss of efficiency rather than a specific cost that can be accounted for in the Budget.

4 Productivity Commission (2003) and Lattimore (1997) as quoted in Access Economics Paper 1.

5 There has been considerable debate about the extent to which the federal tax take has increased in recent years. In part that has been complicated by the decision of the Howard Government not to include revenues from the GST as part of federal tax collections. The previous federal government did not include GST revenues in calculating its tax take, arguing that it was effectively a state tax. The 2007–08 Budget documents accordingly show the federal tax to GDP ratio falling from 22.3 per cent in 1995–96 to 20.7 per cent in 2007–08. But this is not an appropriate comparison because the 1995–96 figure does include tax revenues collected for, and passed on to, the states. The BCA welcomes the commitment of the new federal Treasurer to include the GST as a federal tax.

6 There are clearly factors, such as the drought, which can drive up spending even when the broader economy is strong. More generally, even when the national economy is strong, significant areas of need can remain. But the broader point, that rising spending in times of rising prosperity should be questioned, remains valid.

7 The second Intergenerational Report states that: 'real Australian Government spending per person is projected to increase by 2 per cent a year on average over the next 40 years'.

8 Access Economics makes the broader point that modelling should take into account these and other 'income' effects and their feedback effects on the longer-term budget outlook. See Access Economics Paper 3.

9 The BCA is not arguing that the changes to superannuation should not have been undertaken, but rather that they have implications for longer-term revenues that should be reflected in the Intergenerational Report.

10 Some growth in spending has been focused on more intensive efforts to lift the employment prospects of the long-term unemployed (although this has also involved tighter eligibility). But overall, the growth in per capita spending on social security and welfare cannot be accounted for by these developments.

11 See A. Harding, R. Lloyd and N. Warren, *The Distribution of Taxes and Government Benefits in Australia*, paper presented at the Conference on the Distributional Effects of Government Spending and Taxation, the Levy Economics Institute, 15 October 2004 and *Redistribution, the Welfare State and Lifetime Transitions*, paper presented at the conference 'Transitions and Risk: New Directions in Social Policy', Melbourne, 24 February 2005. Note that this analysis focuses on all government spending.

12 Evidence suggests that in a strong economic and employment environment the income differential between skilled and unskilled workers grows, so it is reasonable to conclude that income inequality may have widened in the absence of some government intervention. The issue here is whether the magnitude of intervention has paid off.

13 Centre for Independent Studies, *Issue Analysis* series numbers 57, 61 and 79, 2005–2007.

14 See Lloyd, Harding and Warren (2004 and 2005).

15 This point has been well made by the Centre for Independent Studies through a series of publications.

16 *Engaging our Potential* provides a detailed discussion of these issues and the BCA's priorities and conclusions. These will not be repeated here, except to highlight the fact that the BCA considers that all governments need to better tailor assistance to those facing significant and multiple barriers to participation in employment and education, and to develop clear targets for assistance and timelines for targets to be met so the efficacy of spending can be assessed over time.

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