February 2008

Paper 1: The bang for our buck – is our Federal Budget doing the job?

Report by Access Economics Pty Limited for the

Business Council of Australia

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EXECUTIVE SUMMARY

Every society pools its resources to try to reach common goals.

There is no greater reflection of the aims and goals of our society – our social compact with ourselves – than the Australian Budget.

Government can be thought of as a luxury good. The higher go average incomes, the greater is our demand for the goods and services provided under our 'social compact'.

Yet there is a vital balance to be struck here: given that ever increasing service levels carry with them commensurate increases in costs – what is an appropriate level? And how is that changing over time?

This report considers those and related issues, asking **are Australians really getting the best bang per buck from Federal Budget spending?**

WHAT ARE WE AIMING FOR ANYWAY?

What do we want? That question is obvious, but it is all-too-rarely asked.

Unless we can first identify the aims of policy, we cannot assess what we are already doing and whether policy proposals for change are good, bad or indifferent.

This report notes that **there are two fundamental aims for any society, and hence for any society's social compact – prosperity and fairness**. The first aim, prosperity, can be thought of as the size of the economic pie, while the second, fairness, can be thought of as the way that pie is sliced up.

Therefore there are two primary reasons for government involvement in the activities of the community: first so as to improve prosperity (often by correcting for some market failure) and, second, to promote fairness (usually by working to increase social equity and opportunity).

There is a third important aim here too – we not only want the Australian Government to work towards common prosperity (our 'commonwealth') and a fair society, we also want it to do that in as simple a way as possible, avoiding unnecessary burdens on people to meet the demands of government, or unnecessarily costly ways for the Government to achieve these ends of prosperity and fairness. In brief, this **third aim of simplicity aims to reduce complexity in the way society transacts**, minimising compliance and administrative costs on individuals and companies, as well as avoiding duplication.

At $278 billion in 2006-07, 27% of the total income generated by our economy, the total revenue of the Australian Government shows the huge extent of society's commitment to these goals.

Given the scale of the investment, the opportunity cost of any unproductive and misdirected policy is high – especially when the economy is close to full employment.

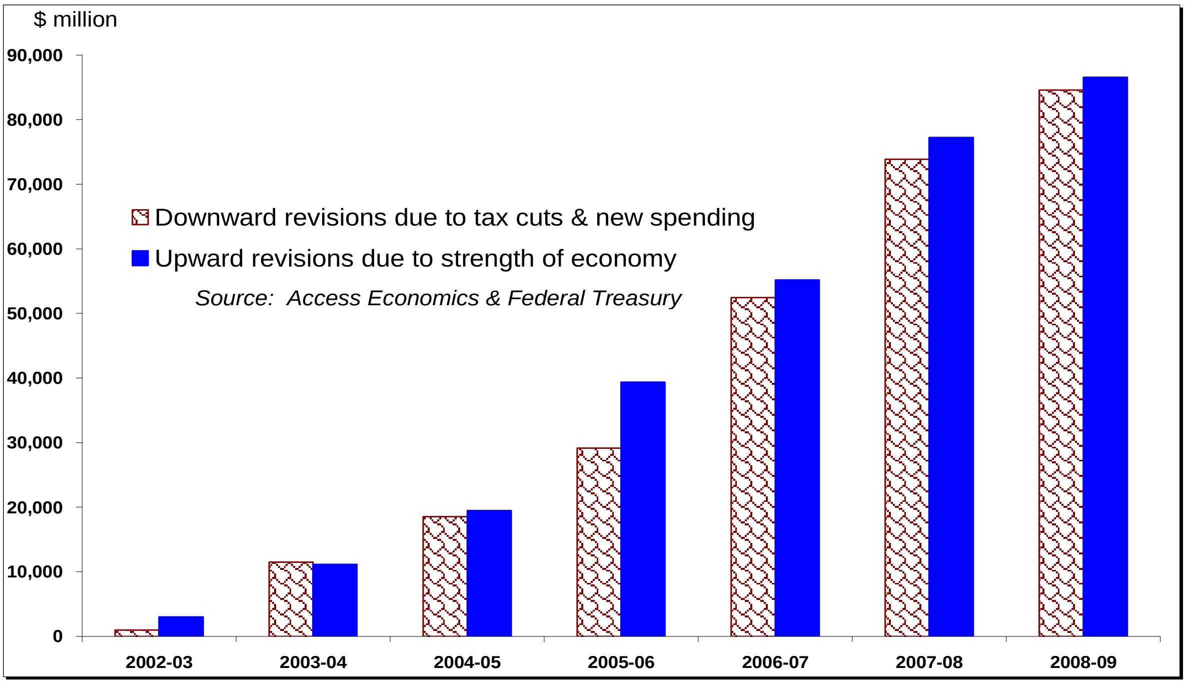
WHY WORRY ABOUT THIS NOW?

It is particularly timely to ask the questions addressed in this report now, in the wake of a Federal election. The last time the Australian Budget was carefully considered, top to bottom, was in the 1996 National Commission of Audit.

Yet subsequent developments in fiscal policy have been huge. In particular, the period since mid-2002 has seen revenues growing rapidly, riding a mining-led boom in corporate profits (and resulting in a leap in corporate tax). The underlying strength of the Budget has been revised upward no less than eleven times since mid-2002. These revisions have resulted in an *economy-driven* net revenue gain since then of $87 billion for the 2008-09 financial year.

That is, economic prosperity has delivered a windfall to Federal finances of $87 billion *over and above Treasury's expectations as of mid-2002 as to where we'd be now.*

ANNUAL COST OF NET NEW POLICIES ANNOUNCED SINCE MID-2002



However, as fast as that money has come in – a historic opportunity to re-fashion Australia's social compact with itself – the policy decisions the previous Government made since mid-2002 are now running at a cost of more than $85 billion a year, or some 7.7% of GDP (as the figure above also shows) – $45 billion in tax cuts, and $40 billion in spending increases.

Easy come, easy go. In the short term, these trends have cancelled each other out, with costly tax cuts and spending being offset by stronger company taxes on the back of surging global commodity prices. But the end result has been yet another lift in spending per person at a time when we are experiencing the greatest gains in prosperity in a generation or more.

And we have failed to continue the process of tax reform (lowering tax rates and widening tax bases), meaning that there is still a substantial gap between the top two marginal rates of personal income tax and the corporate tax rate – with all the inefficiencies that generates.

Have the huge decisions of recent years made sense? Are we effectively achieving the aims of our social compact? Could we be doing better? And, if so, how?

HOW DO WE BEST ACHIEVE THESE AIMS OF PROSPERITY AND FAIRNESS?

That assessment is made more complicated because while the best ways to achieve prosperity and fairness have been changing, our methods of achieving them have been slow to recognise that. In particular, **full employment means that the key drivers of prosperity are rather different today than they have been for a generation**.

That is because demand has caught up with supply for the first time in over 30 years. An unemployment rate close to 4% and interest rates running well above the developed world average show just how tightly these capacity constraints are biting.

This changes the drivers of prosperity – if we want a bigger economy and higher incomes, it is now no longer sufficient to simply boost demand so as to encourage greater use of underutilised resources (such as the unemployed or underemployed).

Rather, the key to boosting future prosperity for the Australian economy now lies squarely with expanding our supply capacity. If we want a more prosperous future, then we need to improve on what Federal Treasury dubs the 3Ps – population, participation and productivity.

- This is because *real* **economic output** or real GDP **equals** the 3Ps. The level of output is determined by **the number of workers** (in turn equal to population – the number of people aged 15 and over – times participation – the average number of hours worked in the labour force by each working-age person) **and the effectiveness of those workers** (their productivity, the average output produced per hour worked).
- *Nominal* GDP (or GDP at current prices), on the other hand, depends on a broader set of factors, including prices of consumption and investment goods, as well as import and export prices (the 'terms of trade'). The higher *nominal* GDP in recent years is partially attributable to the recent strong rise in the terms of trade, which in turn is due to a China-driven leap in commodity prices (IGR2, 2007).

To quote Treasury Secretary Ken Henry[1], **Australia cannot**:

> *"**… generate higher national income without first expanding the nation's supply capacity: one of the 3Ps — population, participation or productivity.** Now you might be thinking that that's all pretty obvious. It is, after all, a tautology. But one of my messages to you today is that if you understand what I have just been talking about, then you are a member of a rather small minority group."*

What the Secretary of the Treasury has pointed out – and that as yet only a minority of policymakers have grasped – is that Australia's long term prosperity (and so our living standards) are largely just a reflection of changes in each of these three factors through time. As a result, **growth in prosperity in Australia depends on:**

- the number of workers as a share of the population (and their participation in the workforce or hours worked);
- how effective (or productive) these workers are when they work; and
- when structural changes affect relative prices in the economy (such as a China boom raising commodity prices), how efficient we are at reallocating Australia's resources (of land, labour and capital) to best release their potential economic value.

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[1] Henry K., (2007) *Treasury's Effectiveness in the Current Environment*, Address to Treasury Staff, March 2007, Treasury.

The Secretary of the Treasury also noted in the same speech that the policy implications of a supply-constrained world are important – but not yet widely recognised or understood:

> "*… we need to have an appreciation of the consequences of policy intervention in an economy operating at, or close to, full employment. In the absence of externalities and other sources of market failure, a market free of policy intervention will allocate resources efficiently. Any government intervention will shift resources, including jobs, from one activity to another and impose a deadweight loss of efficiency on the economy."*

That means that the closer we are to full capacity, the more costly bad government policy becomes, and the more costly big government becomes – because workers could often be doing something more valuable. This shift to a supply constrained economy should prompt a comprehensive review of all government expenditure.

Why? Because it automatically changes some of the policy emphasis of the past:

- For example, Governments often see their role as job promotion and job creation. But whether now off the back of booming demand growth in the Australian economy or over the longer term as the retirement of the baby boomers eats into the supply side capacity of the economy, **the underlying policy question is no longer "where is the next job coming from?", but rather, "where is the next worker coming from?"**
- That puts greater emphasis on tax reform, particularly addressing effective marginal tax rates, rather than simply tax cuts (with the resultant reduction in deadweight losses showing up as better resource allocation – more in line with comparative advantage – and hence achieving higher productivity). In general, broad-based tax reform is preferable to singling out particular groups in society because it avoids the government 'picking winners' at the expense of others. **Tax reform is also one of the best ways of boosting the supply potential of the economy**, including by improving incentives for workers and reducing the disincentives faced by businesses.
- Policymaking, particularly in the current environment should also recognise the longer term benefits implicit in **greater investment in the likes of education and training** (via the future boosts that these investments generate in both productivity and participation).
- Finally, by implication, policymaking should also question whether Australia's scarce resources are being used to their maximum potential – are our policies merely propping up sectors whose workers could be more valuably employed elsewhere?

The 3Ps themselves involve differing degrees of 'quantity' and 'quality'.

If the key aim is to raise prosperity per head (living standards), then population becomes less important to the equation (though not unimportant), and **the greatest long term gain lies in maximising the level of participation and productivity for Australia's workers.**

In a supply constrained economy, that means questioning government resource use, because economists have long agreed that it makes sense for the private sector to create wealth (to concentrate on prosperity) and the public sector to redistribute it (to concentrate on fairness – which mostly means a focus on the way the national income pie is sliced up).

The rationale for that is simple. With rare exceptions, markets and not governments are best at allocating scarce resources and creating prosperity.

- Expanding the growth potential of the economy is not simply a matter of taxing and spending so as to redistribute more and more money. Rather, it requires ensuring an efficient regulatory environment that facilitates the effective operation of markets.

In fact, today's supply constrained economy means that government use of resources is increasingly limiting the ability of ordinary Australians to create prosperity. Governments have a natural tendency to grow, but that increasingly means eating into (or crowding out) the resources available to the private sector. This effectively bids away resources from the private sector and runs the risk of undermining rather than promoting prosperity.

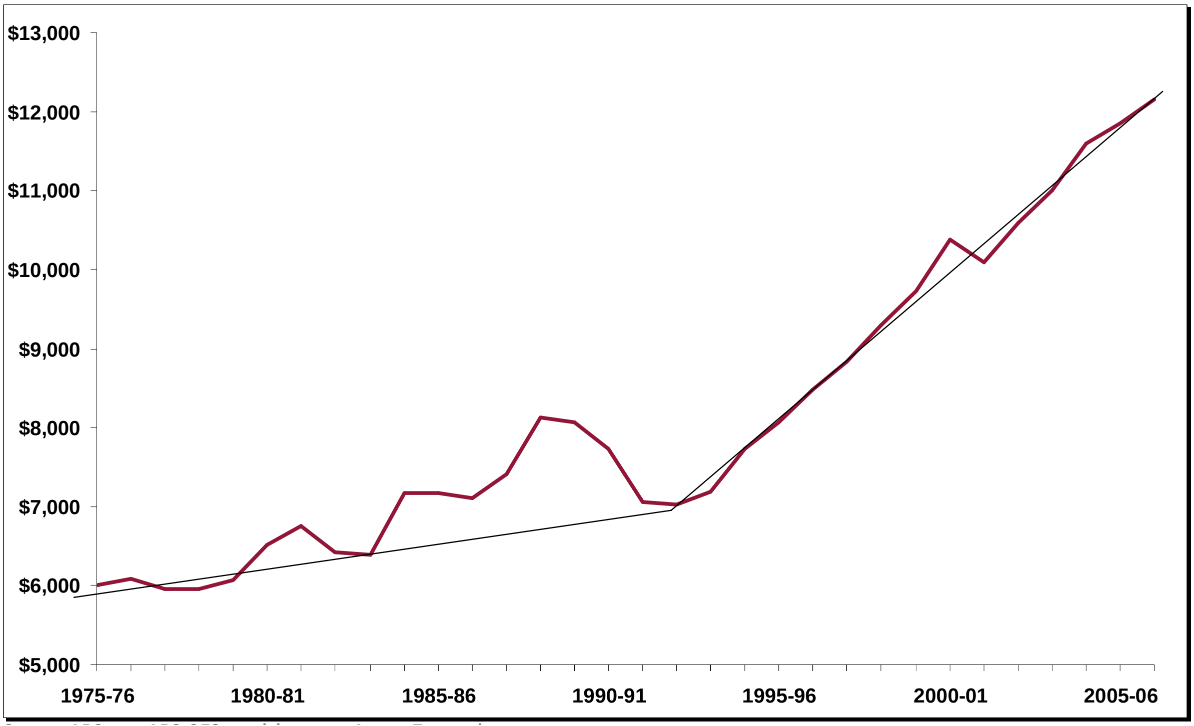
WHAT HAS BEEN HAPPENING?

Government spending and revenue have been increasing rapidly in per person terms at a time when prosperity has been surging. That bears thinking about. It means our per person investment in Australia's social compact has risen.

Yet have returns risen to match? We are investing more in future prosperity and current fairness yet it seems that the bang for our buck has been modest at best.

The figure below maps out Federal tax revenues raised per person over time in today's dollars.

FEDERAL TAX REVENUE PER PERSON IN TODAY'S DOLLARS (INCLUDING GST)

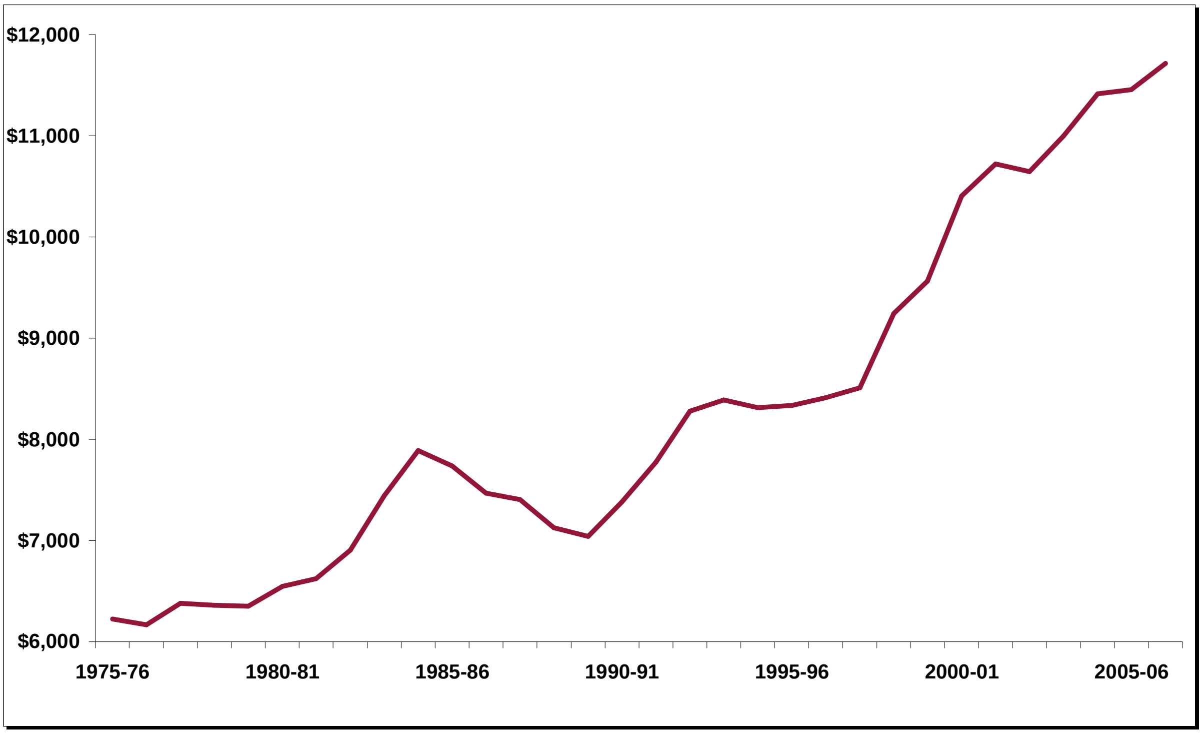


The figure shows the extent to which the burden of government has grown. The Federal tax take (including GST) rose relatively slowly from 1975-76 to 1992-93, lifting by $1,019 per head across that 17 year period. But in the 14 years to 2006-07, tax revenue per person per year in today's dollars is estimated to have risen a further $5,123, to be $12,153 – and still growing at a seemingly inexorable rate.

- Only the tax cuts instituted in response to the recession of the early 1990s have had much impact on the pace of growth of this series.

- The rise of the tax take has meant that it is increasingly reflecting 'churn', with money taken from individuals in the form of taxation and then subsequently returned via transfer payments 'from whence it came'.

FEDERAL SPENDING PER PERSON IN TODAY'S DOLLARS (EXCLUDING INTEREST AND ASSET SALES)



Similarly, the matching figure on Federal Government spending tells the same story. The Federal spend (excluding interest costs and asset sales) rose slowly from 1975-76 to 1997-98, lifting by $2,285 per head across that 22 year period. But in the nine years to the estimated level in 2006-07, spending per person in today's dollars rose by a further $3,207, to be $11,716 per head.

Surely the opposite should be occurring amid the China-driven boom in commodity prices and hence company profits and company taxes?

- There should be relatively less need for new government spending per person – particularly on transfers and welfare – to rise as the economy surges.
- Surging prosperity should be reducing the number of people requiring government services or support as people are better off and better placed to look after themselves.

Real Government spending per person should be falling – not growing.

However, history tells us that governments (of all political stripes) tend to be poor managers of boom times, especially unanticipated booms:

- As more and more unexpected revenue has poured into tax coffers in recent years, Budget decisions increasingly smacked of less strategic and well targeted expenditure.
- In its place came 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.
- This has put the structural (underlying) Budget balance into deficit at a time of exceptional prosperity. That was poor economic management, all the more so as it wasted the once-in-a-generation opportunity thrown up by the commodities boom.

When revenue spikes due to a temporary shock – such as a commodity price boom – the increase in cash is just that: temporary. Although the current revenue windfall is still building, it is not permanent. Therefore the resultant cash windfall cannot be spent in a way that permanently raises government outlays without compromising future prosperity.

Moreover, and in addition to the current boost in spending, Australia faces a number of future pressures on our social compact, including those associated with the ageing population and other issues identified in the *2007 Intergenerational Report*. These additional pressures mean we need to think more strategically about any increased spending. **Once put in place, extra spending is often difficult to roll back.**

WHAT PROTECTS AUSTRALIANS FROM FAILURES IN OUR SOCIAL COMPACT?

Part of the reason for ever-increasing government spending is the lack of an effective framework for review. Budgets are considered in an annual process, but only new policies – there is all-too-little scrutiny of the existing burden of government:

- New spending gets announced atop an ever-growing base of existing programmes.
- More attention needs to be paid to objectively reviewing and reprioritising existing spending and revenues. The focus should be to improve the efficiency and effectiveness of government policy by examining its quality and draw on resources.

WHAT DOES THIS IMPLY FOR POLICY?

The appropriate size of government for Australia depends on how much revenue we need to raise and spending we need to do in order to achieve our twin aims of prosperity and fairness.

As these revenues should be raised as efficiently and equitably as possible, that means **there are natural limits on the size of Government**. First, each additional dollar of tax raised and money spent gives an increasingly smaller bang for the buck in both terms of prosperity and fairness and, second, taxes in particular weigh on the incentives to work and invest that underlie national prosperity.

