Business Council of Australia

BCA BUDGET SUBMISSION 2013–14

Towards Fiscal Repair

CONTENTS

About this publication

This publication is the Business Council of Australia Submission to the 2013–14 Budget, and contains a detailed set of recommendations for consideration by the federal government as part of the 2013–14 budget process. It draws on a report prepared for the Business Council of Australia by Deloitte Access Economics titled 'Risks around Australia's Fiscal Position' and a report by ACIL Tasman titled 'Reforming Federal Finances'.

About the Business Council of Australia

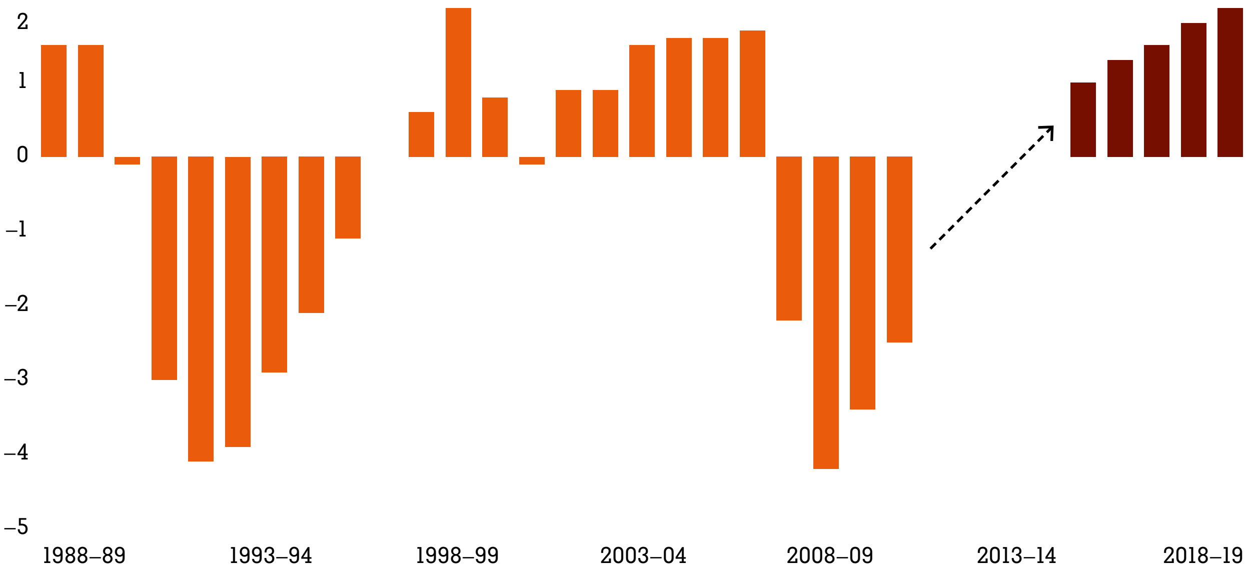
The Business Council of Australia (BCA) brings together the chief executives of more than 100 of Australia's leading companies. For almost 30 years, the BCA has provided a unique forum for some of Australia's most experienced corporate leaders to contribute to public policy reform that affects business and the community as a whole. Our vision is for Australia to be the best place in the world in which to live, learn, work and do business.

EXECUTIVE SUMMARY

The government's execution of its fiscal strategy is not working and requires a major rethink. To set the right foundation in the upcoming budget, the government must set out a sensible and credible pathway back to surplus along with a refreshed fiscal strategy

A medium-term path to fiscal stability

Budget balance as a share of GDP



Source: Commonwealth Budget Papers for balances up to 2011–12.

Major findings and recommendations

- The government's execution of its fiscal strategy is not working and requires a major rethink.
- Just as the task of paring back stimulus spending was nearing completion, new spending in the budget began to accelerate again. Analysis commissioned for this submission from Deloitte Access Economics shows that such new spending amounts to a cumulative $49 billion impact on the budget over the most recent forward estimates.
- Some of these spending decisions were associated with assumptions linked to expected revenue from new taxes such as the carbon tax and the Minerals Resource Rent Tax (MRRT), while some relied on assumptions about improving revenues overall, rather than spending restraint and specific offsets.
- It seems clear that actual receipts from these measures will now not match earlier projections, thereby placing further pressure on the budget. Furthermore, these revenue measures damaged confidence and economic growth prospects by reducing international competitiveness.
- Three years into recovery after the global financial crisis, more should have been done to achieve greater structural savings and put the budget on a more sustainable long-term footing. Instead, savings have been oriented towards deferrals and one-off measures rather than a proper reprioritisation of expenditure.
- The task will only get harder. The government must be able to demonstrate that it can fund its share of the National Disability Insurance Scheme (NDIS) and the Gonski education reforms in the forward estimates and beyond. Some estimates suggest that these reforms could require up to $17 billion of new funding annually, depending on the extent to which already fiscally constrained states are able to provide funding.
- On top of this, we have a looming fiscal challenge associated with an ageing population. As analysis prepared for the Business Council of Australia for the federal government's 2011 tax forum demonstrated, by 2050 Australia will face a combined primary deficit of 5 per cent of GDP or $70 billion per annum in today's terms just maintaining the current level of government services.
- More taxes on business and narrow ad hoc revenue measures are not the answer because they hurt business confidence and detract from a strong and growing economy, which will be vital to meet the fiscal task. Business has paid its fair share – almost a quarter of government revenues based on latest estimates.
- The focus instead must shift to permanent and sustainable savings, with a comprehensive look at spending priorities through an independent review of the size, scope and efficiency of government.
- A proper fiscal strategy should produce growing surpluses over the medium term. We believe that to be credible, this strategy should commit to achieving a budget surplus of at least 1 to 2 per cent of GDP consistently over the medium term.
- The path and structure of the budget over the next four years (the forward estimates period) should set the foundation for meeting this goal.