The ideal is therefore a government which is as small as possible to achieve its aims. While it is difficult to directly define the 'optimal' size of government, the OECD argues that government spending (and the taxes required to finance it) means a loss of efficiency as governments become larger. That means **bigger governments find it harder to achieve one of their basic aims – increased prosperity**.

The unusual feature of recent years is that national prosperity has been climbing very fast amid the commodity price impact of the continuing China boom.

- On the one hand, that has directly boosted national prosperity, raising incomes and cutting unemployment and (other things equal) reducing the need for government intervention in Australia's economy.
- On the other hand, China's boom also tipped considerable extra resources into the Australian Government's pocket.

So the need for government spending fell at the same time as the ability of the government to spend rose.

The unfortunate end result has been growth in real government spending per head in recent years without any matching gains in fairness, and without any likely impact having been achieved on prosperity. Indeed, as Treasury's Ken Henry warned the previous Government in March 2007, increased government intervention in an economy already at full stretch comes at an increasing cost to national prosperity, rather than boosting it.

- **That leaves a policy dilemma. It is likely that the size of government – both taxes and spending – can be rather smaller in Australia without having much impact on what we are achieving on prosperity and fairness.**
- **Indeed, as Ken Henry's point reminds us, it may be that a smaller Australian Government would mean greater prosperity rather than less.**
- **Yet there are risks here too. Although the tax take could certainly be smaller, that is not an argument for tax cuts in the absence of matching cuts to spending.**
- **Rather, it is an argument for smaller Government, not smaller surpluses.**

Indeed, the risk is that further tax cuts which are not matched or bettered by cuts in spending could worsen some existing risks rather than improving them:

- **In the short term**, further tax cuts unsupported by spending cuts would simply add to demand in an economy already at full stretch. That means further tax cuts risk simply disappearing in a puff of interest rate smoke, as tax cuts boost demand and then the Reserve Bank has to raise interest rates to reduce that demand once more.
- **In the medium term**, and as analysed at length in Paper 2 in this series of reports, recent tax cuts were more than financed by the China boom and the resultant lift in commodity prices. But if commodity prices weaken over the medium term as the world's miners boost the supply of minerals to satisfy China's fast growing demand, then the tax cuts of recent years would be seen to have promised permanently lower taxes off the back of a temporary windfall. Hence, further tax cuts unsupported by spending cuts risk being wrong-footed by a partial reverse in the commodity cycle of recent years.
- **Over the longer term**, and as analysed in detail in Paper 3 in this series of reports, the Australian Budget faces striking challenges. Many of these are well known, including the rising cost of our ageing population and the interaction of ageing with rapid cost inflation in health spending. Moreover, the risks may be greater than generally appreciated, as the Federal Treasury's *Intergenerational Reports* of 2002 and 2007 ignore other longer term risks to Australia's revenue coming from the recent abolition of super benefits taxes and the 2001 abolition of the indexation of petrol excise.
- **So there are short, medium and long term risks which mean that the tax cuts Australia needs must also be supported by spending cuts. The former without the latter would be going double or nothing on the risks Australia already faces.**
- **That doesn't mean Australia wouldn't benefit from tax cuts adopted as part of wider tax reforms. Tax reform always makes sense, and there are benefits to be had from broader tax reform and cuts married with offsetting cuts to spending.**
- **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.**

WHAT NEWS ON FAIRNESS?

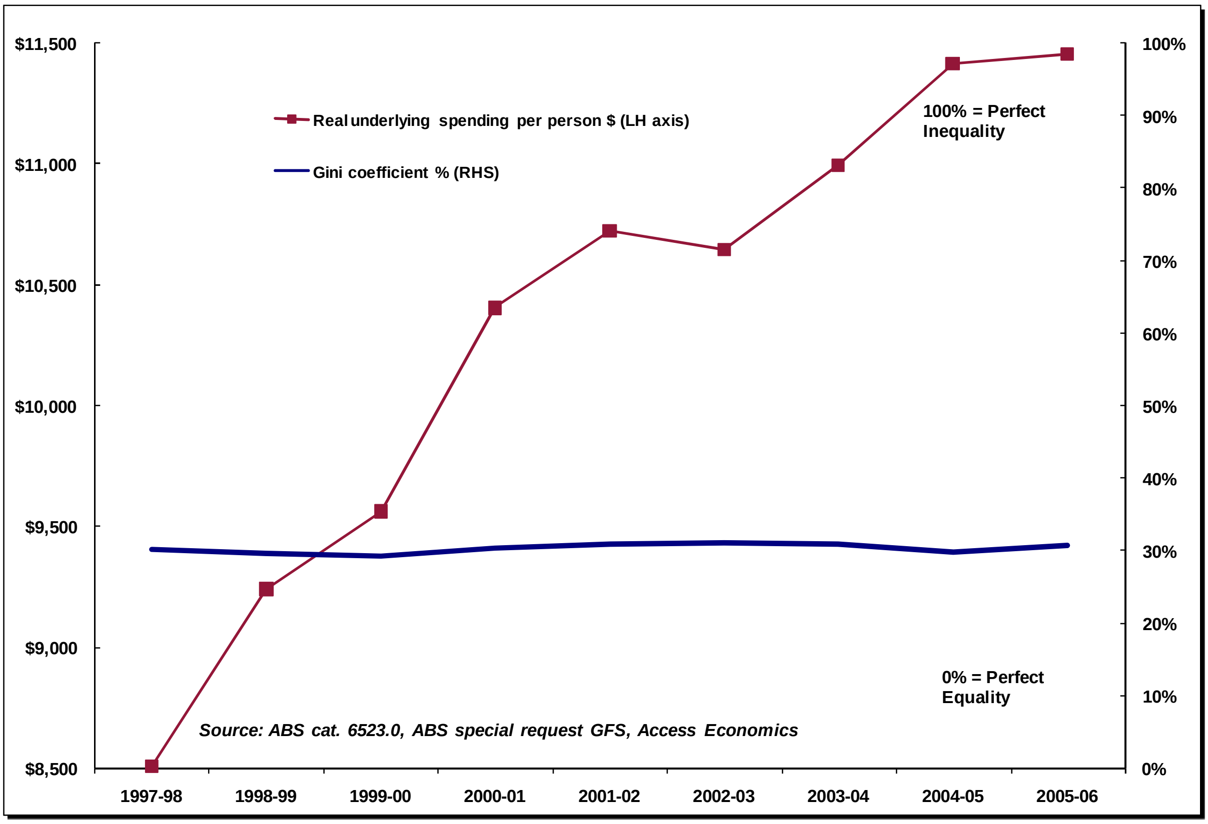
Our leap in prosperity in recent years has not come at the cost of fairness.

- After taxes and benefits, Australian incomes are still shared in much the same way they were over a decade ago.
- In fact, incomes were shared in 2005-06 almost exactly as they were in 1994-95, with the share of income earned by the bottom 20% of families unchanged over that time. The benefit to the least well off is not just due to higher benefits and from lower taxes, but also as more people in the poorest 20% of Australian families are getting jobs.

And the pick up in incomes for those at the bottom appears, if anything, to be gathering pace.

That is no surprise. As Access Economics (and the BCA) have consistently explained, the best method of delivering big gains to all Australians is by making prosperity the key goal of the private sector – not government regulation. The Government should focus on fairness – a key goal of the tax/transfer system.

REAL SPENDING PER PERSON VERSUS A MEASURE OF HOW EVENLY INCOMES ARE DISTRIBUTED AMONG AUSTRALIAN FAMILIES

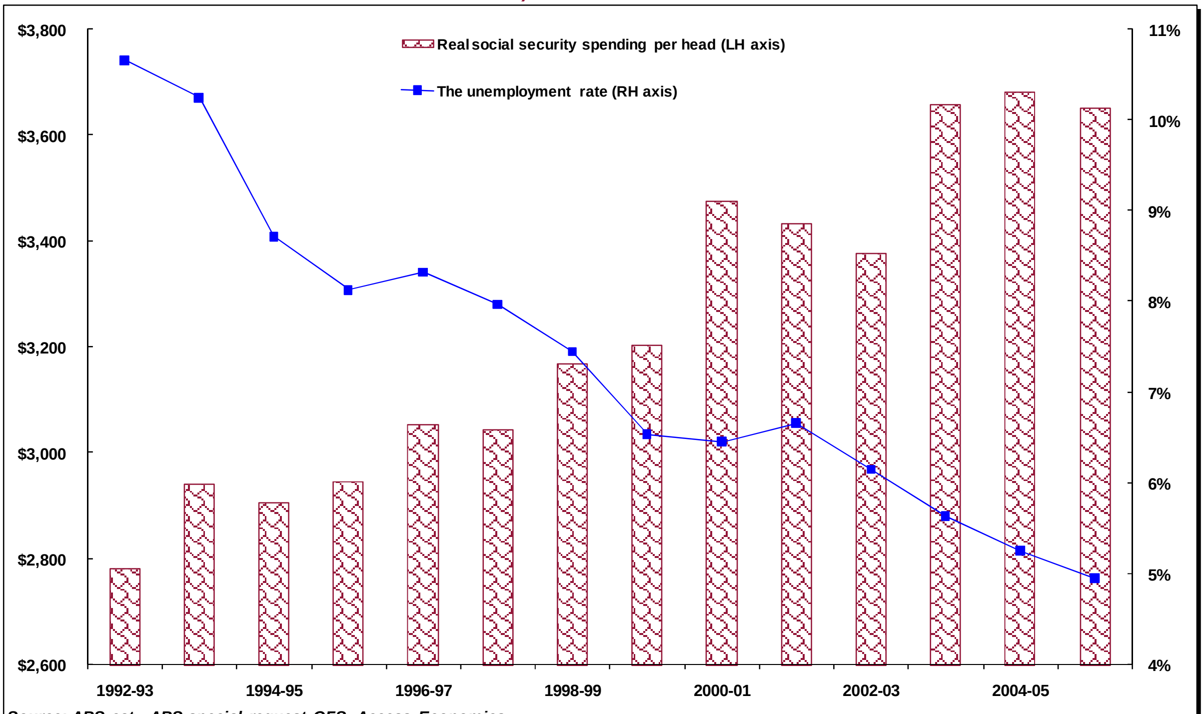


But the bad news is the flipside of that same story. Despite the huge lift in government spending in recent years, **fairness has not improved**. That is a concern. If the government footprint has grown but fairness has remained unchanged, that suggests much of the lift in government spending of late merely spun the wheels of our social compact rather than achieving a fairer society.

That said, there is probably an argument that governments do need to spend more per head over time to maintain fairness at constant levels. That is because the relative return to skill in job markets has been rising in Australia and around the world. In the absence of government action, and other things equal, that leads to a small but steady widening in income differentials. Yet this latter caveat is small, whereas the lift in spending per head in recent years is large.

Hence, and as the next figure shows, unemployment (a simple measure of whether we are achieving success on our goals of prosperity and fairness) has been falling. Yet, despite that good news, the social security bill per person has been steadily climbing.

LOWER UNEMPLOYMENT, BUT A RISING SOCIAL SECURITY BILL



Source: ABS cat., ABS special request GFS, Access Economics

WE CAN DO BETTER

We can do better. Australia has been reforming government activity in a way that limits crowding out and intervention in the economy since the early 1980s. Governments of all stripes have contributed to a massive modernisation and reinvention of government intervention in the Australian economy. Governments and the Australian Public Service are to be commended for being the architects and engineers of this process.

But the reform impetus has since faded. As the China-driven boom in commodity prices has handed money to Canberra on a platter, the incentive to take tough-minded reform decisions has steadily faded. That is all the more frustrating given that ongoing growth in China and India provides great opportunities if we can develop skills, improve productivity and boost competitiveness and reduce the call of governments on our scarce resources.

WHY SETTLE FOR LESS?

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.

That is why this report identifies a series of checklists against which to assess Budget policies. This report uses the broad policy goals of improving prosperity, fairness and simplicity as benchmarks to assess productivity in Federal spending over time.

The current environment boasts examples of best practice in some policies, yet the overall framework is far from transparent and lacks a credible system of policy review. This has led to an excessive burden on taxpayers due to excessive and inefficient non-productive government policy. Reducing that burden through regular comprehensive and transparent review will help to maximise policy productivity and minimise resource use. It will also leave us better placed to manage likely future pressures such as those due to our ageing population.

It's not too late. As identified in the *2007 Intergenerational Report*, small consistent changes set in train now can avoid the need for large and painful adjustments down the track. We should be making the most of the current boom times to implement an efficient, effective and transparent government which is contributing to improved prosperity and fairness in Australia.

Let's get this right.

Access Economics
February 2008

1. CHECKLISTS FOR AUSTRALIAN BUDGET POLICIES

Unless we can first identify the aims of policy, we cannot assess whether what we are already doing and policy proposals for change are good, bad or indifferent.

There are two key economic aims for any society – prosperity and fairness. The first, prosperity, can be thought of as the size of the economic pie, while the second, fairness, can be thought of as the way that pie is sliced up.

Once we know what we are trying to achieve, that then lends itself to identifying simple checklists to apply to new and existing expenditure policy. In brief, **the ideal policy platform promotes a minimalist yet effective approach to the government's call on society's resources**.

At the macro level we can test policy against its likely contribution to prosperity and fairness in society. We can also test policies for their contribution to simplifying and reducing Government-induced complexity in our lives.

Here are the questions to ask whenever governments seek raise the taxes on us or to raise the amount they spend on us.

1.1 THE PROSPERITY CHECKLIST

- Is the policy likely to expand the long-term supply capacity of the economy in a sustainable way?
  - Is the expenditure likely to increase participation or productivity in the long run?
  - Does it minimise barriers to entry and employment?
- Even if a prosperity-based policy objective has been identified, is there a genuine reason for the government to deliver the service?
  - Is there a case for government intervention such as a market failure?
  - Is there a market mechanism or solution available to deliver the policy objective – could the private sector be doing this anyway?
  - Is the service delivery contestable?
  - Is there a case for corporatising the agency responsible for service delivery?
- 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 market distortions?
  - Does it place an overly onerous efficiency burden on people and companies?
  - Does the policy minimise churn?
- Is the policy flexible enough to adapt as society and markets change over time?
  - Does the policy still meet clearly defined goals?
  - How will those goals and progress against them be monitored and assessed?

1.2 THE FAIRNESS CHECKLIST

- ❑ Does the policy assist in providing a 'safety net' for the least well off?
- ❑ Are the gains of prosperity being equitably delivered across society?
- ❑ Does the policy improve access to government services such education and health care?
- ❑ Does Australia have policy frameworks in place that are improving equality of opportunity over time?
- ❑ Is Australia achieving noticeable improvements in fairness, as assessed against global benchmarks such as Gini coefficients?
- ❑ Are the benefits of subsidies captured by society more broadly or by individuals or businesses?
- ❑ Does the governmental framework follow due process, including adequate protections for the rights of individuals?

1.3 THE SIMPLICITY CHECKLIST

- ❑ Is the application and policing of the policy as simple as possible?
  - If the policy is necessarily a complex one, will it actually increase wellbeing?
  - Does the policy reduce the compliance burden on business and individuals?
  - Does the policy reduce the regulatory burden on business and individuals?
- ❑ Is the ownership of the policy clearly defined by level of government?
  - Does the policy reduce duplication across existing Federal or State legislation?
  - Does the policy minimise the likelihood of cost shifting across governments?
- ❑ Has the policy passed a Regulatory Impact Statement?
  - Has the policy been independently peer reviewed against global best practice?
  - Does the policy include a sunset clause and a mechanism for timely review?

These checklist tests are not perfect, but following them would ensure Australians got a better bang for their buck out of their Federal Budget.

2. THE TAX AND WELFARE 'CHURN'

Almost each and every Australian Government since federation has presided over Commonwealth general government revenue growing at a faster rate than national output.

One of the reasons this has occurred without significant backlash from the electorate is that disposable incomes have risen fast, meaning that people are now demanding more of governments than ever before.

This has driven the demand for government services to unprecedented levels. Government is viewed by society as a luxury good – the higher go our incomes over time, the higher go our expectations of the level of service we expect and receive from government agencies:

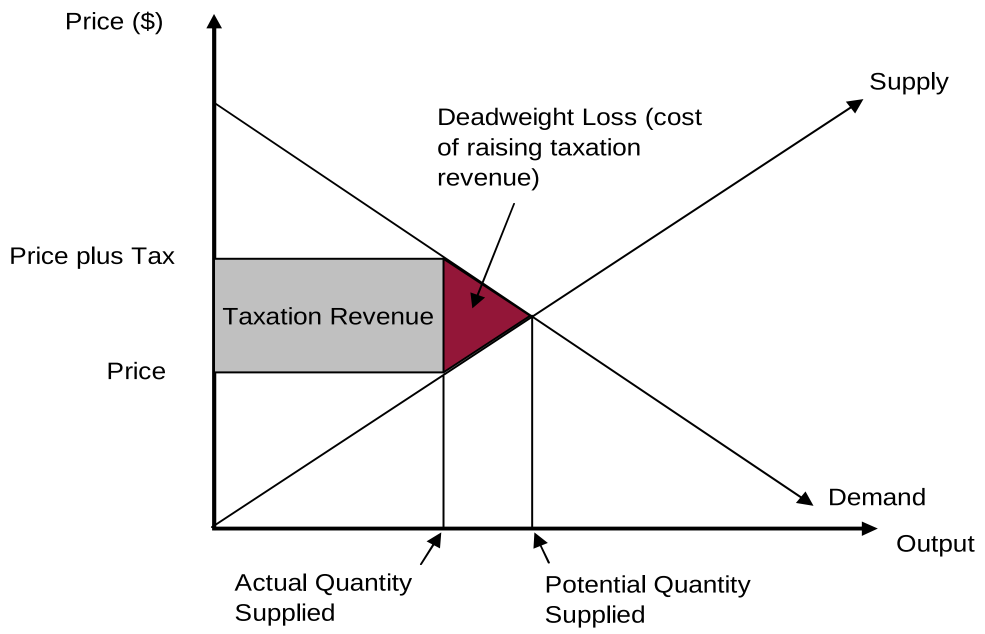
- Both revenues and spending per head have risen rapidly – revenues since the early 1990s, and spending since the late 1990s.
- **The rise of both has meant that they increasingly reflect 'churn', with money taken from individuals as taxes and then subsequently returned via transfer payments 'from whence it came'.**

The problem with taxes and resulting transfer payments is that they result in significant 'deadweight losses' – that is, the economy shrinks in value for every dollar of tax raised.

Taxes typically change incentives, and therefore 'destroy value' as they do so. Taxes alter the price and quantity of goods sold compared to what they would be if the market were not distorted, and thus lead to less trade between buyers and sellers that would otherwise be seen (Figure 2-1).

In a practical sense, this distortion changes the incentives of consumers and reveals itself as a loss of efficiency in the economy – creating deadweight loss.

FIGURE 2-1: DEADWEIGHT LOSS OF TAXATION



Source: Access Economics

The average rate of deadweight loss is around 27.5 cents per $1 of tax revenue raised, based on Productivity Commission (2003), in turn derived from Lattimore (1997).

That is why the Secretary of the Treasury[2] has noted that:

> "*Any government intervention will shift resources, including jobs, from one activity to another and impose a deadweight loss of efficiency on the economy.*"

Moreover, the risks of churn (and the associated lift in deadweight losses it implies) are on the rise. Australia is getting a surge in revenues from the commodities boom and receiving a piecemeal approach to genuine reform in return.

Not all of the blame lies at the foot of the previous Government for its failure to convince the population and act on the need for genuine reform over these past years. Economists and forecasters the globe over failed to foresee the strength of the commodity price boom and strength in the global growth cycle that created it.

- This is not surprising (though it has created a lost opportunity), but the failure to forecast the surge in revenue inhibited the previous Government's ability to plan and carry out large scale genuine reforms.
- Add to this that the previous Government's commitment to maintaining only modest surpluses (of around 1% of national output) for fear of an electoral backlash over the size of Government savings – which would otherwise be in taxpayers' pockets – and we had a recipe for the piecemeal approach to reform and tax cuts of recent years.
- Policymakers have been stretched for ideas, with decisions in recent years increasingly smacking of 'middle-class welfare' and a raft of other 'policy on the run' measures, rather than the simple policy test of asking 'will this improve prosperity and/or fairness?'.
- There is a rising risk that 'good policy' has increasingly been defined by the likelihood of its eventual political attractiveness on implementation rather than on an unbiased assessment of all options based on merit.

Hence the recent flood of cash has put the policy review process under significant pressure, particularly given the structural change that the economy has undergone recently.

[2] Henry K., (2007) *Treasury's Effectiveness in the Current Environment*, Address to Treasury Staff, March 2007, Treasury.

3. TRENDS IN THE GOVERNMENT'S CALL ON RESOURCES – THE FEDERAL TAX TAKE

The last National Commission of Audit (NCA) noted that *"**A range of economic and social pressures are forcing most developed countries to rethink where and how governments should be involved in the community's activities.**"*

This is truer today than when it was written in 1996 because of the extent of supply constraints affecting the economy today.

The government uses resources – workers and capital – which then limits the extent to which the private sector can use those resources. And that limitation bites harder when the economy is already at full capacity.

Historically, each longstanding Treasurer has increased the tax take over their predecessor.

Has that been true more recently? The previous Government argued that it had not. The tax to GDP ratio published in the 2007-08 Budget documents shows a fall from 22.3% in 1995-96 to 20.7% in 2007-08.

Yet the devil is in the detail. That comparison excludes GST revenue in 2007-08 and then compares this series to an all inclusive (and therefore artificially inflated) measure of Federal tax revenue prior to 1999-00. The earlier data is inflated by the amount of tax revenue that was collected for, and passed on to the States, in the same way that the GST is collected and passed on to the States. In other words, the taxes that the GST replaced are not excluded from the data prior to 1999-00. This means that the two series used in the Budget documents compare apples with oranges.

TABLE 3-1: COMMONWEALTH TAX REVENUE FOR OWN PURPOSES – % OF GDP (CASH BASIS)

Year	A Excluding general purpose grants up to 1999-00 and GST[3]	B Including GST – ABS, GFS measure	C 2007-08 Budget measure
1995-96	19.0	22.3	22.3
2005-06	20.8	24.9	21.1
2006-07	20.7	24.4	20.9
2007-08	20.5 (estimate)	24.1 (forecast)	20.7 (estimate)
2010-11	20.8 (projection)		21.0 (projection)

Source: Method A – based on the methodology by Robert Carling in '*The tax take is up*' in Volume 23 no 2 Winter 2007, *Policy*;
Method B – based on ABS Commonwealth and all-government taxation ("cash") series supplied by ABS on request and estimates by Rory Robertson of Macquarie Bank (May 2007), consistent with estimates in Table 3 on p.10 of Taxation Revenue 2005-06 (ABS 5506.0).
Method C – Australian Government 2007-08 Budget Paper No.1 Statement 13, Table 2 – Taxation receipts.

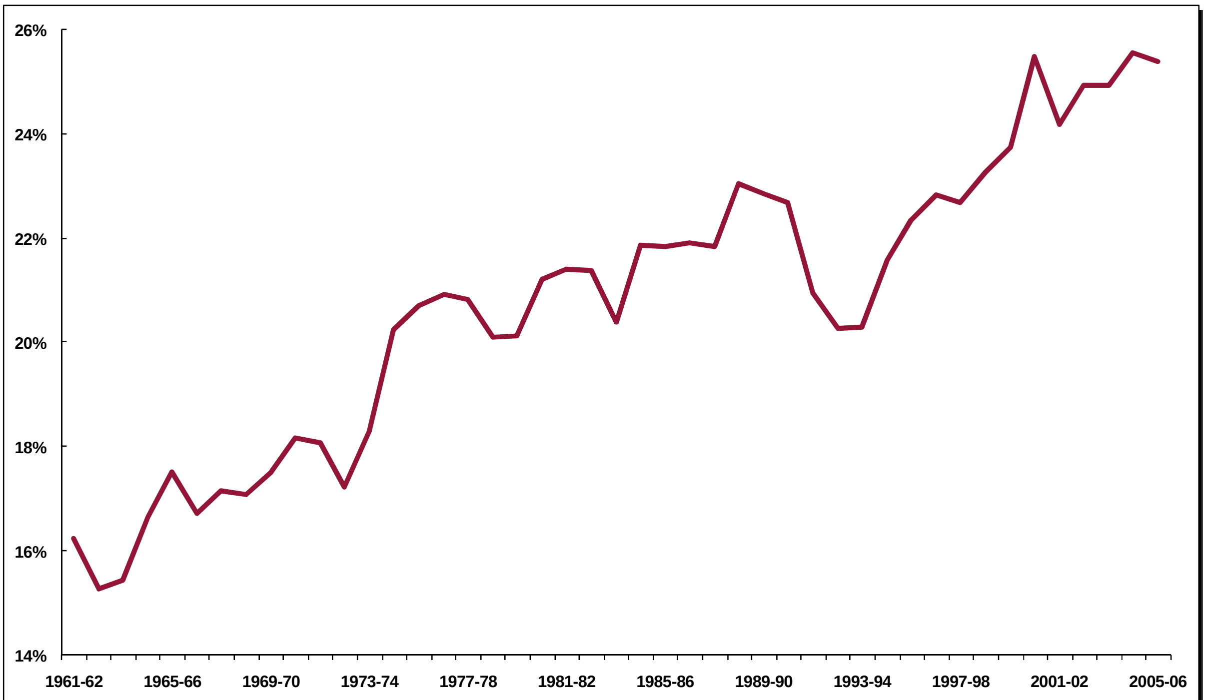
[3] These calculations use a methodology developed by ex-Federal and NSW Treasury official Robert Carling in his article '*The tax take is up*' in Volume 23 no 2 Winter 2007, *Policy*.

The numbers published in the 2007-08 Budget use method C in the table above, whereas method B published by the ABS complies with the IMF methodology for Government Finance Statistics (GFS). Method A could also be published in the Budget as it accounts for both the introduction of the GST and the pre-GST taxes collected for payments to the States.

> All governments should be held to account via legislated best practice benchmarks in transparency.
>
> These standards should be clear and easy to interpret and include specific mention to IMF GFS and ABS guidelines outlining the methodology that should be applied in compiling Budget statistics.

That increase in the government's call on Australian resources is of concern in part because, as is true of much of the developed world, Australia faces an eventual fiscal crisis as the ageing of the population increasingly places government expenditure and revenue base (which will effectively narrow) under pressure as the proportion of the working age population falls over the next 40 years. Consistent change towards greater transparency standards will assist governments to more prudently manage their fiscal responsibilities.

FIGURE 3-1: TAX REVENUE, INCLUDING THE GST (% OF GDP)



Source: ABS cat., ABS special request GFS data, Access Economics

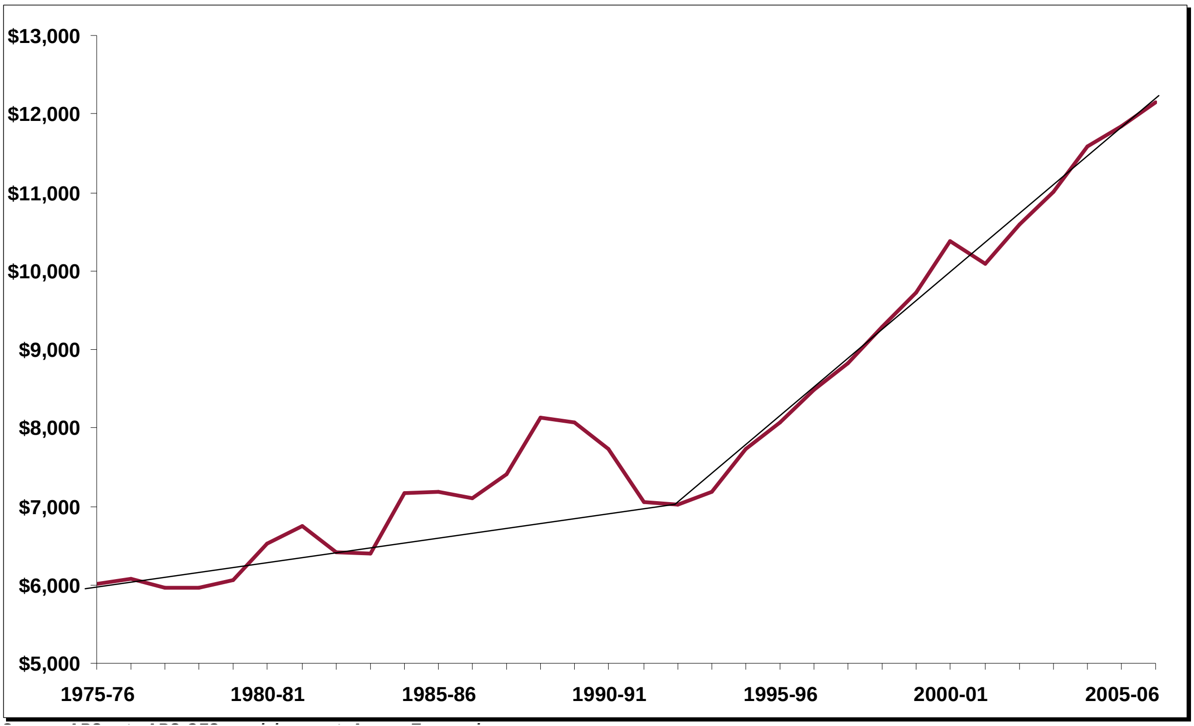
Looking more broadly at the Federal tax take (rather than limiting the analysis to Commonwealth tax revenue for own purpose, as shown above in Table 3-1) as a share of the Australian economy[4]) the picture is not in itself cause for great concern in terms of tax as a share of the nominal economy (see Figure 3-1).

[4] This measure uses the ABS methodology, and therefore includes the GST as a Federal tax. In addition, this methodology uses a broad macro perspective rather than splitting out revenue by its end use as has been estimated in Table 3-1.

Yet the effective increase is larger still, as this masks that the nominal economy has been rocketing along driven by the commodity boom Australia is experiencing. Even with the economic pie growing much faster then average, tax has still risen strongly as a share of GDP since the early 1990s.

Figure 3-2 uses real tax revenue per person to help cut through the transitory impact of the commodity boom and its masking effect on the rising tax burden per person.

FIGURE 3-2: TAX REVENUE PER PERSON IN TODAY'S DOLLARS (INCLUDING GST)



The figure shows the extent to which the burden of government has grown. The Federal tax take (including GST) rose relatively slowly from 1975-76 to 1992-93, lifting by $1,019 per head across that 17 year period. But in the 14 years to 2006-07, tax revenue per person per year in today's dollars is estimated to have risen a further $5,123, to be $12,153 – and growing at a seemingly inexorable rate.

- Only the tax cuts instituted in response to the recession of the early 1990s have had much impact on the pace of growth of this series.
- The rise of the tax take has meant that it is increasingly reflecting 'churn', with money taken from individuals in the form of taxation and then subsequently returned via transfer payments 'from whence it came'.

It is rare that anyone stops to look back at the actual goals of society – prosperity and fairness – to see if our government is meeting society's expectations, or whether there is a better road to follow in getting to the final destination.

This report aims to do just that.

4. TRENDS IN GOVERNMENT SPENDING BY CATEGORY

The earnings of the Australian economy have grown strongly over the past 16 years, with prosperity blossoming since the recession of the early 1990s. Long term unemployment is a third of its peak, and many of those who were not in the workforce have now decided it is worth their while to re-enter or postpone retirement. The unemployment rate is now close to 4% (the lowest in 33 years) and estimates of underemployment have also fallen significantly.

This means the need for government assistance (such as, through transfer payments) has been significantly cut.

Yet the bad news is that, despite the surge in our prosperity, we are seeing a surge in government spending, financed by what could well turn out to be a temporary lift in revenues from a matchingly temporary lift in the price of commodities such as coal and iron ore.

That makes little sense, especially given that, as Saunders (2007) puts it:

> *"Every dollar directed at one section of the population has to be taken from another" or in other words… "Everybody is paying for everybody else's hand-outs, but few of us seem to be aware of it."*

> The data on spending and revenue in this report use GFS-based data compiled by the Australian Bureau of Statistics (ABS), excluding net interest payments and asset sales from the spending estimates. The data has been sourced directly from the ABS rather than the Budget papers, as the latter treats the GST as a State tax when it is collected by the Federal Government.
>
> By removing these items, the resultant 'underlying' measures of spending and the Budget balance provide a useful feel for underlying fiscal pressures.

As Figure 4-1 below shows, the Federal spend (excluding interest costs and asset sales) rose slowly from 1975-76 to 1997-98, lifting by $2,285 per head across that 22 year period. But in the nine years to the estimated level in 2006-07, spending per person in today's dollars rose by a further $3,207, to be $11,716.

Surely the opposite should be occurring amid the China-driven boom in commodity prices and hence company profits and company taxes?

- There should be relatively less need for new government spending per person – particularly on transfers and welfare – to rise as the economy surges.
- Surging prosperity should be reducing the number of people requiring government services or support as people are better off and better placed to look after themselves.

Real Government spending per person should be falling – not growing.

Yet, sadly, there is some evidence that the boost to taxation (and the spending that financed) has achieved little extra for either prosperity or fairness, meaning that spending has become less strategic at a time when the revenue base is being boosted by temporary events such as China-driven boom in commodity prices and hence company profits and company taxes.

FIGURE 4-1: SPENDING PER PERSON IN TODAY'S DOLLARS (EXCLUDING INTEREST AND ASSET SALES)

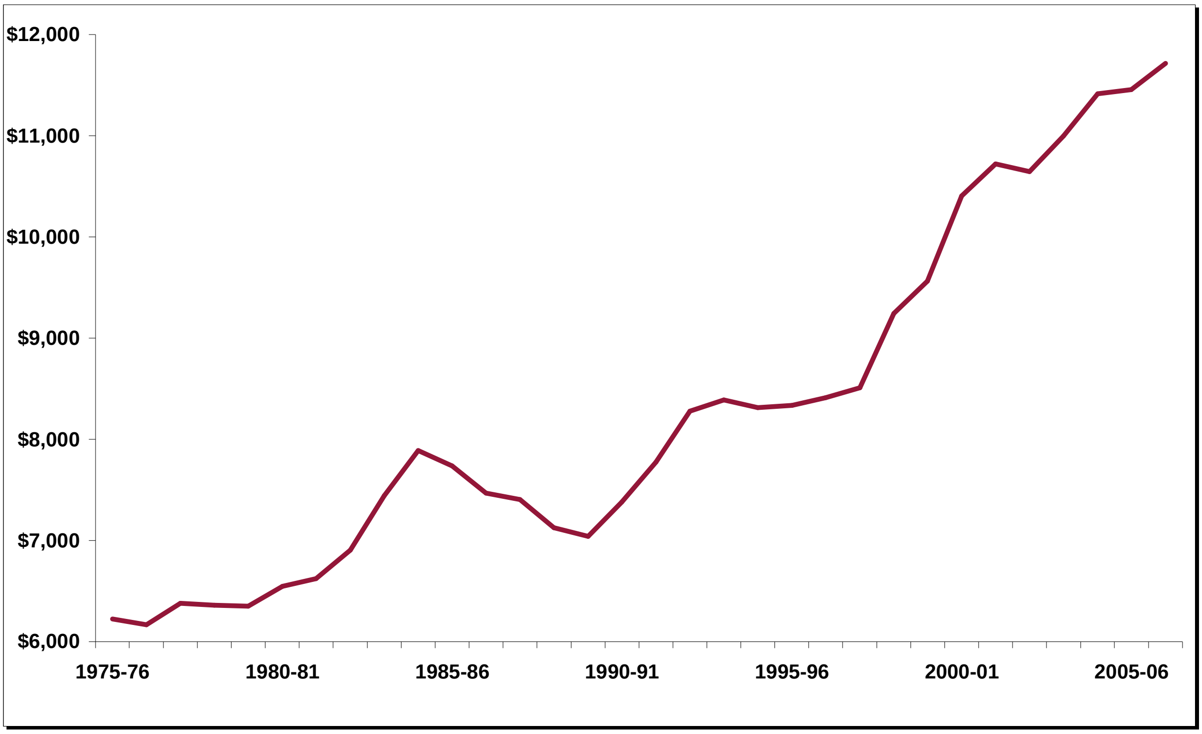
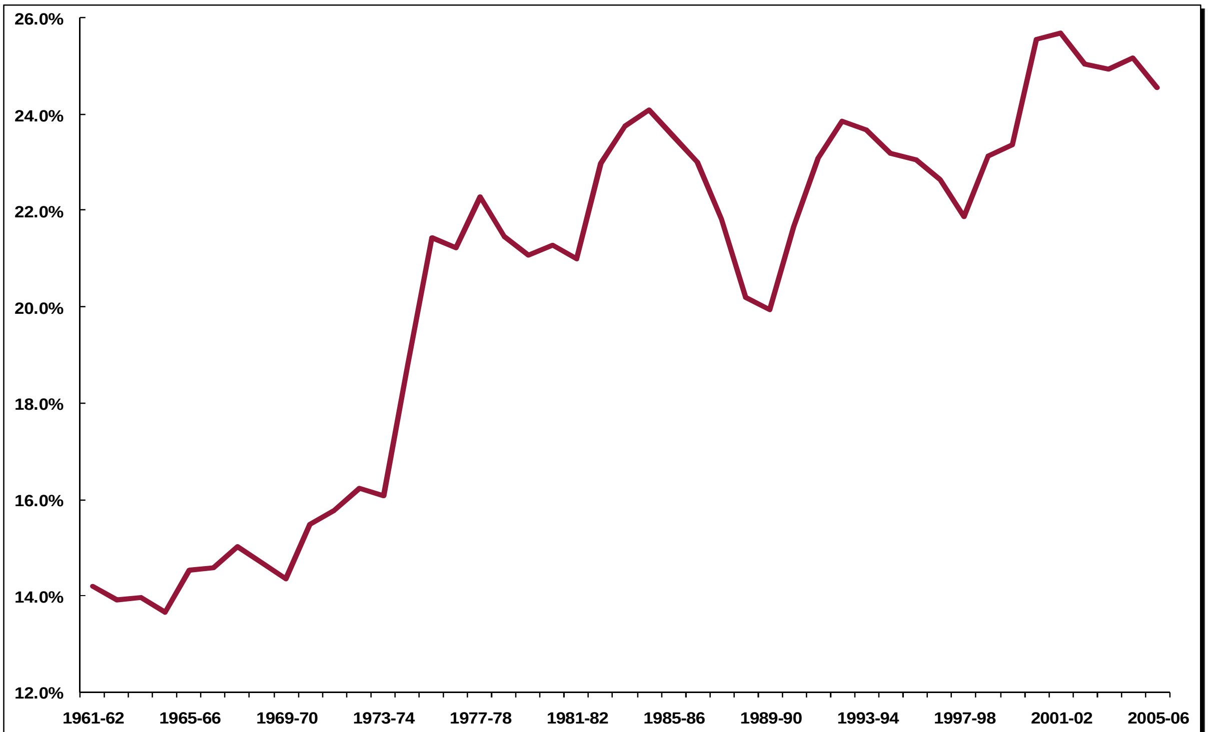


FIGURE 4-2: UNDERLYING SPENDING (% OF GDP)



Source: ABS cat., ABS special request GFS data, Access Economics

Underlying spending as a share of GDP in Figure 4-2 above shows a similar upward trend over time. This uptrend has been tempered most recently by very strong gains in nominal GDP (reflecting the very strong inflows from the commodities boom). If the commodity price boom eventually fades, then underlying spending as a share of GDP will post a rapid gain –

not because of government decisions, but because of the business cycle. That is a reminder why we prefer to consider revenue and spending on a per head basis (and as adjusted for inflation), though more widely there is a need to look carefully at government spending and revenues from a number of different angles so as to ensure a complete picture.

- Looking at spending in per person terms is more useful than a 'share of GDP' measure. Although useful in showing government's overall size relative to the economy, a GDP-based measure can mask increases in government spending if GDP is itself growing strongly.

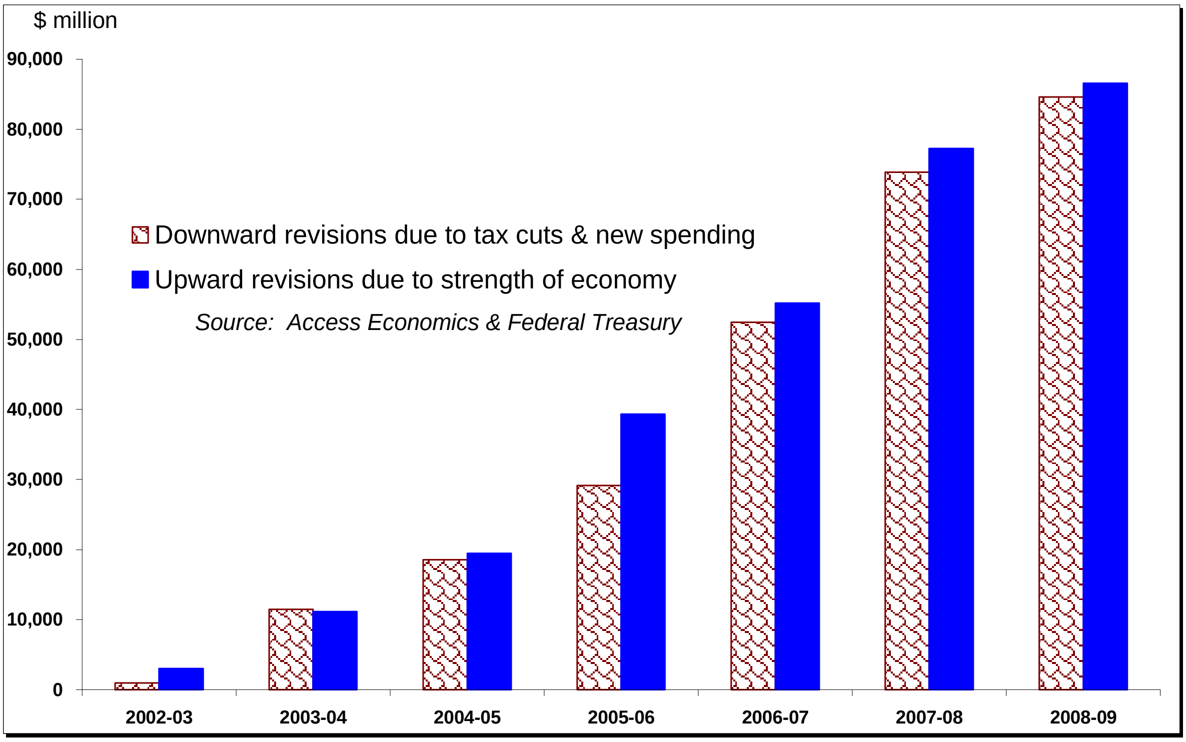
However, history tells us that governments (of all political stripes) tend to be poor managers of boom times, especially unanticipated booms:

- 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.
- This has put the structural or underlying Budget balance into deficit at a time of exceptional prosperity. That is poor economic management, all the more so as it is wasting the once-in-a-generation opportunity thrown up by the commodities boom.