> If the government is to achieve its fiscal goals, a fundamental reprioritisation of expenditure is required

- Improving productive capacity in Australia should also remain a priority and meeting our infrastructure needs remains a challenge. As the resource-related investment cycle turns there is a role for infrastructure project construction to fill the breach. This will necessitate better planning and delivery of infrastructure and funding including from alternative sources.
- In order to set the right foundation in the upcoming budget, the government must:
  - » set out a sensible and credible pathway back to surplus along with a refreshed fiscal strategy, including:
    - » explicitly outlining the extent to which major new spending commitments will impact on the fiscal position over the medium term
    - » delivering on its commitment to a 2 per cent real cap on expenditure growth
    - » undertaking an independent and comprehensive review of the size, scope and efficiency of government
    - » offsetting new spending commitments through reprioritisation of spending
  - » adopt fiscal rules to place a hard cap on the size of government, build capacity to recharge fiscal readiness (to allow us to deal with the next major economic shock), and begin to provision for intergenerational pressures
  - » continue to focus on productivity-enhancing reforms including deregulation and eliminating Commonwealth–state duplication in order to boost the productive potential of the economy and support growth
  - » improve the climate for infrastructure in Australia through improved planning and prioritising of capacity-building infrastructure, fast-tracking planning approvals through streamlined major development approvals, a new federal–state infrastructure agreement and as a priority facilitating new sources of funding and financing
  - » set out a roadmap for undertaking comprehensive long-term tax reform in consultation with the states and territories to boost the efficiency of our tax system and robustness of revenues. As recommended by the Business Tax Working Group, the government should not implement ad hoc changes to the business tax arrangements.

Overview

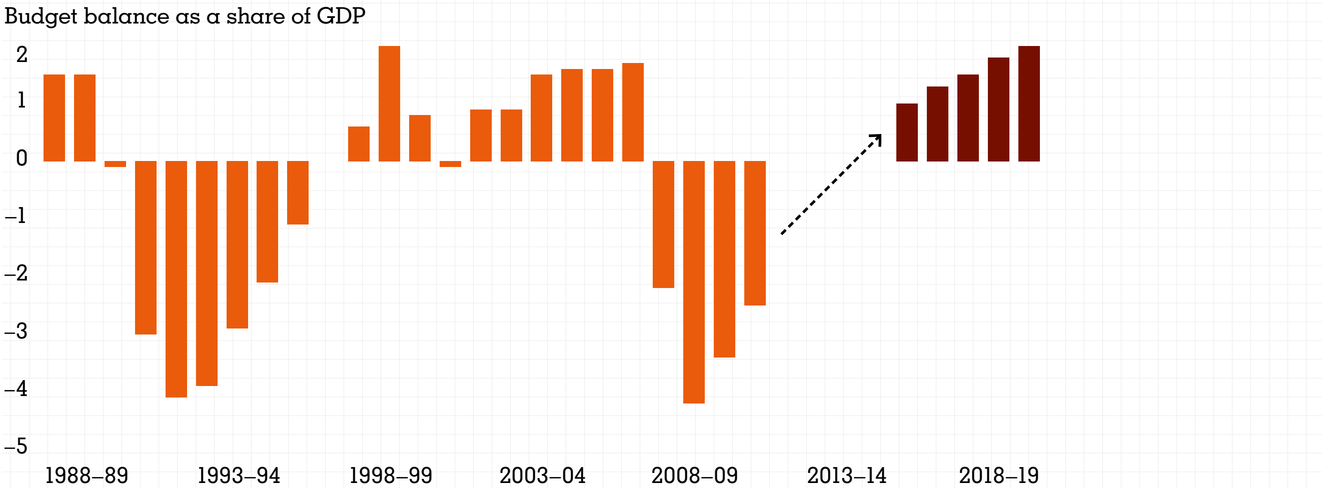
At a challenging time for the international economy, Australia's sound economic fundamentals stand out. However, this is not being reflected in the levels of confidence domestically – either among households or businesses – with sentiment still well below levels of past years despite some recent improvements.

Australians have seen the national budget position deteriorate through the global financial crisis and public debt levels rise. This was an understandable development at the time, but there is a rightful expectation that the course will be corrected and that we will return to our tradition of sound public finances in Australia.

The articulation by the government of a strong and credible strategy on fiscal policy is needed to boost confidence. This will also give Australians greater certainty that we will be able to pay for public services and infrastructure in the future and be resilient to the economic volatility that will inevitably come our way.

However, the strategy must be credible and achievable. At a minimum, we believe that budget surpluses growing to 1 to 2 per cent of GDP will be needed.

A medium-term path to fiscal stability



Source: Commonwealth Budget Papers for balances up to 2011–12.

> Three years into recovery after the global financial crisis, more should have been done to achieve greater structural savings and put the budget on a more sustainable long-term footing

If the government is to achieve its fiscal goals, it now requires a fundamental reprioritisation of expenditure to occur, sooner rather than later. The focus must be on rethinking the structure and pattern of spending, which can only be done through an independent review of the size, scope and efficiency of government. A strategy that rests predominantly on plugging revenue gaps runs the risk of harming confidence, economic growth prospects and having unintended consequences.

Such fiscal credibility is central to a stable environment for investment and innovation – the very things that are necessary for business to lift productivity and assist with adjusting to the structural pressures in the economy.

Economic context

Australia's economy is expected to encounter continuing headwinds over at least the next 12 months. While our economic fundamentals are solid with low inflation, continuing economic growth and relatively low unemployment, there are a number of emerging risks. These risks are associated with potential further declines in our terms of trade, a pullback in resource-related business investment, and the cautious approach of households and consumers in their spending and borrowing behaviour. There is also a prospect that Australia's exchange rate will remain high for some time.

In recent Budget Submissions, the BCA has highlighted how these and other economic pressures and risks can be addressed, in part, through sound and sensible fiscal policy.

In particular, we have highlighted how the budget has become significantly more exposed to movements in commodity prices and the terms of trade and company profits and the risk that there will be greater volatility in the budget estimates in the years ahead. This reinforces the need to deliver material budget surpluses in the good times so that fiscal policy can be used as a buffer during the more difficult times. Any increase in volatility in the coming years naturally suggests that the fiscal buffer will need to be larger.

Australia's terms of trade have declined by 13.7 per cent over the past year and this has had significant consequences for growth in nominal GDP, which has slowed to just 1.9 per cent through the year to the September quarter 2012. Leaving aside the period coinciding with the global financial crisis, nominal growth has not been this low in over 20 years. This has major implications for business profits and tax receipts, with Commonwealth revenues down some $3.9 billion against budget forecasts in just the first four months of 2012–13.

While a weakening in commodity prices might ordinarily result in a depreciation of the exchange rate, the uncertain global financial conditions (and unconventional monetary settings in many countries) are sustaining a higher Australian dollar. This is reinforcing pressures on many companies in trade-exposed sectors.

With these continuing pressures on trade-exposed industries as well as the likelihood that non-resources-related investment will remain subdued in 2012–13, there is a real prospect that economic growth could be threatened should resources-related investment also begin to slow materially.

There have already been some signs that falling commodity prices, rising construction costs and the uncertain global outlook are having an impact on investment decisions in this sector.