When revenue spikes due to a temporary shock – such as a commodity price boom – the increase in cash is just that: temporary. Although the current revenue windfall is still building, it is not permanent. Therefore, the resultant cash windfall cannot be spent in a way that permanently raises government outlays without compromising future prosperity.

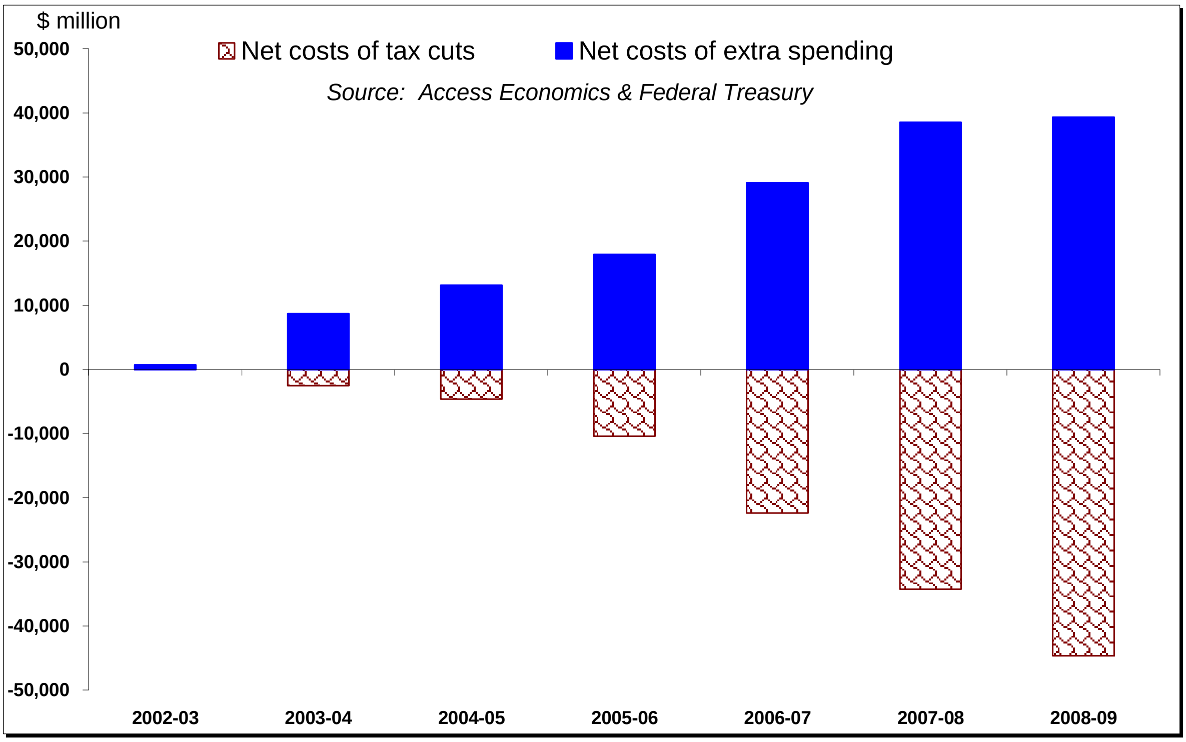
Moreover, and in addition to the current boost in spending, we face a number of future pressures on our social compact, including those associated with the ageing population and other issues identified in the *2007 Intergenerational Report*. These additional pressures mean we need to think more strategically about any increased spending. **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, as Figure 4-3 shows.**

FIGURE 4-3: ANNUAL COST OF NET NEW POLICIES ANNOUNCED SINCE MID-2002



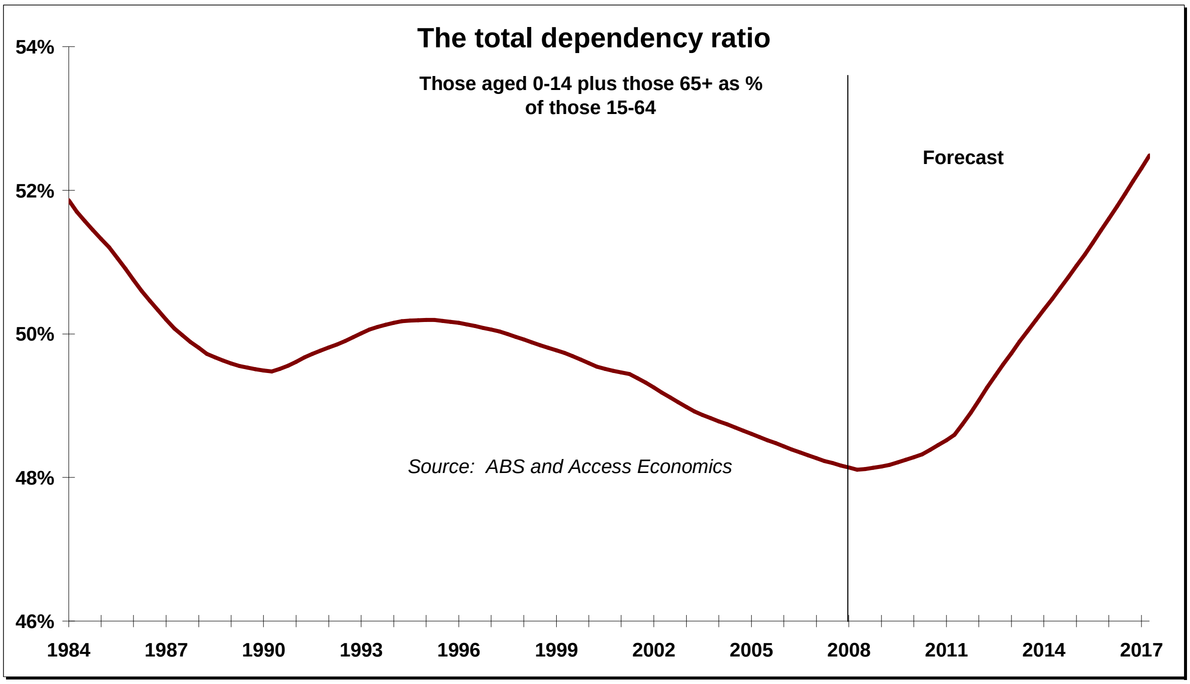
The policy decisions the previous Government made since mid-2002 are now running at a cost of more than $85 billion a year, or some 7.7% of GDP. And as Figure 4-4 shows, those costs have been split roughly half-and-half, with a cumulative $45 billion in tax cuts a year, and $40 billion in spending increases.

FIGURE 4-4: ANNUAL COST OF NET NEW POLICIES ANNOUNCED SINCE MID-2002



The risky side of this story is that much of this recent surge in spending is unrelated to demographic pressures. If there were more old or young people as a proportion of the population, then it would follow that transfers would most likely need to be larger to help to ensure fairness in our society. Yet this is not the case. In fact the opposite is occurring – government spending is rising as we move towards the end of a demographic sweet spot.

FIGURE 4-5: THE DEMOGRAPHIC SWEET SPOT IS PASSING



The number of dependants as a ratio to the number of the working population is only going to increase from here on in as the population ages. So, as the IGR sets out, demographic spending pressures on health and ageing are set to spiral upwards for many years to come.

That is why it is time to think about re-jigging our social compact so as to better enable a more prosperous future. The Government needs to significantly cut spending in a genuine attempt to reduce the level of intervention in the community. As we are now in living in a supply constrained world, any resources that the government releases will be productively put to work by the private sector, raising prosperity and the economic pie.

That is important because just as welfare spending has lifted, the lift in prosperity means that the need for it is no longer as strong as it once was. Indeed, it may well be that government spending would be much lower if we were developing the system from scratch today.

This chapter therefore looks at longer term spending trends across the different functions of the Australian Government.

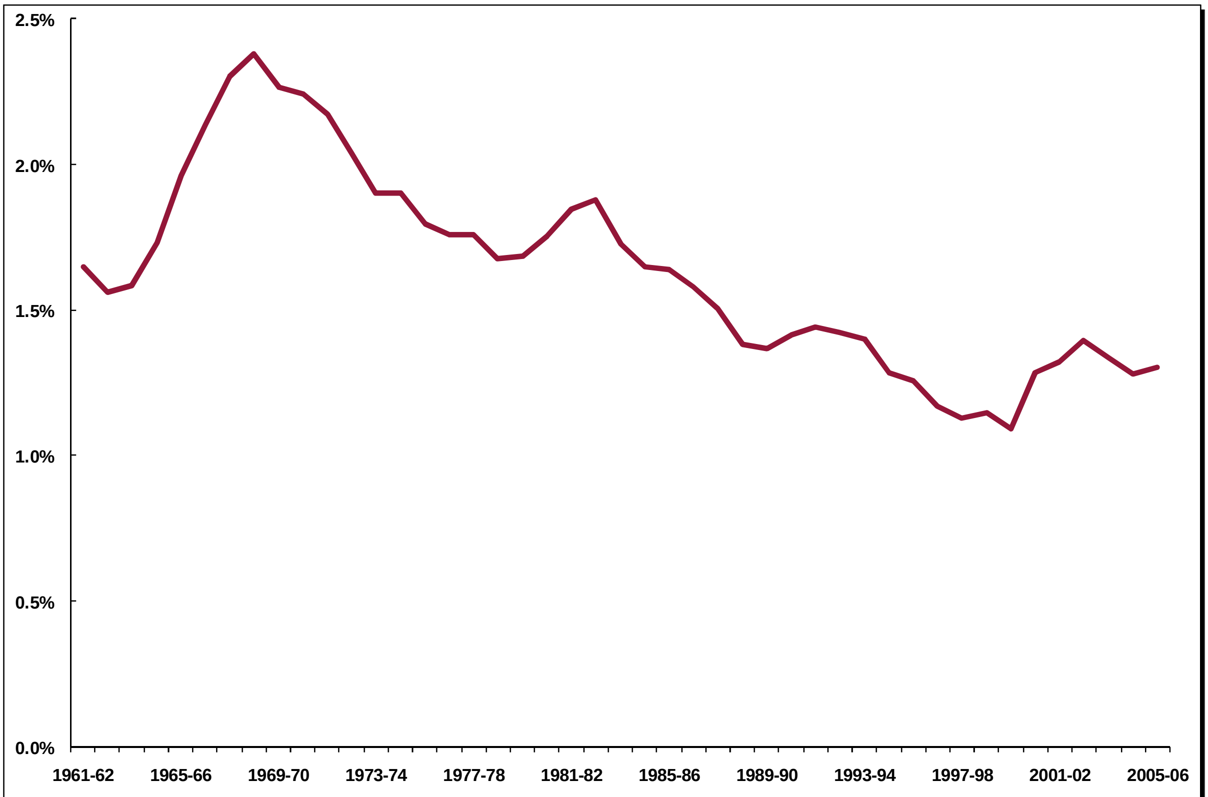
4.1 DEFENCE

Spending on Defence has lifted sharply since September 11, 2001 and the start of the 'war on terror'. But the ADF has some expensive plans in mind (partly it has to, due to the need to replace obsolete weapons platforms) and, despite the many billions added to the spend in recent years, only a portion of the future cost is in the forward estimates (the four year planning horizon of the Government).

There is therefore a reasonable chance that Defence spending will continue to rise in coming years. (The *Intergenerational Report* assumes it will be constant as a share of national income beyond the forward estimates.)

Figure 4-6 shows spending on Defence as a share of national income[5] since 1961-62. Since peaking with the Vietnam War in the late 1960s and early 1970s, spending has trended down as a share of the economy, but it has picked up again in the wake of September 11, 2001.

FIGURE 4-6: DEFENCE (% OF GDP)



Source: ABS cat., ABS special request GFS data, Access Economics

The war in Iraq, as well as assistance in Afghanistan and East Timor and the Solomon Islands have seen the most significant calls on Australian Defence resources since our engagement in Vietnam. More broadly, the current process of modernising the ADF and investing in new capabilities is by far the largest ongoing call on government spending in a generation. As much of it falls beyond the forward estimates (the four year planning horizon

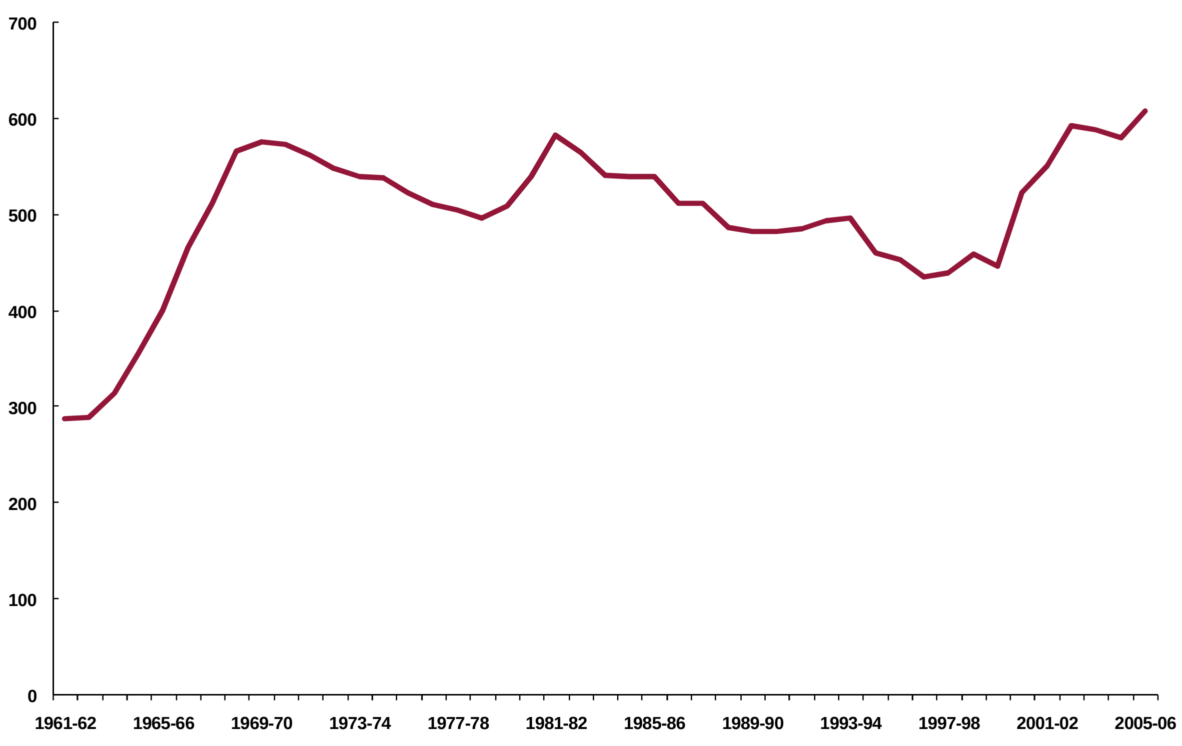
[5] GDP is a measure of output rather than income, but we use the latter term for ease of understanding.

of governments), the spending to support these new capabilities has not yet been fully factored into the current expenditure level of less than 2% of GDP.

Real spending per head (in 2005-06 dollars) on Defence was $539 in 1985-86, then it fell to $453 in 1995-96, before again increasing to $608 in 2005-06 (the highest level in this data series back to 1961-62).

The previous peak was in 1969-70 at $570, towards the end of the Vietnam War where Australia's troop commitment peaked at over 7,600. To date, 2007 has seen around 4,000 ADF personnel deployed in operations, with 1,000 in the immediate region and 3,000 split between Afghanistan and Iraq.

FIGURE 4-7: DEFENCE (REAL PER PERSON $)



Source: ABS cat., ABS special request GFS data, Access Economics

AN INCREASING CAPACITY TO PAY HAS CONTRIBUTED TO DEMAND

Defence spending has fallen as a share of national income since the Vietnam War. While it has grown in real terms, the economy has grown faster still. But recent significant growth in Defence has reversed this longer term trend and the increased level of expenditure will continue to increase in the period ahead as the true cost of increasing and maintaining the ADF stock of capabilities is realised.

- The demand for Defence spending has no direct links to demographic factors, and is linked more to desired levels of Defence capabilities stemming from the planning of the ADF and the government of the day.

- Defence spending is not related to population growth but more generally equates to willingness and capacity to pay.

The rapid growth in recent years has nearly doubled spending prior to 2001. The Budget estimates Defence spending at around $19.8 billion in 2007-08, up from $9.5 billion in 1999-00. Future spending will depend on a wide range of factors, maintaining the planned expanded Defence capabilities (as yet un-costed), the cost of inputs, the strategic environment and the government of the day and the community's tolerance and perception of risk.

The Defence Department's mission statement is straightforward. The aim of its spending is:

> *"… to defend Australia and its national interests. In fulfilling this mission, we [the Defence forces]: serve all Australians, and are accountable to the Commonwealth Parliament, on behalf of the Australian people, for the* ***efficiency and effectiveness*** *with which we carry out the Government's defence policy."*

Yet 'efficiency and effectiveness' are not always the first two words that best describe many Defence spending programs. ASPI's[6] summary of the 2007-08 Defence budget said:

> *"This year's budget capped off an extraordinary thirteen month period that saw the government promise more than $41 billion worth of new defence initiatives over eleven years; around $16 billion last budget, $14 billion this budget, and in excess of $11 billion in between."*

In fact ASPI note that;

> *"Overall, Defence has been granted just about everything that they have asked for in recent years, all that remains is for them to deliver the military capability they have promised."*

Yet;

> *"Despite all the money flowing into Defence, still more money will be needed to cover the personnel and operating costs of new capabilities that will be delivered over the next few years."*

Just how much more money will be required to support the 'new capabilities' in the future to meet the governments plans for the ADF? It seems that current budgeted expenditure levels are judged by ASPI to be inadequate to maintain the new capabilities.

There is therefore a risk the current Budget includes the money to purchase new capability but not to run or maintain it. ASPI note that the running costs are as yet 'unknown'.

The Defence Budget must report all estimated running and maintenance costs along with the upfront investment costs of the capabilities it plans to deliver.

Upgrading to a modern Defence force is clearly a community priority – but what is an appropriate level of commitment given the current economic circumstances? The rapid rate of increased spending is cause for concern largely because the new capabilities require significantly more spending than may yet have been disclosed.

[6] The Australian Strategic Policy Institute, 2007.

- The opportunity cost of investing in Defence capabilities is very high amid an ageing population and an economy operating close to capacity.
- A difficulty is that while the current (China-enhanced) Budget surplus allows for Defence capabilities to be upgraded it is an inopportune time to be expanding the government's call on the economy's resources – both monetarily and in terms of personnel levels – via permanently increasing Defence expenditure (the current commitments incorporate elevated spending up to 2016).
- Of course, this recent surge in spending comes in the wake of the September 11, 2001 attacks on the US. This spending increase has seen the largest military build-up in Australia since the Vietnam War. As a share of GDP our spending is not exceptionally high by international standards (we rank 13th in the OECD), but it is high by Australian standards.

The previous Government committed to increase real defence spending by 3% a year. In addition, supplementation continues for overseas deployments, with the accumulated cost of current operations in Afghanistan and Iraq now exceeding $1.7 billion and $2 billion respectively. Yet the commitment of 3% real Defence spending growth a year comes off of this recently increased base of spending, and it will effectively hold the current elevated level of spending constant as a share of national income out to 2016.

ASPI indicate that:

> *"The initiatives in the 2007–08 budget, and those that preceded it mid-year, amount to a total commitment of more than $25 billion extending over the forthcoming decade in addition to the 3% growth promised by the White Paper.*

But importantly

> *"If the government (or the present opposition should they win office) hope to deliver a defence force of the size and shape currently planned, substantially more money will be required."*

4.2 PUBLIC ORDER AND SAFETY

Public order and safety includes police and fire protection services, law courts and legal services, prisons and corrective services, and control of domestic animals and livestock.

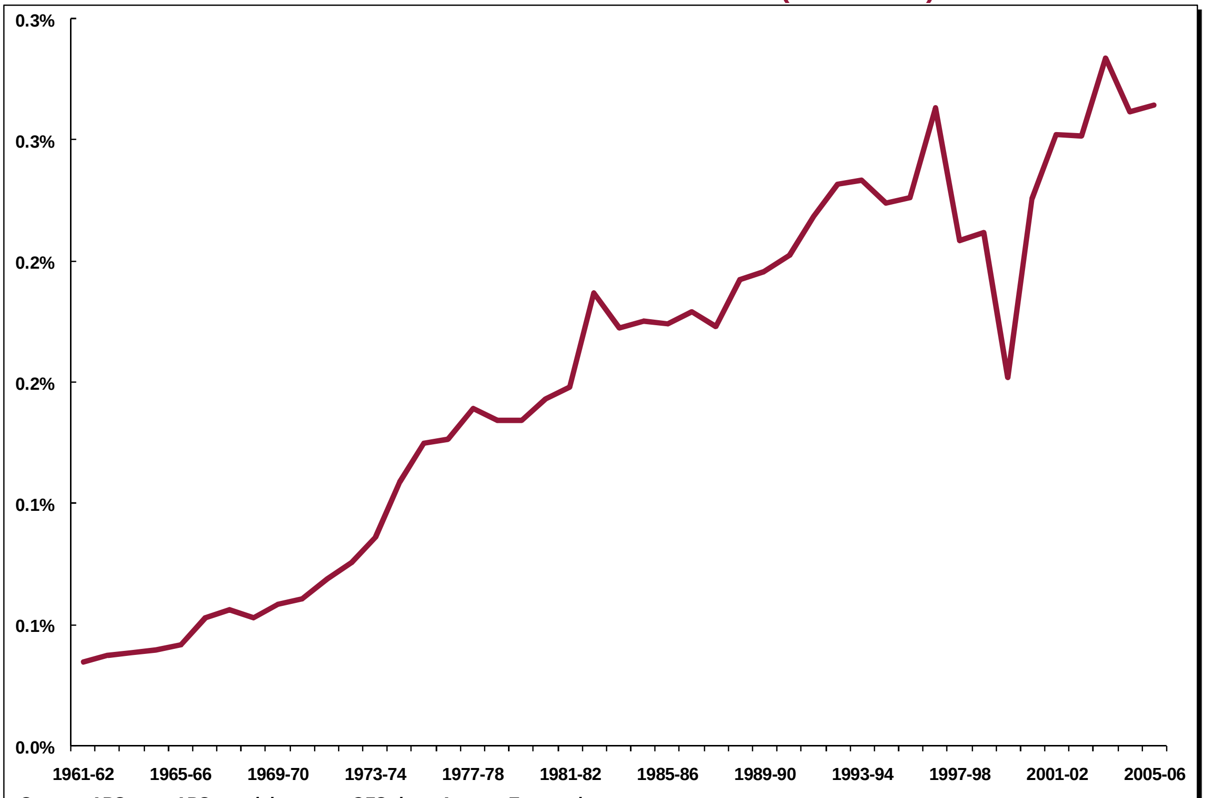
After falling as a share of GDP from 1997, spending on public order and safety has also undergone a significant resurgence, now accounting for just over $2.5 billion of recurrent spending. The resurgence followed the September 11, 2001 attacks in the US, and the subsequent ramping up of the spending associated with the 'war on terror'.

Spending is currently holding steady at about 0.25% of GDP, but given that GDP is itself growing very fast in nominal terms due to the China boom, this has meant a significant increase in nominal expenditure for this category. In real terms, spending per head of the population has increased from $82 per head in 1995-96 to $123 in 2005-06. In 1985-86 real spending was around $57, up from around $6 in 1961-62.

The increased spending reflects that the perception of risk in the community and the government has undergone radical change since the 2001 attacks in the US and the 2002 Bali bombings. As a result, a significant proportion of the additional expenditure in recent times has been devoted to implementing anti-terrorism measures.

Key areas of growth in the 2007-08 Budget documents include a considerable expansion in anti-money laundering funding, such as a new set of regulations whose compliance cost falls on the financial sector. Other measures include the development and implementation of a maritime identification system, aviation security accommodation, and the continued growth in the resources for the Australian Security Intelligence Organisation (ASIO).

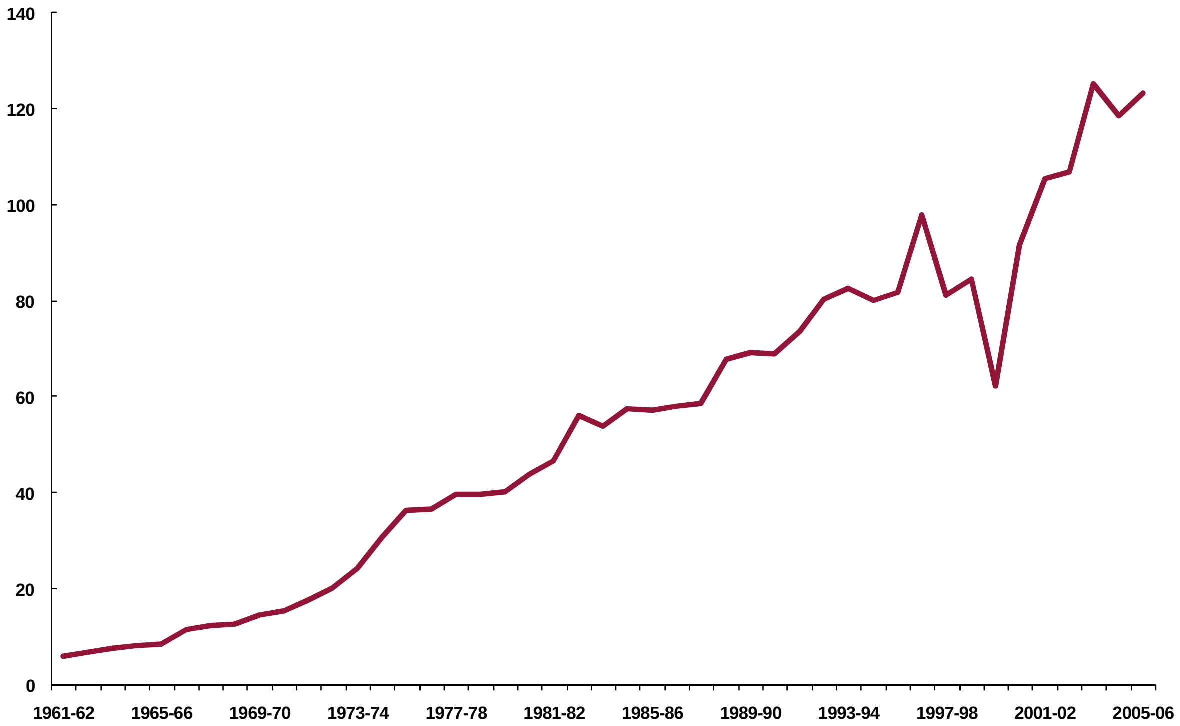
FIGURE 4-8: PUBLIC ORDER AND SAFETY (% OF GDP)



Source: ABS cat., ABS special request GFS data, Access Economics

ASIO has also received funding for a new building to house its new staff as well as the staff of the Office of National Assessment.

FIGURE 4-9: PUBLIC ORDER AND SAFETY (REAL PER PERSON $)



Source: ABS cat., ABS special request GFS data, Access Economics

4.3 EDUCATION AND TRAINING

Education and training score well in terms of both prosperity and fairness. That is as higher levels of education raises both productivity and participation (and hence have a notable long term impact on prosperity), yet education also improves fairness by raising wages and cutting the risk of unemployment.

There are therefore good reasons for further investment in education. However, this area of spending is bedevilled by three problems:

- First, there is increasing overlap between areas of Federal and State responsibility, leading to cost-shifting (as well as blame-shifting).
- Second, not all the increased investment in education currently desirable should be financed by taxpayers in general. Although returns to education are very high, the returns to the community are highest at lower levels of education. At higher levels – such as university – the return to the community comes from the increased tax paid by the better trained individual, but most of the benefits of additional training go to the individual involved. It is these individuals who need to realise the benefits to themselves of further study.
- Finally, the key to education is not necessarily higher levels of spending, but perhaps greater efficiency in the use of the available public funds.

The biggest challenge facing Australia in the future is the impact that ageing of the population will inevitably lead to falling participation as the workforce shrinks as a share of the population when the baby boomers retire. This also eventually puts immense pressure on the Budget largely via higher health care and aged care costs. This leads to increased pressure on the working age population to provide for and support the young and elderly.

This conundrum has been the focus of a number of research papers from Access Economics, the BCA, Federal Treasury, State Governments and various academics. The resultant policy prescriptions revolve around developing frameworks and policy to offset the economic and budgetary impacts of Australia's demographic destiny.

A key to resolving these issues in a way that minimises the cost to future prosperity is by expanding the supply side potential of the economy and maximising output. An economy's output is limited by these key inputs; the working population, the hours they work (participation) and the amount of output they produce per hour (productivity). This is the '3Ps' framework used by the Federal Treasury.

Policies which boost any of these three factors will increase future prosperity, and thereby help to counter the demographic trends which threaten future prosperity and the Australian Budget balance.

The links between education, productivity and participation

One of the implications of a shift to supply side policymaking is a greater recognition of the potential benefits of well crafted policies in areas such as child care and early childhood intervention and education.

On early childhood intervention and education, it is increasingly recognised that higher levels of education provide an economic payoff for the nation and for individuals. For the economy as a whole more education means more skilled workers, which means:

- **Higher productivity**. Workers with more education bring a higher level of skills to the workplace.
- **Higher participation**. Workers with higher skill levels are more likely to work, and also tend to work for longer by choosing to delay retirement.
- **Higher employment**. Workers with more education are more employable and enjoy lower unemployment rates.

There is a clear and well-established relationship between education and productivity. Economists have also begun to emphasise the second and almost as well-established linkage – that those with higher levels of education also have higher rates of workforce participation, both during working age and as they approach traditional retirement age.

Australia's working age population usually grows by an average of around 166,000 people every year. But trends already in place will see the working age population grow by just 190,000 for the entire decade of the 2020s – a tenth of the current pace.

So we cannot do much about population save by increasing the number of new migrants marginally and upping the fertility rate marginally. So that leaves participation and productivity or **to put it simply, education is the key to human capital development, and hence to both participation and productivity.**

With the Australian economy facing the dual pressures of an ageing population and rising skill shortages, there are clear benefits from increasing educational attainment across all levels of society – but perhaps most importantly with young children as a solid foundation ensures strong lifelong links to further education.

Economists have long espoused the benefits of education as a driver of an individual's productivity. More recently empirical evidence has also been used to draw out another important link between education and lifetime participation in the workforce. The higher an individual's educational attainment, the higher the chances of participating in the workforce (and having the skills an employer wants to purchase).

Recent research has also drawn out another important link – one between educational attainment and the length of time an individual is likely to remain actively attached to the labour force. In part, this no doubt reflects that the body tires before the mind.

For **society**, higher levels of education also mean higher average incomes. That in turn means even faster growth in income tax collections because of our progressive income tax system (which applies higher average tax rates to higher earnings). Those increased taxes may be spent for the benefit of everyone.

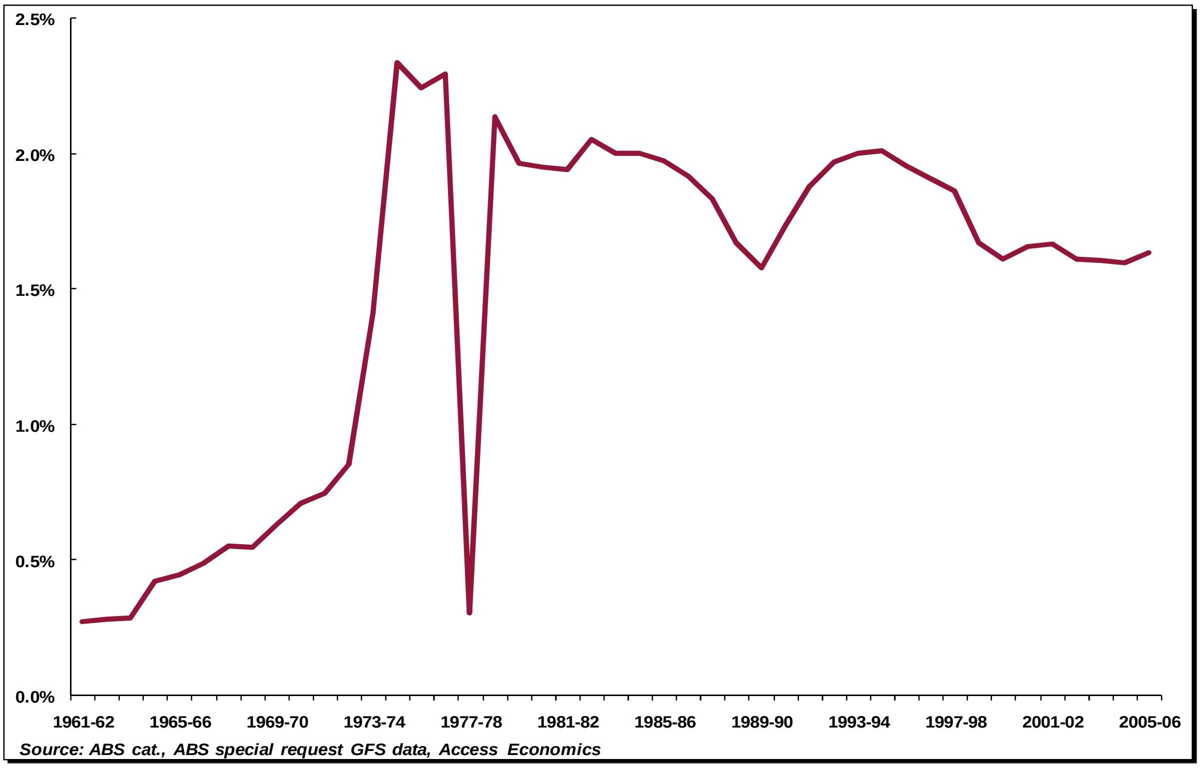
Increased tax collections – which can then be redistributed to everyone by the government – are perhaps the most direct economic channel by which society benefits from having a more educated workforce.

Education is increasingly becoming the 'engine room' of modern economies. If we get this part of the economy right, most other things ought to fall into place (or be better placed), because increased investment in education boosts both productivity and participation.

Education has a direct effect on the level of productivity in the economy (and therefore output growth) because it increases the productivity of individuals. A more educated worker is a more productive worker, and investment in education provides a pool of more skilled labour.

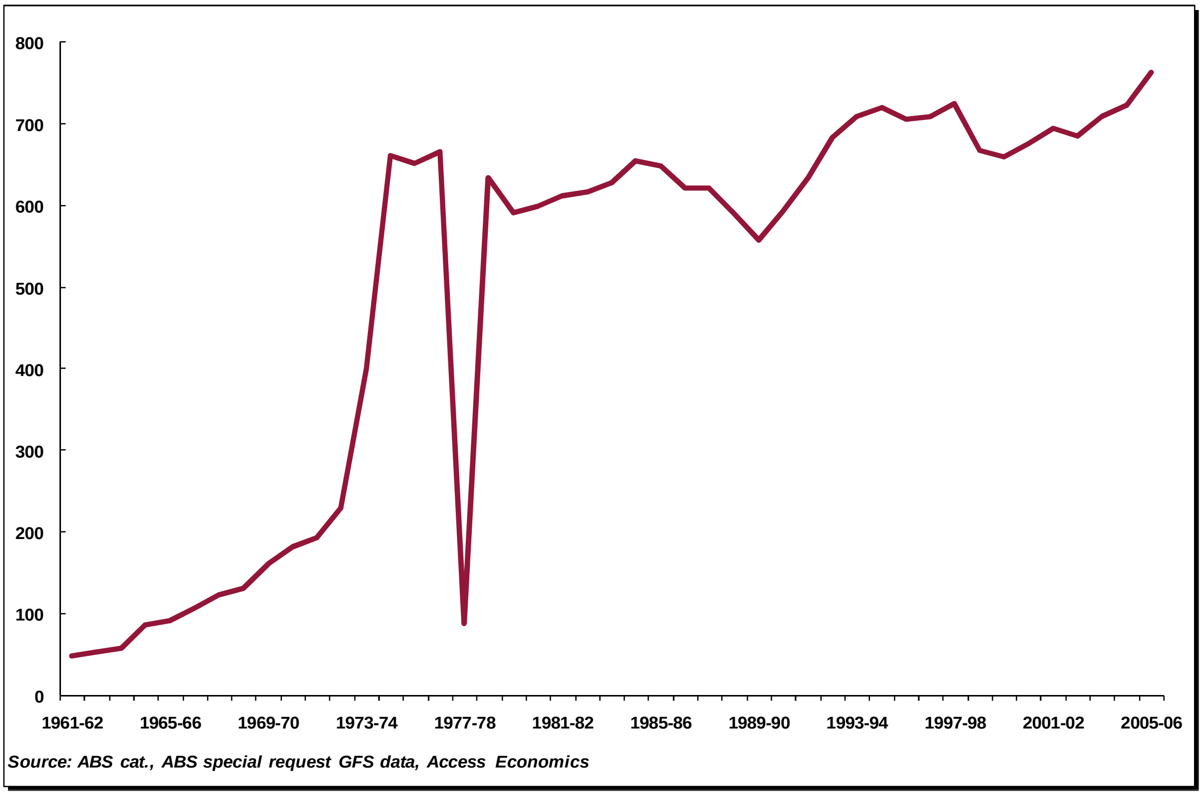
Importantly **individuals** benefit from investing in higher skills because they can command higher earnings in the labour market. This is the fundamental principle behind the current system of higher education assistance, where individuals pay part of the cost of their higher education through the HECS system. This is also part of the reason behind falling government expenditure on education as a share of the nominal economy, with individuals picking up progressively more of the tab over the last decade or so.

FIGURE 4-10: EDUCATION (% OF GDP)



As seen in Figure 4-11 and Figure 4-12, spending as a share of GDP has fallen in the last decade, having grown at a slower rate than the economy. But Commonwealth spending per person has still increased over this time to under $800 per person in 2005-06.

FIGURE 4-11: EDUCATION (REAL PER PERSON $)



There are a few conditions under which expenditure on education can and arguably should increase. In particular, the net gain to society needs to be positive. There are examples of policy solutions that do deliver a net gain to the community over time for example:

- Increasing Year 12 retention rates.
- Early intervention for disadvantaged children.
- Matching industry demands with skills development through strong general education programs, not through picking winners in terms of specific skills.

The picture is not so positive where intervention is left until adulthood with the programs generally very costly and results variable. The good news is that early intervention is extremely successful and cost effective particularly with children of preschool age.

4.4 HEALTH

Health care services in Australia are funded and provided by both the public and private sectors. Health is a major spending priority for all levels of government – particularly at the federal level.

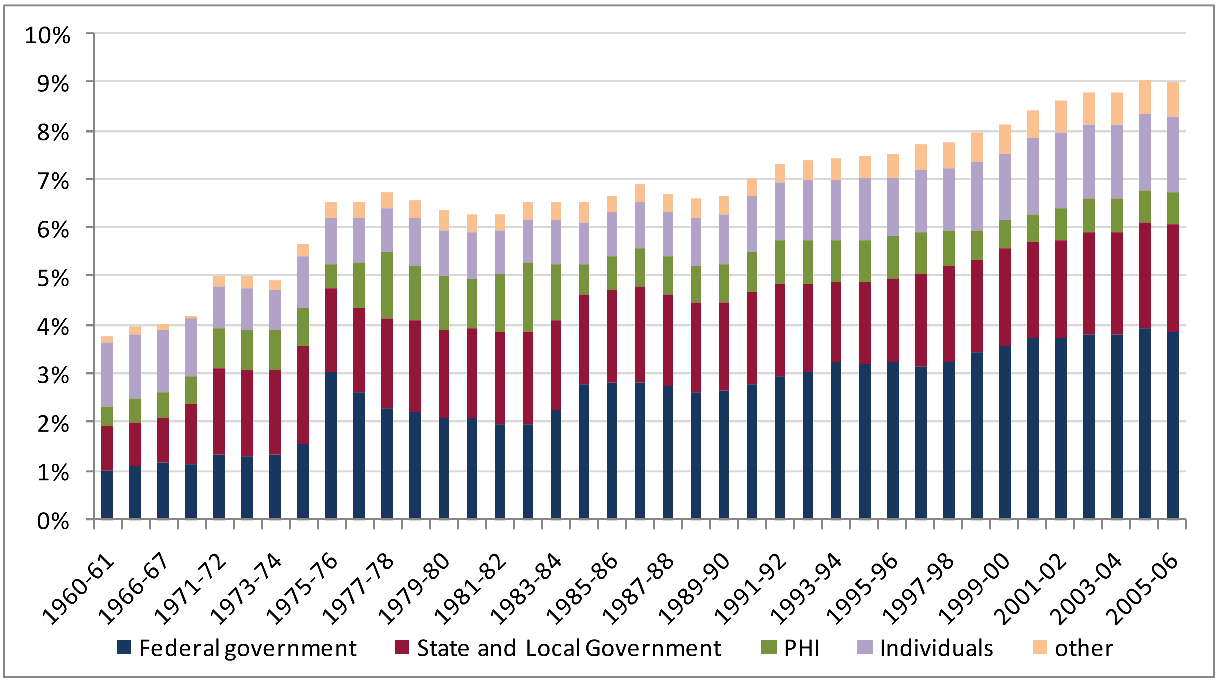
- **The Australian Government provides almost half of the total health spending for Australia**, and is the major source of public funds, although State and Territory governments also fund health services and have responsibility for public hospitals.
- As outlined in the 2007-08 Budget, the major purpose of federal health expenditure is to ensure that all Australians have access to essential health services through a range of providers and without excessive price barriers.