The series of interest rate reductions that occurred through 2012 should provide impetus to the housing sector in 2013. However, feedback received from some Business Council members suggests that an upturn is not assured. Again, a restoration of confidence will be important in this regard.

Even so, it is likely that a recovery in housing and other building-related construction will not be sufficient to fill any gap that is likely to arise when the surge of resources-related investment begins to wane.

The possibility that the terms of trade will continue to weaken (they remain above historical average levels) highlights the importance of restoring Australia's productivity performance if we are to keep national incomes high.

While these short-term pressures on the economy are important, we should not lose sight of the long-term pressures on our economy – such as from an ageing population – that are continuing to build. The Australian Bureau of Statistics (ABS) recently released updated life expectancy figures which show that Australians born today are now expected to live longer than ever before.

Assessment of current fiscal position

Analysis prepared by Deloitte Access Economics to support the BCA's 2013–14 Budget Submission highlights that the current budget position presents a risk that the government will be unable to achieve its fiscal goals. Repairing the fiscal position and meeting these goals are considerable tasks.

Expenditure

While the current fiscal position has been heavily affected on the revenue side, an analysis of recent expenditure trends suggests that new discretionary spending decisions have continued to grow.

Discrete stimulus spending associated with the policy response to the global financial crisis has now been largely unwound, but other decisions have added to spending. New expenditure introduced since 2008–09 has had an accumulated impact of $49 billion across the most recent forward estimates.

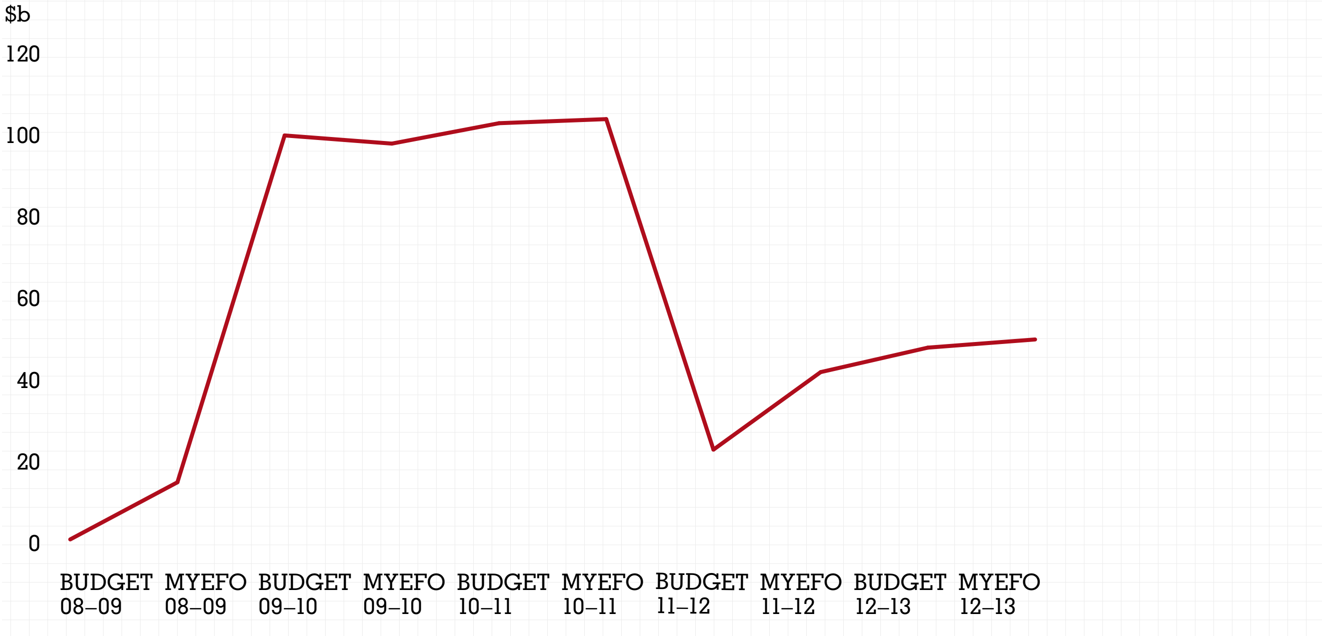
Some of these spending decisions were associated with new taxes such as the carbon tax and the MRRT, while some relied on improving revenues rather than spending restraint and offsets in other areas. It seems clear that actual receipts from these measures will now not match earlier projections, thereby placing further pressure on the budget.

Savings

As Deloitte Access Economics has also highlighted, the 2011–12 budget position was still expansionary, worsening the budget bottom line. A more dedicated focus on savings has only come more recently and the quality of these savings has been mixed.

It is the case that some very sensible structural decisions on the expenditure side of the budget have been made in earlier years – including the increase in the age pension qualifying age – but these have been few and far between. More recently, many of the savings decisions have been characterised by 'timing shifts' that do not have an enduring impact on the budget bottom line.

Government expenditure: cumulative new discretionary spending since 2008–09
Fiscal impacts over four-year period of each budget/MYEFO



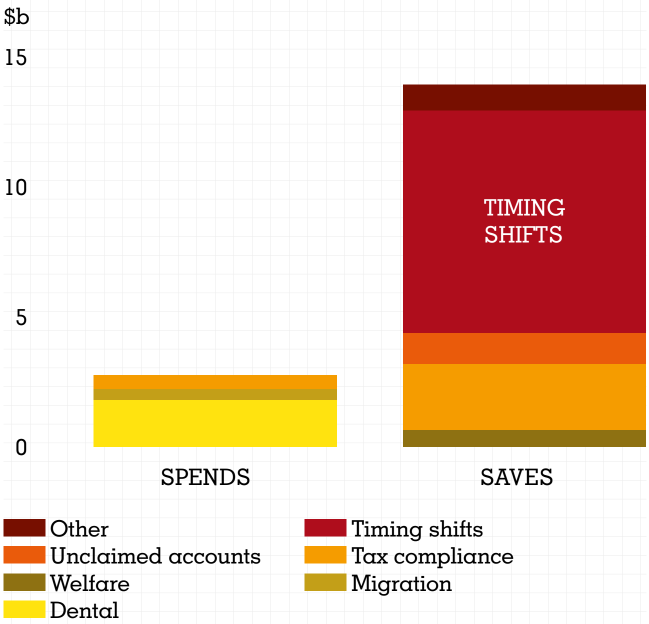
Source: Deloitte Access Economics, 'Risks around Australia's Fiscal Position', January 2013.
Chart shows fiscal impacts cumulated over four-year periods.

The deterioration in the quality of savings measures is most apparent in the 2012–13 Budget and the Mid-Year Economic and Fiscal Outlook (MYEFO), with measures involving ‘timing shifts’ the most significant contributor to savings. Of the approximately $28 billion of savings claimed by the government across the forward estimates, Deloitte Access Economics notes that more than half or around $15 billion were timing adjustments.

Revenue

The durability of savings measures is particularly critical when there is likely to be further revenue volatility ahead. The likelihood and frequency of commodity price swings have increased in recent times and it is inevitable that there will be further volatility ahead. As previous analysis for the BCA has shown, a 7 per cent fall in commodity prices could open up a $36 billion shortfall in revenue across the forward estimates.

Impact of 2012–13 MYEFO policy decisions across the forward estimates



Source: Deloitte Access Economics, ‘Risks around Australia’s Fiscal Position’, 2013. Chart shows fiscal impacts cumulated over four-year periods.

The budget position over the medium term

We acknowledge that Australia’s finances are in better shape than other economies, but we should be doing more now to build up the nation’s long-term strength and resilience. Moreover, three years into recovery after the global financial crisis, more should have been done to achieve greater structural savings and put the budget on a more sustainable footing. There is an increasing risk that Australia will squander its relative fiscal advantages in the future.

The size of the task

The government’s current stated fiscal strategy is to: achieve budget surpluses, on average, over the medium term; keep taxation as a share of GDP, on average, below the level for 2007–08 (23.7 per cent); and improve the government’s net financial worth over the medium term.

The cumulative task of getting on a firmer fiscal footing and meeting these goals is considerable.

The following figure provides an illustrative example of the type of path to fiscal consolidation that is needed in Australia over the medium term and out to 2021.

The starting point is four years of accumulated deficits from 2008–09 to 2011–12 – equal to more than 12 per cent of GDP in aggregate. In order to meet the government’s goal of achieving an average surplus position over the medium term, it will be necessary to produce consistent and growing surpluses through to the beginning of the next decade.

At a minimum, we believe that budget surpluses growing to 1 to 2 per cent of GDP will be consistently needed from at least 2016–17 and beyond.

This will put Australia in a position to pay down net debt and build a buffer to provision for future economic shocks and intergenerational pressures.

This task is made even more difficult by the need to find funding for future commitments including the NDIS and the Gonski education reforms, and the ongoing prospect of volatile revenues. At this stage, various estimates suggest that these reforms could require up to $17 billion of new funding annually, depending on the extent to which states that are under considerable budgetary pressure themselves are able to provide funding. Further transparency is essential about the longer-term budgetary impacts of these measures.

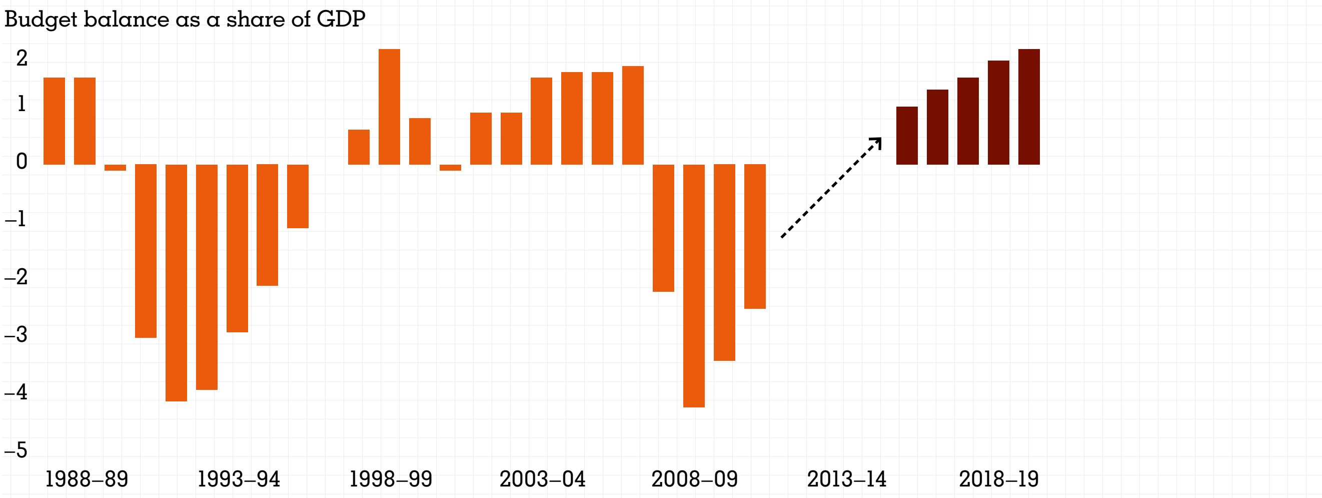
On top of this, we have a looming fiscal challenge associated with an ageing population. As analysis prepared for the BCA for the federal government's 2011 tax forum demonstrated, by 2050 Australia will face a combined primary deficit of 5 per cent of GDP or $70 billion per annum in today's terms and with the current level of government services.

Meeting the task

Taking account of the need to deliver large and growing surpluses over the medium term, the task for government is to use the 2013–14 Budget to lay out a pathway that will turn around the budget position from a deficit of 2½ per cent of GDP in 2011–12 to ultimately deliver a surplus of 1 per cent or more from 2016–17.

The path and structure of the budget through the forward estimates period (i.e. from 2012–13 to 2015–16) will be fundamental. This is the real challenge. A budget strategy that returns to surplus and then builds growing surpluses and does so in a way that is credible and achievable is required now.

A medium-term path to fiscal stability



Source: Commonwealth Budget Papers for balances up to 2011–12.

Expenditure reprioritisation and constraint

If the budget strategy is to be credible given the size of the task, then there is no avoiding the need for fundamental reprioritisation of expenditure. This along with strong economic growth are likely to be the only means of funding new commitments within the government's cap on the size of government.

If the nation's finances can be managed in a strong and prudent way not only will this provide the buffer when difficult economic times are encountered, but it will also play a role in helping to build confidence among households and businesses more generally.

While current economic conditions are challenging, we do not believe that any discretionary loosening on the expenditure side of the budget is warranted at the moment. The government must live within its means.

The government should hold to its commitment to expenditure restraint without slippage, to build sustainable and credible surpluses in the medium term.

In an election year, the pressure for increased spending will be especially acute, but we would urge both sides of politics to offset the cost of all new election commitments that have an impact on the budget through a reprioritisation of spending priorities elsewhere.

Looking beyond the forward estimates

In building a coherent fiscal strategy for the medium term, the government must look beyond the current four-year time horizon, as has been acknowledged recently by senior Finance and Treasury officials.