Major health programmes funded by the Australian Government include the Medicare Benefits Schedule and the Pharmaceutical Benefits Scheme:

- The Medicare Benefits Schedule (MBS) provides patient subsidies for medical practitioner services, optometry, diagnostic imaging and pathology.
- Under the Pharmaceutical Benefits Scheme (PBS), the Australian Government subsidises a wide range of pharmaceuticals to provide patients with affordable access to medicines. New procedures, tests and pharmaceuticals are added to the list of those which receive subsidies under the MBS and PBS following government approval of the recommendations of the relevant advisory bodies.
- Other areas of Australian Government spending on health include: contributing funding to public hospital services provided by State Governments; providing rebates to subsidise the cost of private health insurance; financial support in other areas, including medical research, public health, indigenous health services, health information; and provides health care services to veterans.

Overall Australian health spending (that is, public and private together) has grown relative to GDP from around 3.8% of GDP in 1960-61 to nearly around 9% today. The Federal Government has financed most of this growth, with the private contribution hovering between 2-3% of GDP (Figure 4-12).

FIGURE 4-12: HEALTH FUNDING BY SOURCE AS A PROPORTION OF GDP



Source: AIHW health expenditure database, **www.aihw.gov.au/expenditure/datacubes/index.cfm**.

The reasons for that steady growth have changed over time. Early on it was mostly driven by increased access and lifting patient expectations. New health technologies have also played a hand, increasing possibilities and again, feeding patient expectations. In recent years, the ageing of the population has made a larger contribution.[7]

- Health expenditure has grown over time because health goods and services are highly income-elastic. That is, as income grows, individuals want to consume proportionately more of their total 'consumption basket' on health goods and services. Indeed, health has one of the highest income-elasticities of all types of consumption – unsurprisingly, humans have a voracious appetite for a healthy life and, so far at least, health technologies have delivered in enabling the supply of greater longevity and wellbeing.

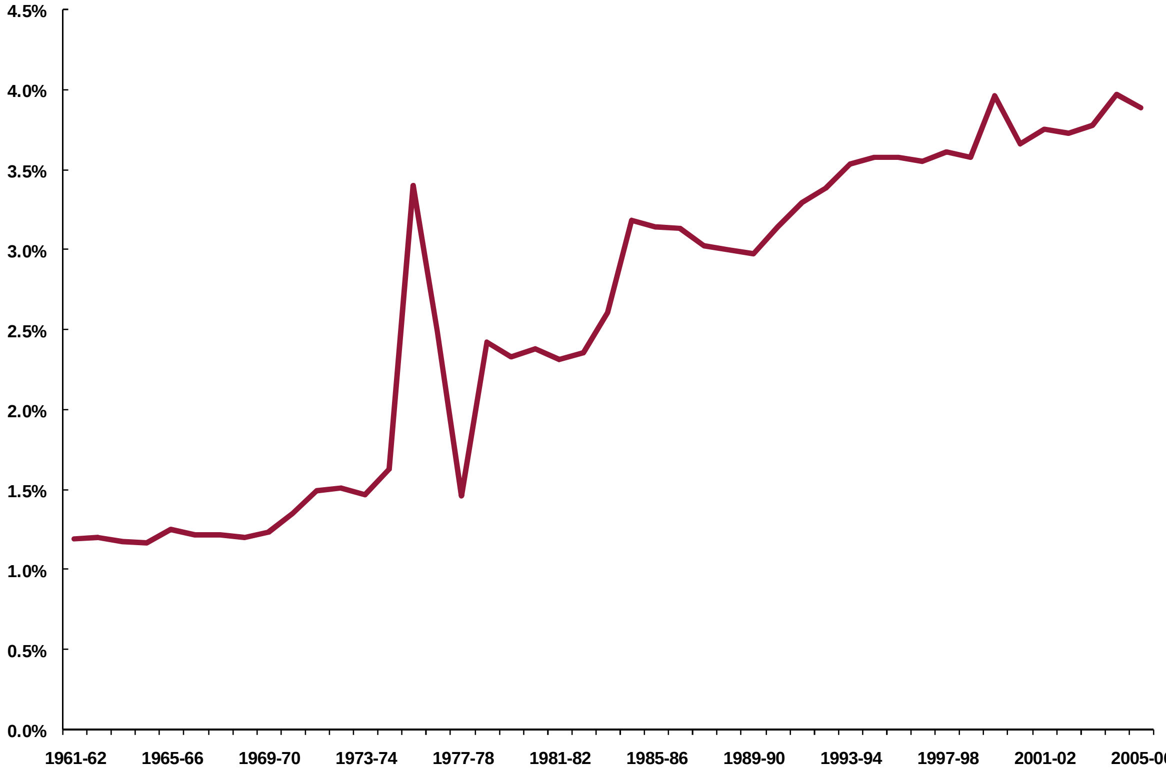
If we look at Australian Government spending on health alone, it has risen from 1.2% of GDP in 1961-62 to almost 4% of GDP in 2005-06 – a more than threefold increase (Figure 4-13).

The increase is even greater when we consider the costs in real per person terms – rising from $208 in 1961-62 to $1,814 in 2005-06 – a more than eightfold increase (Figure 4-14).

- The reasons behind the increase are similar to those driving overall health spending. Following the gyrations from the 1970s through to the mid-1980s (driven in part by the Whitlam Government with Medibank and the Hawke Government with Medicare, punctuated by changing systems under the Fraser Government), health spending has been following a steadily rising course.
- Medical services and benefits funded through Medicare and the Private Health Insurance Rebate are the main contributors to federal health expenses – making up around 43% of total health spending.

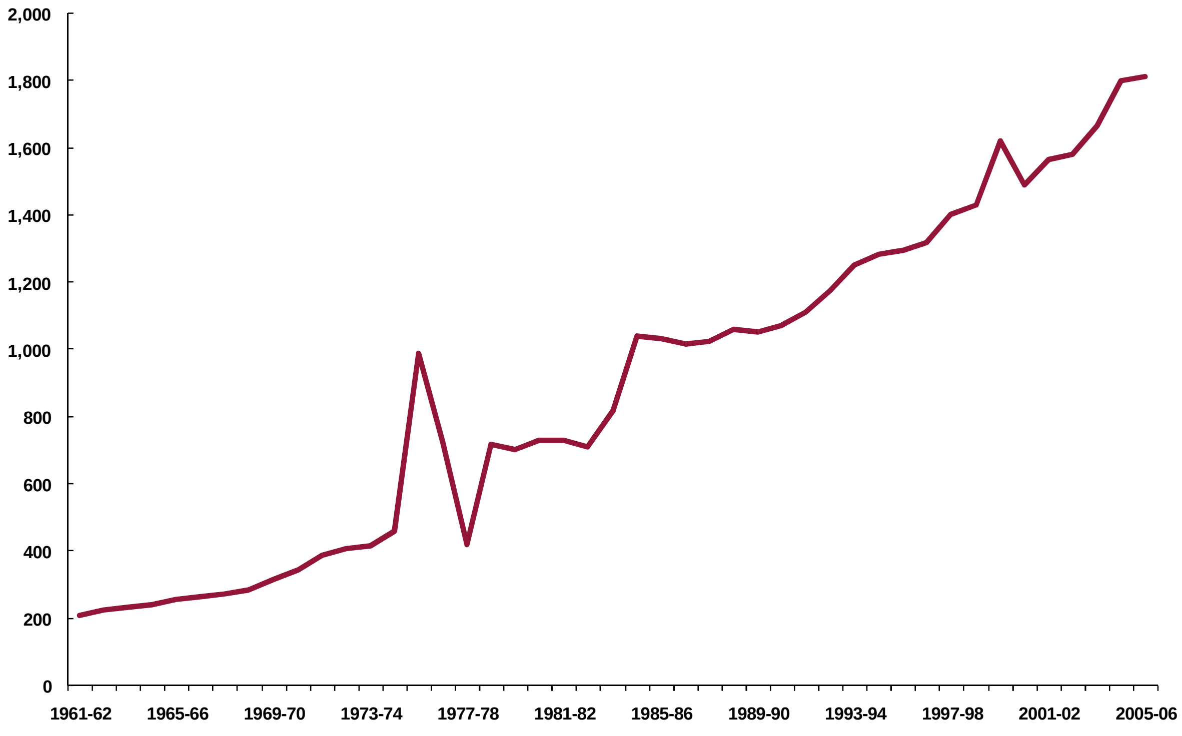
[7] Health function outlays in the budget do not include some aged care programs administered by the Department of Health and Ageing. Residential aged care subsidies are classified as "assistance to the aged" and reported in the social security and welfare function discussed later.

FIGURE 4-13: AUSTRALIAN GOVERNMENT SPENDING ON HEALTH (% OF GDP)



Source: ABS cat., ABS special request GFS data, Access Economics

FIGURE 4-14: AUSTRALIAN GOVERNMENT SPENDING ON HEALTH (REAL PER PERSON $)



Source: ABS cat., ABS special request GFS data, Access Economics

As highlighted in the *Intergenerational Reports (IGRs)*, expenses related to health are likely to be a major contributor to the growth in Australian Government spending over coming decades. IGR2 notes that Australian Government spending on health is projected to increase as a proportion of GDP from 3.8% in 2006-07 to 7.3% in 2046-47.

- Non-demographic growth (such as the listing of new medications on the Pharmaceutical Benefits Scheme and greater use of diagnostic procedures), rather than population growth or changes in the age structure of the population, is likely to be the key driver of health spending pressures – contributing *three-quarters* of the projected increase in health spending over the next 40 years. These new medications and new medical technologies are likely to be expensive.
- The 2007 IGR makes the further great point that this non-demographic growth is driven by choice.

  "Technological change, including the development of new drugs, accounts for a significant proportion of non-demographic growth in health spending per person. As the Australian Government exercises significant controls over whether to adopt new technology in the health system, past increases in spending partly reflect the Australian Government's choice to fund new technologies" (IGR2, 2007)

In other words, demography is not necessarily destiny when it comes to health spending.

4.5 INCOME SUPPORT

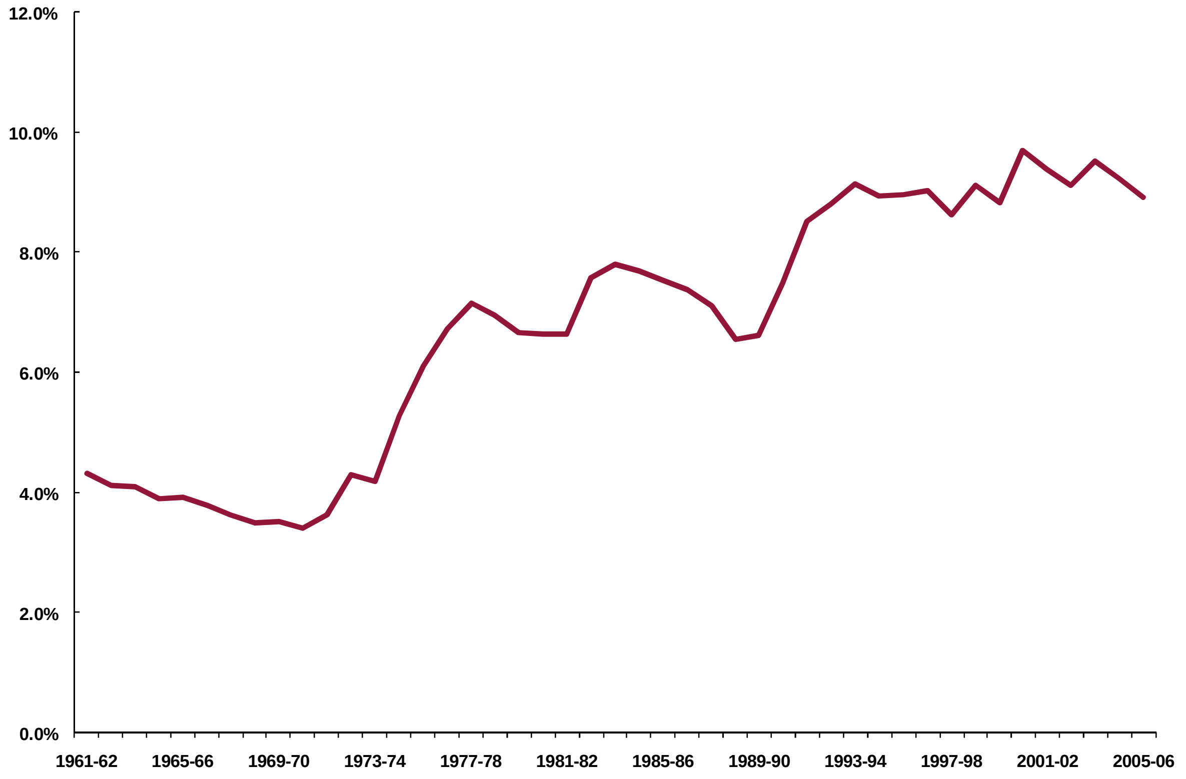
> "As government spending has spiralled upwards, we have learned to take the extended role of government for granted. We rarely stop to ask why we need to rely so heavily on politicians to provide for us when we are so much more affluent than earlier generations were." (Saunders, 2007).

The Australian Government has in place a range of programmes accessible to individuals who meet its criteria of requiring support or supplementary assistance. These Government payments to individuals fall across three broad groups:

- assistance to the aged;
- assistance to those of workforce age; and
- assistance to families with children.

It is fair to say that these payments are sensitive to changes in population cohorts and the age structure within population cohorts, so to some extent ageing of the population will drive income support higher as a share of national over time.

FIGURE 4-15: SOCIAL SECURITY AND WELFARE (% OF GDP)

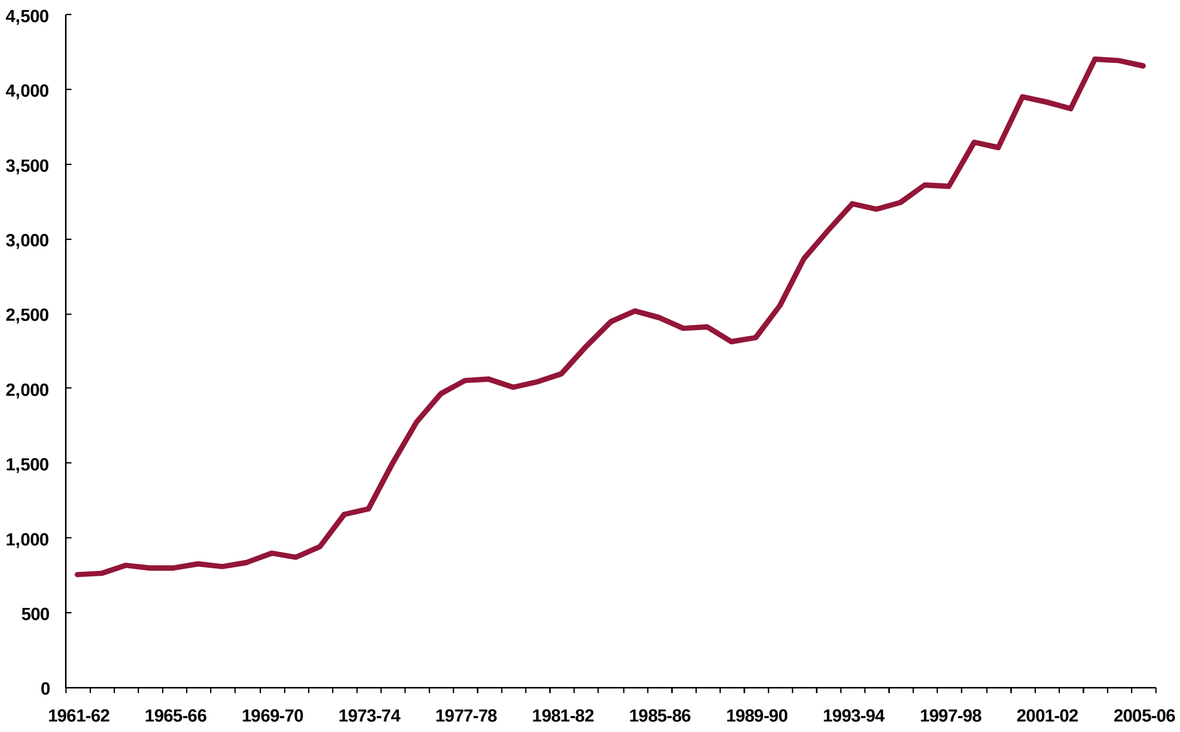


Source: ABS cat., ABS special request GFS data, Access Economics

That said, trends in social security and welfare show some worrying signs given that we face the tightest labour market and the lowest proportion of unemployed in a generation. Australia's employment to population ratios are at all time highs. In theory the welfare to work initiatives are also adding downward pressure to the aggregate payment base. Yet Figure 4-16 shows that, since the recession in the early 1990s, the new level of payments (as a share of GDP) never really returned to pre-recession levels. Figure 4-16 shows an even more alarming trend, with real per person spending ratcheting ever higher through time, showing little if any relationship to the business cycle or what should be the fundamental level of spending on assistance to families and individuals.

Indeed, real growth per person has averaged a remarkable 4.2% a year since 1961-62 (and 17.3% a year under the Whitlam Government).

FIGURE 4-16: SOCIAL SECURITY AND WELFARE (REAL PER PERSON $)

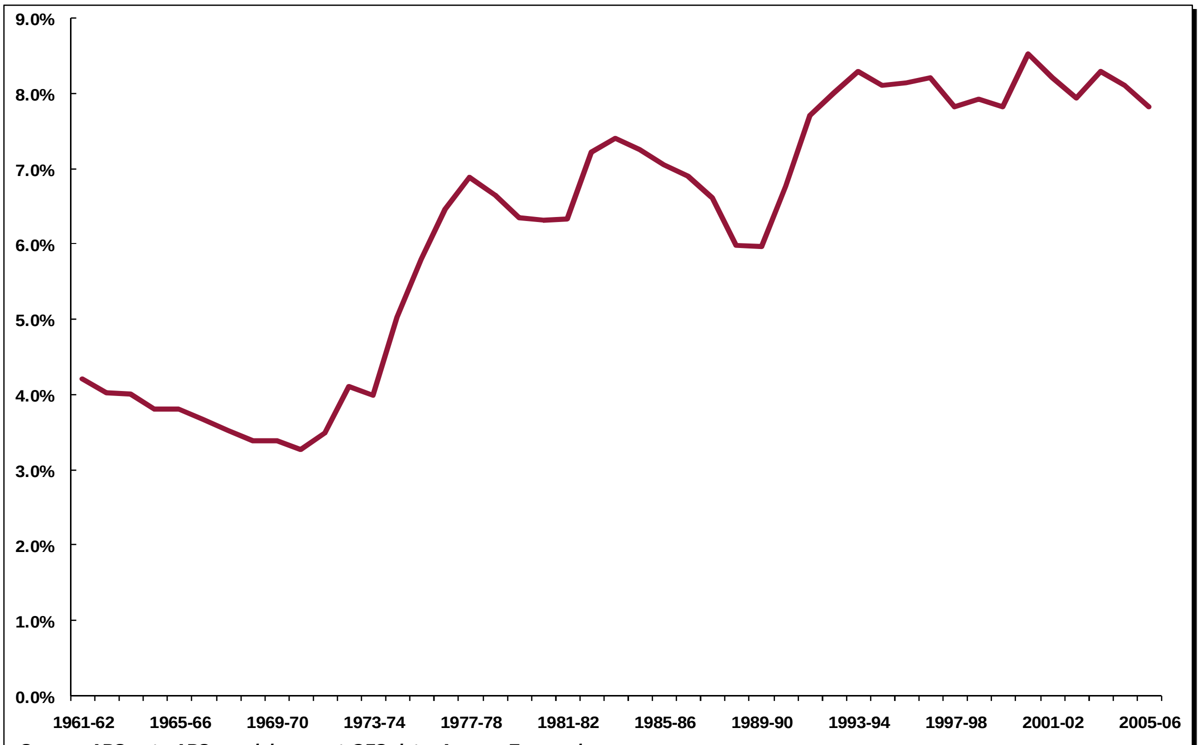


Source: ABS cat., ABS special request GFS data, Access Economics

It is worth breaking the wider spending category of social security and welfare into its two key component parts:

- Figure 4-17 and Figure 4-18 show that social security expenditure has stabilised at around 8% of nominal GDP, whereas there was a sharp shock to spending on welfare services in 1997-98 as a share of GDP.
- Notwithstanding the latter, the trend level of welfare spending as a share of national income has progressively and incrementally increased over time from the early 1960s when welfare expenditure was virtually non-existent.

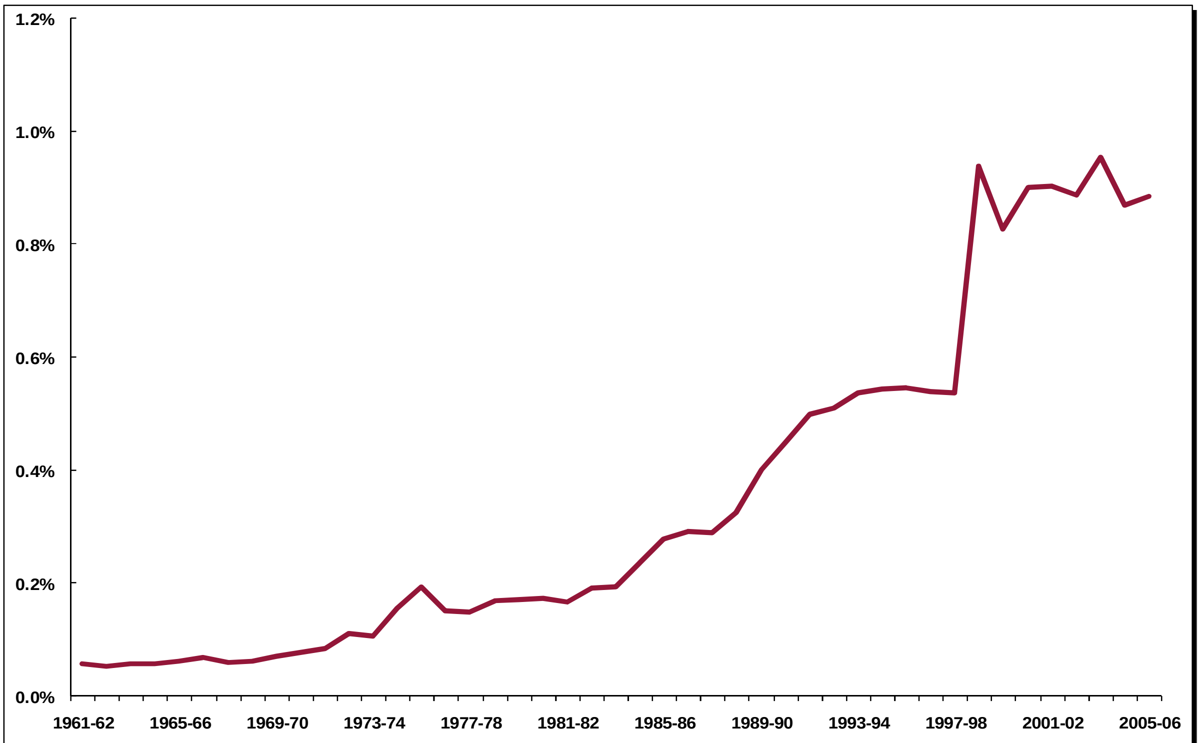
FIGURE 4-17: SOCIAL SECURITY (% OF GDP)



Source: ABS cat., ABS special request GFS data, Access Economics

The rise of the welfare state and the expectation of the community that the government must smooth life cycle transitions is entrenched in the Australian psyche. This has in part reflected the impact of major economic shocks and the social cost of these shocks.

FIGURE 4-18: WELFARE (% OF GDP)



Source: ABS cat., ABS special request GFS data, Access Economics

Yet now that economic prosperity has improved so significantly it may be timely to review in detail the arrangements for assistance to individuals.

Assistance to the aged

- Assistance to people older than usual workforce age includes the age pension and similar payments to veterans and war widows. These payments are estimated to be around 2.5% of GDP in 2006-07.

The age pension currently provides income support to men aged 65 and over and women aged 63 and over. The eligibility age for women is being increased gradually so that by 2013 it will align with that for men. The age pension is means-tested on both income and assets.

Between 1980 and 2005, the total number of age pensioners increased from 1.3 million to over 1.9 million. According to the April 2007 Intergenerational Report, this is expected to double by 2046-47. As personal superannuation adequacy grows over time, this will act to put downward pressure on pension take-up rates.

Government initiatives aimed at increasing savings and superannuation contribution levels now could also act to reduce future fiscal pressures stemming from an ageing population.

Assistance to those of workforce age

The main payments to people of workforce age are Newstart Allowance, Youth Allowance (YA) for unemployed youths, Disability Support Pension (DSP – see *Box 1 below*), and Parenting Payment Single (PPS), previously known as Sole Parents Pension. Projections of these payments were included in IGR1. Parenting Payment Partnered (PPP), Austudy, Youth Allowance (student), Carer Payment and Wife Pension have also been projected for IGR2.

Payments for people of workforce age are means-tested, and are estimated to be around 2.3% of GDP in 2006-07.

- Where appropriate, people on these payments are required to seek work or undertake training. This report projects the costs of these payments to individuals, but not the cost of job search support or training services.
- The Welfare to Work reforms which came into effect on 1 July 2006 introduced changes to the income support system for those of working age. The policy changes are designed to both lift workforce participation and reduce welfare dependency. Under the changes, eligibility requirements for the DSP and Parenting Payment were tightened, recognising that many people have the capability to work part time.
- Sustained economic growth over many years has seen the unemployment rate drop, with a corresponding drop in the number of Newstart Allowance customers.

BOX 1: DISABILITY SUPPORT PENSION

The disability support pension (DSP) is the main income support for those with a physical, intellectual or psychiatric impairment that prevents them from working for at least 30 hours a week at or above the relevant minimum wages for at least two years.

The DSP is for people aged 21 years and over. It is paid at the same rate as the age pension (that is, the highest rate of support available for those below retirement age) and is subject to the same income and assets tests, except for permanently blind recipients, who are not subject to either the income or assets test. Youth rates apply to those aged under 21 years. These are largely tied to Youth Allowance rates, but include a supplement.

The use of DSP rose fast over time, raising concerns about the benefits of using this form of payment system (for both the individuals concerned and for society more generally).

The numbers relating to DSP are large in both people terms and in dollars (see Figure **4-19**):

- In 2005-06 there were 712,163 recipients, mostly men (415,618) but also a large number of women (296,545). The cost of the program is now around $8¼ billion.

- In 1996-97 there were 527,514 recipients in total; so the 2005-06 figures represent an increase of around 35% in the last decade.

As the job market tightened progressively through the early part of this decade, our understanding of the need to increase participation across all levels of society became more acute, as did our failure with regards to those moving onto the DSP. This led to a range of reforms to the welfare system, with many of them targeted at providing better assistance to people on and moving into the DSP.

- While DSP recipients were able to access the same types of rehabilitation, training, job market programs or labour force re-entry assistance, it also became apparent that this form of assistance (for re-entry to work and society) was not targeted well enough.

- The result was that the 'old' DSP was not helping those who really needed assistance to move back into the workforce.

In 2002 the policy focus moved to providing better support people with disabilities so as to promote independence and self-reliance through the provision of rehabilitation services, specialist employment services and other services for people with a disability. This involved an increased focus on the assessment of work capacity for people who are ill, injured or have a disability and on the early identification of useful interventions (such as rehabilitation and employment assistance) to help people.

These reforms continued, with the 2005-06 Budget announcing a new work threshold would apply for new claimants for the DSP. This reduced the hours threshold to 15 hours per week from July 2006. This means that new claimants who can work part time for 15-19 hours per week are no longer eligible for DSP. Instead, they will generally qualify for Newstart or Youth allowance, with modified activity requirements to reflect their level of work capacity.

In other words the DSP pension now comes with an inbuilt mechanism to encourage workforce participation as well as the development and use of the individuals' abilities to the extent possible.

This led to a notable slowing in the rate of increase in recipient numbers (see Figure 4-19 and Figure 4-1920) due to this very successful policy intervention and the dedication of those delivering the services.

Figure 4-19: DSP recipients and its cost (persons '000, $bn)

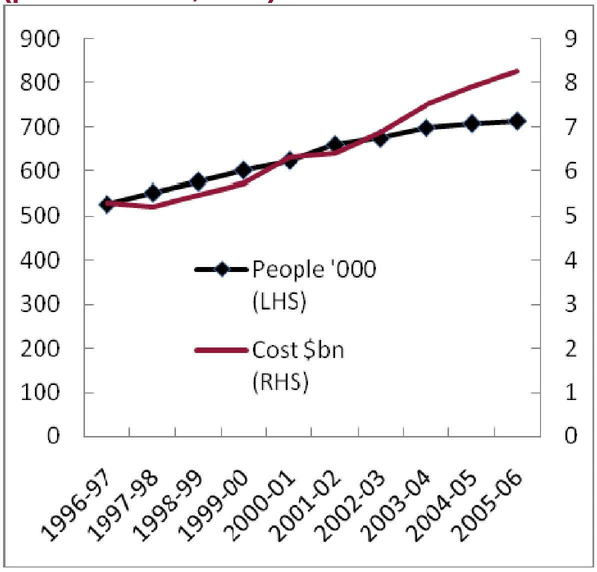
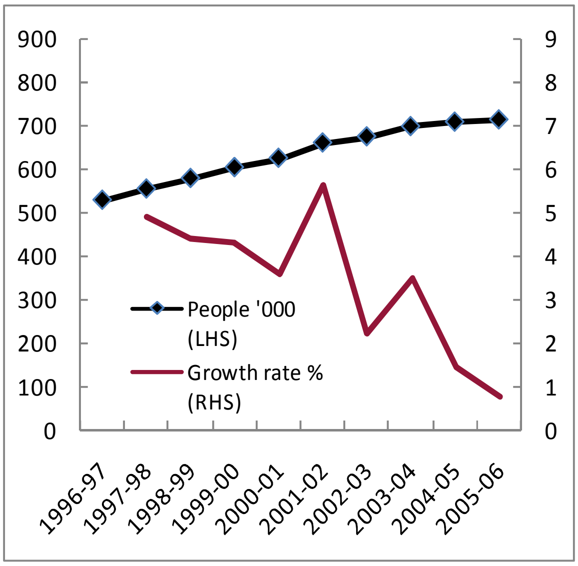


Figure 4-20: Increase in DSP recipients (Growth)



Source: ABS Year Book Australia (1301.0), Department of Families, Housing, Community Services and Indigenous Affairs and Access Economics estimates.

That slowdown has been a great outcome for fairness and future prosperity – well done!

Welfare to Work

- New applicants for Parenting Payments are now subject to an obligation, based on their capacity, to seek part-time work when their youngest child turns six.
- For new customers to be eligible for the Parenting Payment they must have a child aged less than six if they are partnered and under eight if single.
- Over time, these changes will reduce the number of people on Parenting Payment.
- The coverage trend in disability (DSP) recipients has flattened out since 2002, except for women aged 60-64 where the rise in female age pension age has had an effect.
- Under the *Welfare to Work* reforms, eligibility criteria for the DSP have been tightened, and new applicants are eligible for the DSP only if they are unable to work 15 hours per week at award wages.
- The previous criterion was based on being unable to work 30 hours per week. Due to the eligibility changes, the number of DSP customers in the future is expected to decrease.
- As a consequence of the *Welfare to Work* initiatives, the number of people on Newstart Allowance is expected to increase; however, this should be offset by reductions in Parenting Payment and DSP customers.
- A softening in the Newstart Allowance income test is expected also marginally to increase the number of part-rate Newstart allowees.
- Consistent with the intent of the *Welfare to Work* changes, the total number of these clients is expected to decrease over time as people move off payments and into employment.

Assistance to families

Assistance to families appears to be a mess. For example, there is no means test for receiving Family Tax Benefit Part B – a classic opportunity for churn and providing middle class welfare (see *Box 2 below*).

> *"For most of Australia's history, working age people have expected to look after themselves and to care for their families from their own resources…the question we have to ask is whether the money we are currently handing over in taxes could be better spent by organising our affairs for ourselves" (Peter Saunders, 2007).*

Family payments provide assistance to families with children, with higher assistance provided to families with lower incomes. The payments include Family Tax Benefit Part A (FTBA) and Family Tax Benefit Part B (FTBB), as well as Child Care Benefit (CCB).

- The level of assistance for FTBA and FTBB has increased significantly at a time when arguably the growth in per capita incomes has never been stronger. The main culprit is that payment rates and income test thresholds have increased over this period, with tapers being reduced.

BOX 2: FAMILY TAX BENEFIT – PART B

FTB B was introduced as a sweetener for families when the *New Tax System* (GST) package began in July 2000. FTB B is designed to provide assistance to families with one main income earner, including single parent families. It is paid per family, not per dependent child. Payment to a family is based on the age of the youngest child, and is assessed on the income of the family's second income earner.

In other words the primary breadwinner's income is *not* means tested – the main income earner could earn a million dollars a year and the spouse who stays at home will still get the full FTB B as long as he or she is not earning anything and has a dependent child.

This smacks of classic middle class welfare.

The dollars are large.[8] **Almost 1.4 million families get FTB B (Figure 4-21), costing $3.4 billion a year (Figure 4-212).** These amounts are the result of a rising trend caused by successive government increases in payments and relaxation of the eligibility criteria.

Figure 4-21: FTB (B) recipients (millions of persons)

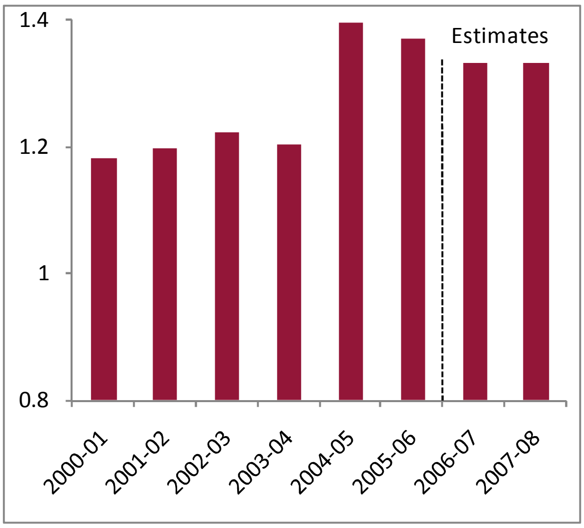
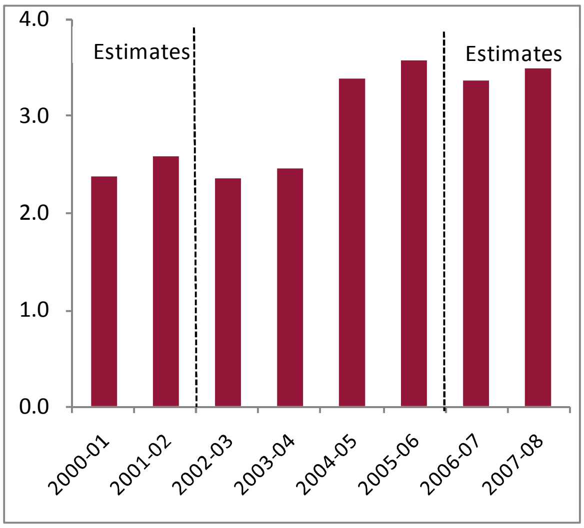


Figure 4-22: FTB (B) nominal spending ($ billion)



Source: ABS Year Book Australia (1301.0), Department of Families, Housing, Community Services and Indigenous Affairs and Access Economics estimates.

Rather than improving fairness by transferring money from those who have it to those who don't, FTB B largely creates churn with money taken from taxpayers and then subsequently inefficiently returned via transfer payments 'from whence it came' (Section 2). As such **FTB B is poorly targeted welfare. It has significant budgetary costs but limited social impact.**

FTB B therefore fails the fairness test.

Further, the structure of the FTB B discourages families from increasing the secondary earner's participation in the labour market. If the second income earner re enters the workforce, then the Government soon starts clawing back the benefits, thereby creating a disincentive to work. That is not what is required in an economy already struggling to find enough workers. As a result, **FTB B also fails the prosperity test.**

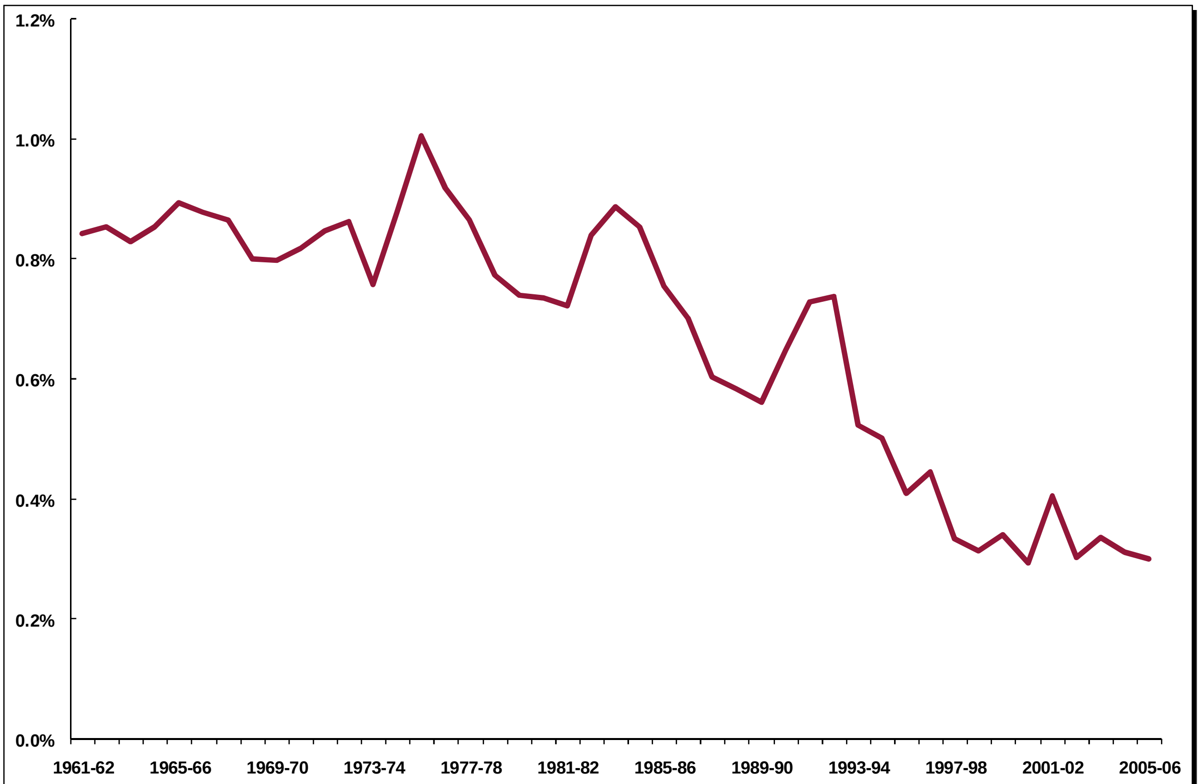
[8] If the youngest child is under 5 years the family stands to get a maximum of $120.96 per fortnight, and if the child is 5 to 15 years (or a full-time student aged 16 to 18 years) then the top payment is $84.28. But wait there's more. There is further yearly supplement of $324.85.
Source: http://www.familyassist.gov.au/Internet/FAO/fao1.nsf/content/payments-ftbb (accessed 21 December 2007).

4.6 TRANSPORT AND COMMUNICATIONS (INFRASTRUCTURE)

Transport and communication expenses support the infrastructure and regulatory framework for Australia's transport and communications sectors.

- Spending on transport and communication includes road construction, road maintenance, parking, water transport, rail transport, air transport, pipelines, multi-mode urban transit systems, and communications.

FIGURE 4-23: TRANSPORT AND COMMUNICATION (% OF GDP)



Source: ABS cat., ABS special request GFS data, Access Economics

In other words, it covers key infrastructure areas under the control of the Australian Government.

While increasing in nominal terms, spending on transport and communications has not kept pace with the growth in the economy.

- Spending in this area has steadily fallen as a proportion of GDP – declining from 0.84% of GDP in 1961-62 down to 0.30% of GDP in 2005-06 (Figure 4-23).
- **In real per person terms, spending in this area is at the same level it was in the 1960s – at around $150**.

However, a turnaround may be in store. For example, the Government has announced some major increases in road and rail infrastructure – $22.3 billion over five years from 2009-10 – mostly under the second AusLink national land transport plan (AusLink 2).

FIGURE 4-24: TRANSPORT AND COMMUNICATION (REAL PER PERSON $)

Source: ABS cat., ABS special request GFS data, Access Economics

It remains to be seen whether this will stem the downward trend.

4.7 ENVIRONMENT

Awareness of the importance of Australia's natural environment has increased as evidence of global environmental pressures from climate change have continued to emerge. In Australia, issues like land degradation, soil erosion and salinity, water use as well as climate change are the key issues.