It is an established practice in Australia for the detailed budget figures to extend out over a four-year forward estimates period (comprising the current financial year and the three following financial years). This practice is also fully consistent with the requirements of the Charter of Budget Honesty.

However, in recent times there has been a growing tendency for new spending measures to be announced that either commence or move to full budget impact in the years well beyond the forward estimates.

We have seen this with the decision to gradually increase the age at which eligibility for the age pension occurs from 65 to 67 from 1 July 2017, as well as the decision to sequentially increase the superannuation guarantee to 12 per cent by 1 July 2019.

New spending programs such as the NDIS and Gonski education reforms (which have been supported in principle by the BCA as worthwhile aspirations) also fall into this category. They will place significant demands on the Commonwealth, state and territory budgets in later years when they take full effect.

The exact magnitude of these commitments is not yet widely appreciated because such commitments are largely outside of the forward estimates period in the budget and in some instances also place equal funding obligations on states.

Priorities for the 2013–14 Budget

Taking account of the issues identified above and the overriding objective of instilling greater fiscal discipline over the medium term, we believe that the 2013–14 Budget should be underpinned by a number of key actions:

1. An independent review of the size, scope and efficiency of government
2. A refreshed set of fiscal rules
3. A focus on measures to improve productive capacity through continuing infrastructure investment
4. A blueprint for long-term comprehensive tax reform
5. Measures to improve productivity such as deregulation, measures to lift skills and encourage innovation.

1. Undertake an independent review of the size, scope and efficiency of government

An independent and comprehensive review of the size, scope and efficiency of government would provide significant benefits to the budget strategy. A review can shed light on reprioritising what governments do, determining which level of government is best placed to provide services, and understanding how efficiently services can be provided. It will be particularly useful in enhancing transparency and accountability.

We propose that the government agree that an independent review of the size, scope and efficiency of government be undertaken. The terms of reference for this review would extend across a number of areas, including to:

1. Undertake a stocktake of current government programs in order to identify the composition and distribution of expenditure according to program, portfolio, function and size of outlay.
2. Focus on the outputs being achieved in these programs against the assumptions at the time they were funded.
3. Identify the fastest-growing areas of expenditure and the underlying drivers of that growth.
4. Identify the quantum of committed expenditure beyond the forward estimates period.
5. Critically analyse the state of the government balance sheet, including any emerging risks or contingent liabilities that are not reflected in the current position.
6. Analyse the current split of roles and responsibilities between the Commonwealth Government and state and territory governments, including identification of areas of duplication, overlap and inefficient administration.
7. Assess the efficiency of government programs along with policymaking and administration functions with reference to comparable public service benchmarks. The focus should be on outputs rather than inputs.

8. Assess the adequacy of current institutions and budgetary practices in promoting efficient and effective government, disciplined expenditure, focus on outputs, long-term fiscal sustainability and budget transparency.
9. Outline recommendations with an associated implementation plan, including near-term actions, a program of rolling audits of key areas of expenditure, and institutional reforms that promote the transparency of expenditure and incentives for expenditure discipline and efficient service delivery.
10. Examine and recommend areas for greater contestability in the provision of government services as a means of lifting the quality and efficiency of government services.

Restraining real spending growth while implementing reforms in education and disability services in future years will require a highly disciplined reprioritisation of other expenditures. In the current subdued revenue environment and given the projected long-term fiscal gap, the reality is that the government must be prepared to reconsider its involvement in the funding of certain activities to make room for new programs. No amount of rephasing or timing adjustment will create the capacity required.

We believe that a comprehensive review is particularly urgent on the basis that:

- there are advantages in taking early preventative action to address the structural vulnerabilities in the budget, including that early action provides greater time and flexibility in how these vulnerabilities are tackled
- a detailed look at the quality and composition of spending is well overdue. It has now been over 16 years since the last such exercise was undertaken at the Commonwealth Government level. It is notable that in that time the overall composition of spending appears to have changed little despite changing economic and social conditions
- the fundamental roles and responsibilities of the Commonwealth and state governments are changing with each new reform progressed by COAG, but the fiscal consequences are not properly understood. The increasing centralisation of policy at the Commonwealth level can lock in increased expenditure for the states, increase potential for duplication of effort, lead to inefficient administration and reduce incentives for innovative service delivery.

2. Commit to a refreshed set of fiscal rules

The government could refresh its fiscal rules to reinforce medium-term discipline around fiscal policy. These rules need not unduly constrain elected governments from pursuing their policy priorities. What the rules can do, however, is define a set of boundaries in which fiscal policy will work so as to provide a corridor of stability for the long-term budget position.

The uncertainty of the global economic situation and falling terms of trade that have placed pressure on revenues and precipitated the pullback from the commitment to surplus in 2012–13 only reinforces the need for a medium-term anchor for fiscal policy that builds a buffer against terms of trade volatility and other pressures.

In order to effectively manage extreme economic circumstances, governments have to create some spare capacity through prudent fiscal management in normal times. Expenditure restraint in the short term and a review of the size, scope and efficiency of government should enable the government to begin to anchor the budget to these medium-term objectives.

As noted previously, the BCA believes that to be credible, this strategy should commit to achieving a budget surplus of at least 1 to 2 per cent of GDP consistently over the medium term. The BCA also reiterates its call from last year's Budget Submission to implement refreshed fiscal rules to:

- place a hard cap on the size of government by holding tax as a share of GDP below 23.7 per cent, such that future budgets do not see any slippage
- specify a new objective that targets a percentage surplus based on 'recharging' fiscal readiness around every 13 years such that fiscal policy is able to make a 3 per cent of GDP contribution to the economy should the need arise
- target a modest proportion of the surplus – to be known as an 'intergenerational surplus' – to provision for the projected fiscal gap that is expected to arise as a consequence of demographic pressures.

3. Maintain a focus on measures to improve productive capacity through continuing infrastructure investment

In the competition for scarce funds in the 2013–14 and future budgets, it is essential to keep in mind the economic and social benefits that flow from well-managed infrastructure investment. This includes its potential to raise productivity, assist workforce participation, grow export income, meet social objectives for the provision of basic utility services to all Australians, and through its contribution to growing the economy and the tax base.

In addition, as the resource-related investment cycle turns there may be a role for infrastructure project construction to fill the breach. But this will necessitate better planning and delivery of infrastructure.

Prioritising public spending on increasing Australia's productive capacity has been a consistent theme in BCA Budget Submissions in recent years. Two key ways that capacity can be increased is through spending on economic infrastructure, particularly transport infrastructure, and well-targeted spending on education and training programs, which was a feature of last year's budget.

This year's budget should support an improved climate for infrastructure in Australia through:

- a commitment to improve the planning and prioritising of capacity-building infrastructure. While the government should set the public funding envelope, a critical role remains for Infrastructure Australia to help in independently identifying priority projects suitable for both public and private investment. The criteria for national projects should be driven by competitiveness and productivity
- a commitment and action to fast-track planning approvals with major development approvals processes streamlined
- the development of a new federal–state infrastructure agreement to address infrastructure funding imbalances
- an openness to explore new sources of funding and financing for infrastructure.

A number of recent reports have pointed to Australia's substantial future infrastructure investment needs and the desirability of tapping into private finance to deliver these projects. The main barriers to this investment occurring are a lack of a pipeline of vetted, quality projects and deficiencies in infrastructure funding that is necessary for providing a reasonable return on investment on each project.

Australia's infrastructure planning systems have improved in recent years and with Infrastructure Australia well established we now have a solid and growing list of priority infrastructure projects eligible for funding.

To address the infrastructure funding shortfall, in principle, Australia's infrastructure should be paid for by users wherever feasible, and there is more that can be done to increase user charges as a funding source.

However, governments will also continue to have an important role to provide funding for significant national public infrastructure investments where user pays is not always the best option. With state governments facing fiscal and borrowing constraints, the federal budget's contribution to funding nationally significant infrastructure projects becomes increasingly important.

4. Develop a blueprint for long-term comprehensive tax reform

Attempts to make the expenditure side of the budget more efficient must be matched by similar attempts on the revenue side. A more robust and efficient revenue base will enhance economic growth and make the fiscal task more manageable in coming decades.

The experience of the Business Tax Working Group confirmed the difficulty of pursuing narrow-based tax changes while realising net benefits to the economy overall. The tax system must be able to raise sufficient revenue, but in a way that is least harmful to economic growth.

In the immediate term, we call on the government to avoid ad hoc, narrow-based changes to business taxes, as this will erode certainty and business confidence.

A renewed process needs to commence to determine a comprehensive roadmap for improving Australia's tax system, in consultation with the states and territories. This should include consideration of the pros and cons of pursuing a tax system characterised by a different tax mix – one that gradually reduces our reliance on direct taxes such as personal tax and company tax as well as inefficient state taxes and increasing reliance on more efficient indirect taxes such as consumption tax. There is compelling evidence that this is the right course for small open economies like Australia, particularly given a need to maintain and enhance competitiveness.

In light of the current issues associated with roles and responsibilities in the federation, as outlined previously, such a roadmap would also need to consider how revenue-raising powers between the Commonwealth and the states could be matched more closely with expenditure responsibilities to increase accountability for fiscal outcomes.

> Doing more now to build the long-term strength and resilience of the budget and economy will help Australia avoid the risk of squandering its relative fiscal advantages in the future

5. Measures to improve productivity such as deregulation, measures to lift skills and encourage innovation

Australia's long-term budget position will also be enhanced through a continued focus on policies that promote economic growth through productivity.

In recent budgets, the government has made considerable investments in skills and training, and the focus must now be on implementing these packages in the most efficient and effective manner to realise the full productivity potential of Australia's workforce.

Recent changes to regulatory processes must also be backed up by more disciplined implementation of best practice on the ground by ministers and agencies. Reducing the existing stock of regulation including Commonwealth–state duplication, much of which places considerable costs on business without meeting its core objectives, must also be tackled with greater commitment by all governments.

Reducing regulatory impediments while also maintaining the certainty and stability of policy settings will create a business environment conducive to investment, innovation and the application of new technologies to respond to structural pressures in the economy.

Conclusion

Australia comes to the fiscal challenges outlined above in a much stronger economic and budgetary position than many other advanced economies at present. Our task of fiscal repair is also much smaller than other advanced economies. But that should in no way diminish the urgency nor the diligence with which we go about this task.

In addition, we have considerable experience and institutions capable of putting these plans into action if there is political will. Doing more now to build the long-term strength and resilience of the budget and economy will help Australia avoid the risk of squandering its relative fiscal advantages in the future.

PART ONE

ECONOMIC CONTEXT

Key points

- It is likely that the world economy will remain relatively weak in 2013, although some improvement is in prospect.
- Uncertain global financial conditions along with unconventional monetary policy settings in many countries are affecting the Australian dollar. A persistently high exchange rate is reinforcing structural pressures for many trade-exposed sectors.
- While resources-related investment has driven domestic economic growth in recent years, this influence is likely to wane. Investment intentions across the non-resources sectors of the economy continue to be subdued.
- The decline in the terms of trade of 13.7 per cent over the past year is putting pressure on nominal GDP growth, which is running well below historical averages. This is placing a strain on government revenues.
- In the longer term, a declining terms of trade will place downward pressure on national incomes unless productivity growth recovers.
- These economic prospects for 2013 underline the importance of having in place macroeconomic policy settings that are geared to enhancing confidence for business and consumers.

This year's budget will provide a critical opportunity to enhance confidence

International developments

Entering 2013, the global economic recovery remains tentative, with many analysts noting the strong downside risks, particularly in the Euro area.

The International Monetary Fund (IMF) expects the world economy to grow by just over 3½ per cent in 2013[1]. Subdued growth (1.4 per cent) will remain in many advanced economies, while emerging economies are expected to be the key drivers of growth.[2]

The picture for both the US and China is more optimistic. Forecasts from the Organisation for Economic Co-operation and Development (OECD) based on the assumption that the US would avoid its fiscal cliff have it growing at 2 per cent in 2013.[3] There are also signs that growth in China is consolidating, with the IMF projecting growth of just over 8 per cent in 2013.[4]