Improved scientific methods and analysis have also increased the understanding of environmental problems, environmental systems and their interactions. This has improved the capacity and the will of the community to address environmental problems.

At the same time, increasing real wealth and incomes tend to increase the demand for to address issues in the environment.

As the 2007 *Intergenerational Report* (IGR2) notes, part of the challenge in understanding and managing the environment lies in data limitations.

- There is a lack of data on government environment spending, and what is available lacks consistency. Data is only available for recent years, complicating both comparisons over longer periods of time and the use of past trends as a basis for future projections.

The available data still show that spending by the Australian Government on protecting and conserving the environment is estimated to have more than doubled, from around $1.8 billion (0.2% of GDP) in 2001-02 to an estimated $3.9 billion (0.4% of GDP) in 2006-07 (IGR2, 2007).

Therefore, climate change is a key issue weighing on the minds of Australian communities. The OECD (2007) notes that Australians are not alone in this mindset:

> "*Global climate change is one of the key concerns of the 21st century, with serious implications for economies, societies and the environment. A central challenge is the integration of climate policy objectives into other sectoral policy areas*".

Clearly, the sustainable use of the Australian environment and the likely impact of climate change present a major risk to the future prosperity of the Australian community.

Environment and climate change is crucial, without natural resources we lose our greatest gift to future generations.

- The impact that current generations are having on the environment and the increasing cost of government inaction that will be brought to bear on future generations should we continue to do nothing to address these major environmental policy issues as they emerge.
- This issue is as important as the ageing of the population in terms of risks to future prosperity if we don't push for greater change. Government needs to contribute significant resources to understanding the scale of the issues we will face in the near future.

The OECD notes that:

> "*Climate change is already being observed through rising temperatures, melting glaciers, shifting rain patterns, increased storm intensity and rising sea levels. Greenhouse gas (GHG) emissions from human activities – mainly fossil fuel use, deforestation and agriculture – cause climate change*".

It is now becoming increasingly clear that if greenhouse gas emissions are not reduced to significantly below current levels within the next few decades, there will be further warming and sea level rise around the globe, potentially for centuries to come. To the extent that this occurs, adverse impacts on human health, natural ecosystems, and the global economy result.

Issues of intergenerational fairness are high on the agenda in terms of the environment and more modelling and resources need to be applied to improve our understanding of the issues and the actions required to offset if possible or prepare for change if not.

- Without proper measurement and research we cannot estimate how to price the externalities generated through production. This could lead to exponential increases in the eventual clean up cost of our activity today.
- It is also unclear exactly what environmental outcomes we should be aiming for – that is, what does sustainability really mean?
- Finally, there is uncertainty regarding the policy instruments that governments will choose to deal with environmental problems.

These issues need to be considered. **Australia is a long way behind best practice when it comes to the environment. It is time to lift our game.**

5. TAX EXPENDITURES

Tax expenditures are concessions, benefits and incentives delivered to taxpayers through the tax system. **They are often a big, bad, opaque and ugly form of government spending.**

Tax expenditures are not subjected to the same degree of scrutiny as other government spending, but otherwise they are an equal mechanism to other public sector expenditures for providing assistance to individuals.

According to the Treasury's 2006 Tax Expenditure Statement (TES), there are around 270 tax expenditures totalling an estimated net value of $42.1 billion in 2005-06 – a value which is projected to increase to a whopping $52.7 billion by 2009-10. As the TES itself points out:

> *"Tax expenditures, like direct expenditures, affect the government's budget. However, unlike direct expenditures, tax expenditures once legislated become part of the tax law with a recurring fiscal impact and do not receive regular scrutiny through the budget process."*

While the TES tries to publish information on the impact of tax expenditures and thereby improve transparency and accountability, there are number of problems with the way the current system operates:

- The Treasury and the Taxation Office are both unsure of the actual recipients of these expenditures (or subsidies and exemptions).
- The costings that are provided are often rubbery due to factors such as a lack of data and can underestimate the full impact of the tax expenditures. Further, the costing frameworks can be complex and opaque.
- There are a lack of resources devoted to keeping track of tax expenditures compared with those devoted to monitoring programs, also adding to the insufficient level of information about tax expenditures.
- Tax expenditures suffer from less by way of checks and balances. Control of program expenditure is enhanced by individual Ministers being held responsible for spending in their portfolio. This is not the case for tax expenditures.
- Tax expenditures also tend to be almost open ended (that is they are available to all those who meet certain eligibility criteria). As a result they have the potential to blowout over time, without an adequate mechanism for limiting these blowouts.
- **Even worse, tax expenditures are often a preferred way to keep measures of government spending lower. If the choice is between a transparent subsidy for some section of the community (adding to spending) versus a tax expenditure (reducing the tax take), then the tax expenditure has the political advantage of hiding 'big government' policymaking behind 'small government' measures.**

Consideration should therefore be given to converting tax expenditures to regular government outlay programs immediately. There is little genuine reasoning to use this form of transfer system instead of the standard Budget process other than speed of application. Therefore, where these measures are used they should be progressively rolled into the Budget process over time to ensure proper scrutiny and transparency in the future. The 1996 National Commission of Audit found that:

> *"Tax expenditures are less transparent, more open ended, but otherwise equivalent mechanism to public sector expenditures for providing assistance to individuals and business. Many help those who can help themselves or may be the source of discriminatory treatment between competing business activities".*

Or, in other words, tax expenditures are all-too-often used by governments to pick winners, make friends and intervene in what would otherwise be efficient markets, while at the same time hiding the impact of further government intervention.

The same tests that this report recommends be applied to spending measures should also be applied to tax expenditures (see the above policy checklists). These tax expenditures have as much chance of bidding away resources from more productive areas of the economy as active spending measures – particularly in the current economic environment. They are also associated with similar deadweight losses.

Given that tax expenditures should essentially be treated the same way as other spending, **a comprehensive review is also required for *existing* tax expenditures to see whether they are worthwhile.**

6. THE CASE FOR BETTER BUDGET REPORTING

The above analysis of various forms of government spending and tax expenditures underscores the need for comprehensive and transparent budget reporting. Democracy has surprisingly humble underpinnings. One that Access Economics has always championed is simple: it is important to know what our governments are and aren't doing.

That makes the way in which they report – their fiscal transparency in particular – a vital part of a healthy democracy. The more transparent are a government's financial reports, then:

- The greater is public awareness of the government's spending and taxing intentions.
- The more informed is public debate on the issues involved, and
- The greater certainty there is for families and companies as they make decisions.

Accountability is promoted and the quality of decision making on spending and taxes should be improved. However, as noted by Uhlmann:

> *"Transparency is a quality much admired by politicians when they are in opposition but proximity to government seems to act as an antidote. So it is best not to listen to what governments say about how honest they are, but judge them by what they do."* (The Canberra Times, 21 August 2006)

That is why the *1998 Charter of Budget Honesty* – a law which requires reports on policies, including intergenerational issues and during Federal election campaigns – was a key advance. Yet, even so, the Australian Government Budget process is not adequately geared to provide a comprehensive review of the effectiveness of government spending as a whole:

- **The Budget itself is mainly focused on reporting *new* spending rather than reviewing the quality and effectiveness of existing spending.**
- Other documents such as the Portfolio Budget Statements report against broad and often unclear outcomes and outputs for each portfolio. It is difficult to match these broad outputs and outcomes to the effectiveness of actual programmes affecting people who are supposed to benefit from these government services.
- The process is largely focused on the short term impact of government decisions, mainly covering a four-year forward estimates period rather than regularly monitoring the ongoing impact of decisions.
- Current reporting arrangements require the preparation of two major sets of financial reports. They are based on the Government Finance Statistics (GFS) framework as well as Australian Accounting Standards (AAS), being the Australian Equivalents to International Financial Reporting Standards (AEIFRS) and AAS 31 Financial Reporting by Governments. This complex reporting regime can cause confusion for financial report users and can adversely affect their ability to monitor government operations.
- Risks to the Budget outlook such as contingent liabilities are loosely reported without enough rigour to, for example, identify their likelihood of occurring.
- Further, the focus of policy tends to be on the federal level alone, without adopting a whole of government approach which puts federal policy in the context of what is being done in the States and Territories. This has the potential to create overlap and inefficiency in the provision of services across different levels of government. Access Economics has estimated that 'flawed federalism' cost Australians almost $9 billion in

2004-05. This was due to things like unnecessary duplication of government services, lack of coordination, cost-shifting and inefficient taxes.

As a result of these and other issues, policy tends to be created in a piecemeal manner, without looking at its overall long term impact and without properly measuring its effectiveness. In particular, much policy is often developed in the midst of crisis, rather than in an environment that nurtures planning and consideration. **Good examples here include the talkback campaigns that saw the Government (1) abolish petrol excise indexation and (2) drop out of the privatisation of the Snowy Hydro.**

The Budget and policy decision-making process could be better served by:

- Implementing a simpler and more consolidated structure of the Budget papers in order to decrease duplication and aid transparency. This could include reporting aggregates on a per person basis (and using real terms, to adjust for the impact of inflation).
- Changing the Budget papers to better identify and analyse the allocation of spending to particular programmes and groups of recipients across time. This should also focus on how effective the government programmes have been in achieving their specific goals.
- Reporting the impact of government decisions over a longer period of time and on a more regular basis. For example, the five year gap between *Intergenerational Reports* may be too long and periodic updates may be required.
- The decision-making process itself should also focus on the impact of government decisions on the economy as a whole. This is particularly important in an economy operating a close to full capacity where an increase in government activity has the risk of taking resources away from the private sector and adding to inflation.

Perhaps most importantly, **the overall base of government policy should be reviewed on an ongoing and objective basis** – rather than simply focusing on new spending.

- The last comprehensive look at government activities was commissioned in 1996 – called the National Commission of Audit (NCA). This review looked at fundamental issues such as:
  - the role of government in delivering services;
  - the mix between public and private provision of services;
  - what level of government is best placed to provide these services;
  - the specific aims of government activity and whether these objectives were being met – with a view to lifting the efficiency and effectiveness of spending; and
  - promoting choice and competition in relation to government services.
- Among other things, this resulted in difficult yet necessary decisions being made on various government services and provided a *temporary* check on spending. However, spending has increased significantly since that time.
- Such detailed reviews are required on a more consistent and regular basis, followed by the political will to act on their recommendations. Ideally, they would be conducted objectively and independently of the political process by an independent body.

This report recommends that the government legislates to review all expenditure and revenue policies every five years using a framework similar to that for the previous National Commission of Audit (NCA). The review could be carried in conjunction with the already established *Intergenerational Report* process.

7. WHAT DOES THE IMF SAY?

The International Monetary Fund (IMF) has, in recent times, commended the performance of the Australian economy while at the same time offering some backhanded criticism on its management. In its October 2007 *World Economic Outlook*, the IMF noted the strong performance of the Australian economy. However, it also cautioned that:

> "the main short-term policy challenge…**continues to be to keep firm control on inflation** in the face of strong domestic demand and tight labor markets."

It then went even further by imploring the previous Government to:

> "…**continue to exercise fiscal restraint in the period ahead**."

Looking through the diplomatic jargon, this means the IMF is saying that **the previous Government should not have been pump priming the economy with more new spending at a time it was already bursting at the seams**. This restraint proved to be particularly difficult to achieve in an election year.

The latest messages from the Fund are part of a consistent line of advice for Australian Governments to remain sensible and restrained in the face of the current commodity price (terms of trade) boom.

In the latest *Article IV Report on Australia*, the IMF further 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**."

This is a prudent point given that the States are already injecting stimulus in to the economy. As the Fund noted:

> "**Another stimulus that raises concern comes from the States. The States are collectively forecasting a fiscal deficit of around ½ percent of GDP in 2007-08.**"

In the past, the IMF has said fiscal policy in Australia should be framed against the budget balance adjusted for temporary boost in commodity prices as a result of the terms of trade boom.

In light of the upcoming spending pressures highlighted in the *Second Intergenerational Report (IGR2* – see also the discussion in Paper 3), the IMF recommended that:

> "Continued attention to the **efficiency and effectiveness of spending** will be key to preserving long term fiscal sustainability."
>
> "While Australia is well-placed to deal with long term fiscal challenges, continued attention will also need to be given to the efficiency of health-care spending."

The message on fiscal restraint was hammered home by the following statement:

> "**The main concern is fittingly dealing with possible additional revenues stemming from further terms of trade gains. Given the current economic situation and prospects staff urge the government to continue exercising fiscal restraint.**"

Basically, the IMF called on the Australian Government to lift its game on the efficiency and effectiveness of its existing spending rather than pump-priming an already fully stretched economy with new spending.

That advice was then promptly ignored by both the then Government and the then Opposition in the 2007 election campaign.

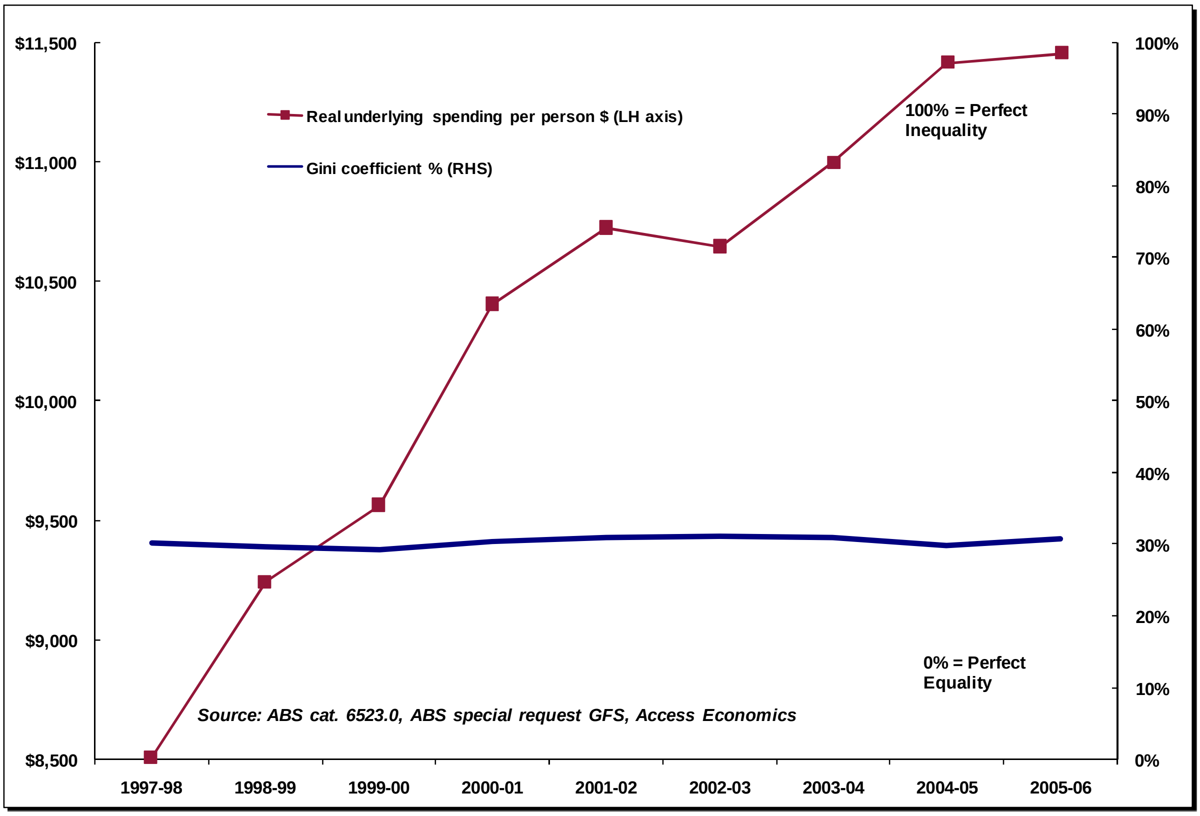
8. HAS A LARGER GOVERNMENT LED TO A FAIRER AUSTRALIA?

Has all the spending been worth it after all? Has fairness actually increased?

Australia's 'social compact' is such that it could handle a further expansion of government intervention in the economy were that expansion in spending and taxation to be making significant inroads into boosting fairness and reducing poverty.

Yet the data tells us that fairness has been little changed over the years. Figure 8-1 indicates that the recognised global fairness index – the Gini coefficient of income dispersion – has changed little over the past decade despite the significant increase in real underlying spending per person over that time.

FIGURE 8-1: REAL SPENDING PER PERSON VS. A MEASURE OF HOW EVENLY INCOMES ARE DISTRIBUTED AMONG AUSTRALIAN FAMILIES



- The statistics are clear that incomes were shared in 2005-06 almost exactly as they were in 1994-95, with **the share of income earned by the bottom 20% of families largely unchanged in the last decade.**
- That is why the Gini coefficient barely budged over that time period. (The coefficient, seen in Figure 8-1, is 0% in an economy where incomes are shared equally, and 100% in an economy where all incomes are in the hands of one person.)
- Importantly, this is also exactly the same period when prosperity in Australia has significantly increased.

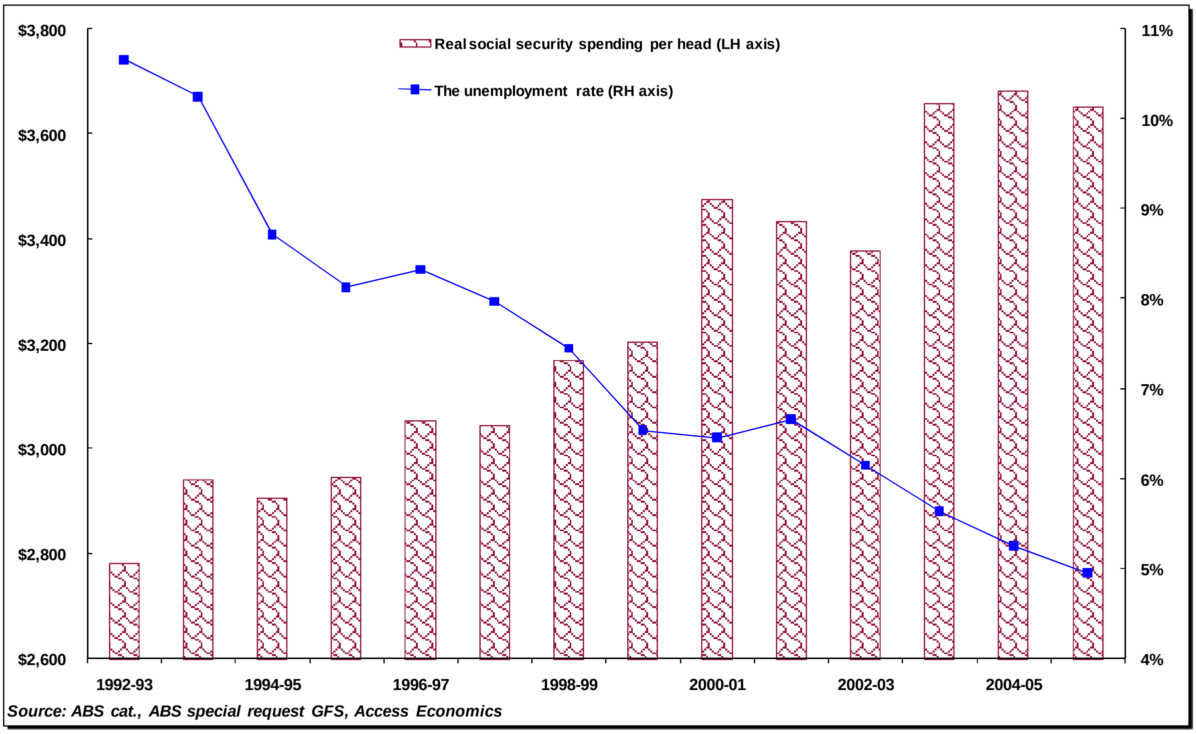
- Or, in other words, the lift in Australia's prosperity came at no cost to our fairness – the way in which the national economic pie has been shared.
- But just as importantly, it has come at a cost in terms of size of government (the spending and taxation share of the economy), so **the growing the government footprint has not been accompanied by any improvement in fairness**.

Economists have long agreed that it makes sense for business to create wealth and governments to redistribute it. As we have argued elsewhere, the rationale is simple. With rare exceptions, markets work. They are good at creating prosperity. Governments and their rules and regulations aren't.

That said, there is probably an argument that governments do need to spend more per head over time to maintain fairness at constant levels. That is because the relative return to skill in job markets has been rising in Australia and around the world. In the absence of government action, and other things equal, that leads to a small but steady widening in income differentials. Yet this latter caveat is small, whereas the lift in spending per head in recent years is large.

Hence, and as Figure 8-2 shows, unemployment (a simple measure of whether we are achieving success on our goals of prosperity and fairness) has been falling. Yet, despite that good news, the social security bill per person has been steadily climbing.

FIGURE 8-2: LOWER UNEMPLOYMENT, BUT A RISING SOCIAL SECURITY BILL



Source: ABS cat., ABS special request GFS, Access Economics

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