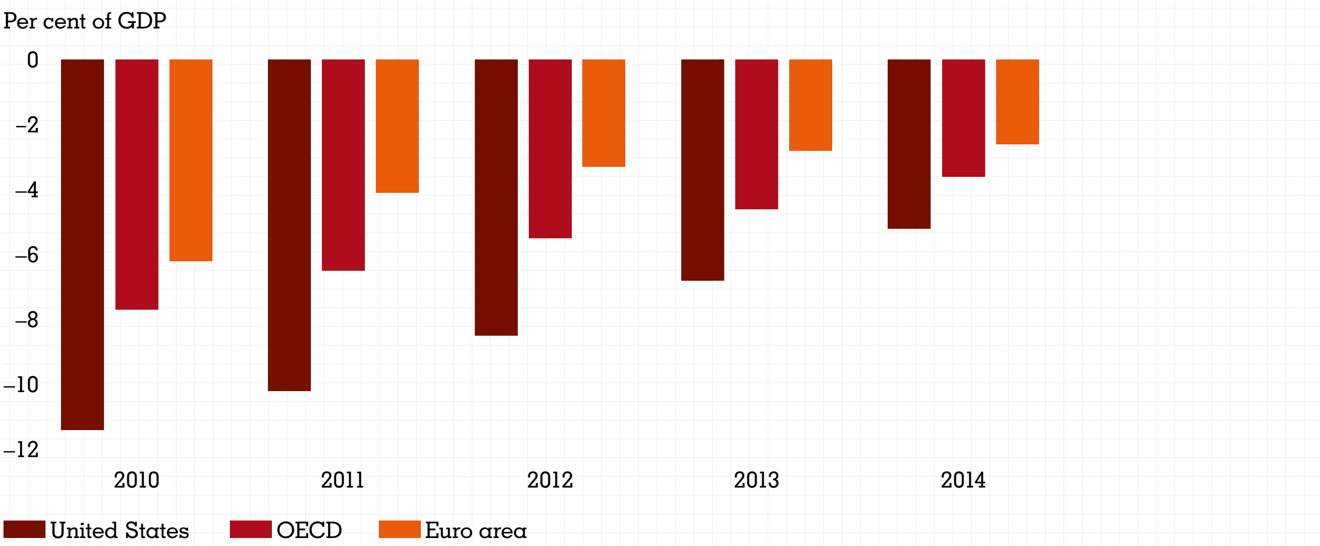
At this stage, the OECD does not envisage a return to positive growth in the Euro area until 2014 and beyond that it will take some time for stability to return.

The OECD has further highlighted the challenges for producing a broadly based global recovery. It will be necessary to boost confidence in the quality of policy responses – both in terms of short-term actions and credible long-term strategies.[5]

The inherent challenge for many policymakers around the world is to devise credible strategies to repair public finances in the medium term without detracting from growth in the short term.

As Figure 1 demonstrates, there is still much further to go on the fiscal repair task for most countries in the developed world.

Figure 1: Fiscal balances



Source: OECD Economic Outlook 92 Database.

Domestic economic conditions

There continues to be a disconnect between Australia's reasonable economic fundamentals on the one hand and the emergence of some weaker, partial indicators including in the labour market and in relation to business and consumer confidence on the other.

At a headline level the lead economic figures appear quite reasonable – economic growth of 3.1 per cent, low inflation of 2¼ per cent and unemployment at 5.4 per cent.

The latest quarterly National Accounts data showed that labour productivity has improved, growing by 3.1 per cent over the year (albeit that this was a result of a combination of relatively robust real GDP growth and weak growth in the labour force).

However, beneath the headline numbers are some areas of vulnerability and a number of watchpoints remain for the domestic economy – with conditions challenging for many businesses outside the resources sector. Further attention needs to be paid to efforts to boost productivity performance more broadly across the economy.

Confidence

Despite Australia's relatively good economic fundamentals, levels of business and consumer confidence are not strong.

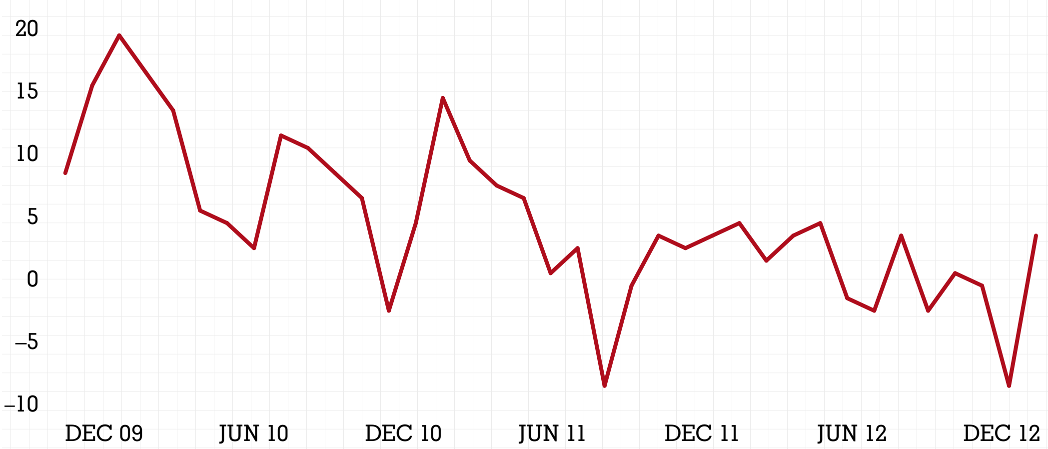
As evident in Figure 2, the National Australia Bank's measure of business confidence has remained below long-term averages for some time now, notwithstanding improvement in the most recent survey.

Other recent business surveys also suggest that companies remain hesitant about the coming year.

- After signs of optimism leading in to the new year, the February 2013 Dun and Bradstreet Business Expectations Survey recorded businesses lowering their profit expectations for the coming months with a 12-point drop in the profit expectations index.
- The Westpac Survey of Industrial Trends from December 2012 highlighted expectations of difficult business conditions within the manufacturing sector, with a net 1 per cent reporting expectations of a deteriorating business environment.
- The ACCI Survey of Investor Confidence for January 2013 showed expected business indicators remaining in deep contractionary territory. Business taxes and government charges remained the largest perceived constraint on business investment for the 18th successive quarter.
- The Sensis Business Index for Small and Medium Enterprises (SMEs) from November 2012 found a small improvement in confidence levels among SMEs; however, confidence was still well down on the corresponding time a year earlier. A lack of incentives for small business and too much bureaucratic red tape were key factors holding the sector back.

In terms of consumer confidence, the Westpac Melbourne Institute Index of Consumer Confidence has remained in positive territory for the past three months after spending much of the previous 18 months in negative territory.

Figure 2: Business confidence



Source: National Australia Bank Monthly Business Survey.

Even so, it is surprising that consumer sentiment hasn't rebounded more strongly given the total of 175 basis points of interest rate cuts from the Reserve Bank since October 2011.

Exchange rate

The fact that the Australian dollar has continued to be strong in the face of weakening commodity prices and cuts in official interest rates has surprised both analysts and policymakers. The Reserve Bank continues to note that the high level of the exchange rate is weighing more heavily on the economy than might be expected.

The ongoing strength of the Australian dollar is a corollary of the extraordinary situation with the global economy and the unprecedented interventions by policymakers, including the US Federal Reserve.

A zero interest rate policy has been in place in the US for four years as policymakers there do everything possible to kick the economy into a higher gear, including through quantitative easing programs. This has massively boosted the balance sheet of the Federal Reserve and increased the money supply in the US. One consequence has been to push down the value of the US dollar.

The Australian dollar has remained high throughout the past two years coinciding with the second and third instalments of the Federal Reserve's quantitative easing program. In fact, it could be argued that whenever US monetary policy settings are in abnormal mode, there is likely to be a floor under the Australian dollar.

It's a fraught exercise to forecast the exchange rate, but a lower Australian dollar will probably require a normalisation of policy settings overseas and in the US. This will be contingent on the US economic recovery. The current futures market suggests no increase in US interest rates until 2015.

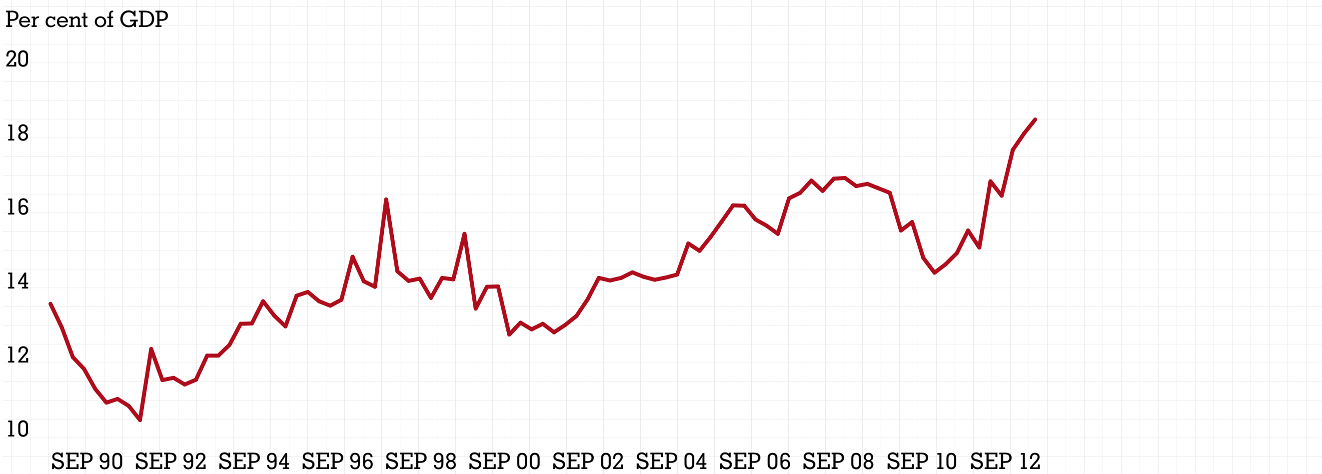
There is unlikely to be a deliberate policy response available to counter the strong Australian dollar. Rather, the approach for governments and businesses alike in 2013 must be to redouble efforts to lift productivity and boost competitiveness.

Investment

Growth in business investment in recent years has continued to be driven by strong growth in investment in the mining and resources-related sector. Mining investment grew by 57 per cent in 2011–12, while the relative contribution of most other sectors declined.[6]

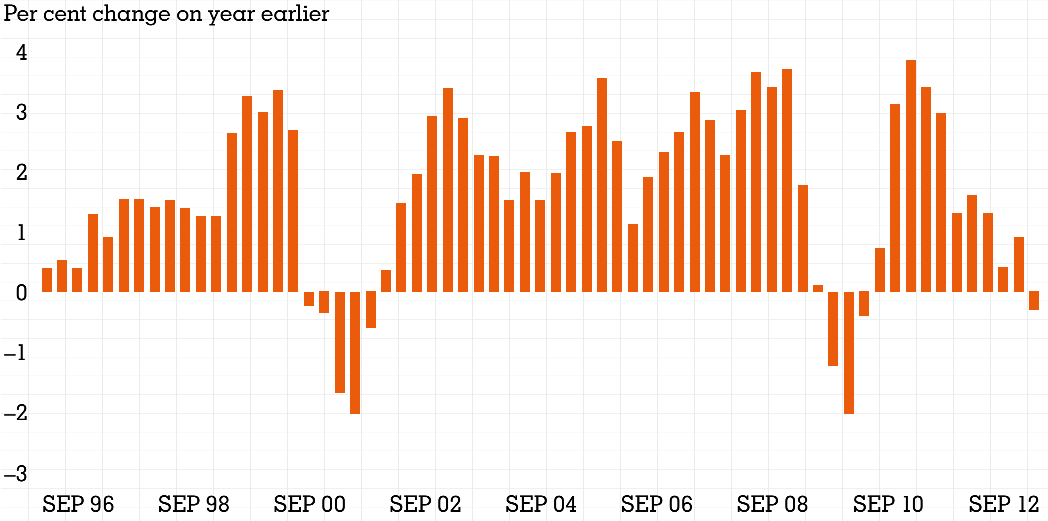
Notwithstanding the recent boost in iron ore prices, investment decisions are being affected by falling commodity prices and the uncertain international economic environment. The BCA's work last year on major project costs demonstrated that it is by no means assured that the existing investment pipeline will come on stream or be delivered on time or on budget (particularly in relation to liquefied natural gas projects). There have also been a number of recent decisions made to postpone or abandon some major investment decisions.

Figure 3: Business investment



Source: ABS, *Australian System of National Accounts: National Income, Expenditure and Product*, cat. no. 5206.0, September 2012.

Figure 4: Aggregate hours worked



Source: ABS, *Australian System of National Accounts: National Income, Expenditure and Product*, cat. no. 5206.0, September 2012.

As capital spending associated with the resources sector subsides, the question remains whether growth in other parts of the economy will step in to fill the gap. There are some signs that housing construction may play a significant role on the back of previous interest rate reductions – but this is not assured.

A redeployment of construction-related resources into other activities – including for example around infrastructure-related construction – would be a natural response. However, this will require that sufficient preparations be undertaken on prospective infrastructure projects to ensure that such a redeployment can occur as seamlessly and quickly as possible.

Employment

Australia's unemployment rate currently remains at 5.4 per cent, with the Mid-Year Economic and Fiscal Outlook projecting the rate to remain steady at 5½ per cent in 2012–13 and 2013–14. However, the unemployment rate in isolation is not necessarily the best gauge of the strength of the labour market.

The unemployment rate has been held down to some extent by a fall in the participation rate (0.7 per cent in the last two years) as people move outside the mainstream labour force. The labour market is also softer than the unemployment rate and employment growth figures suggest, with growth in aggregate hours worked in the economy having lost momentum in the last two years.

Terms of trade

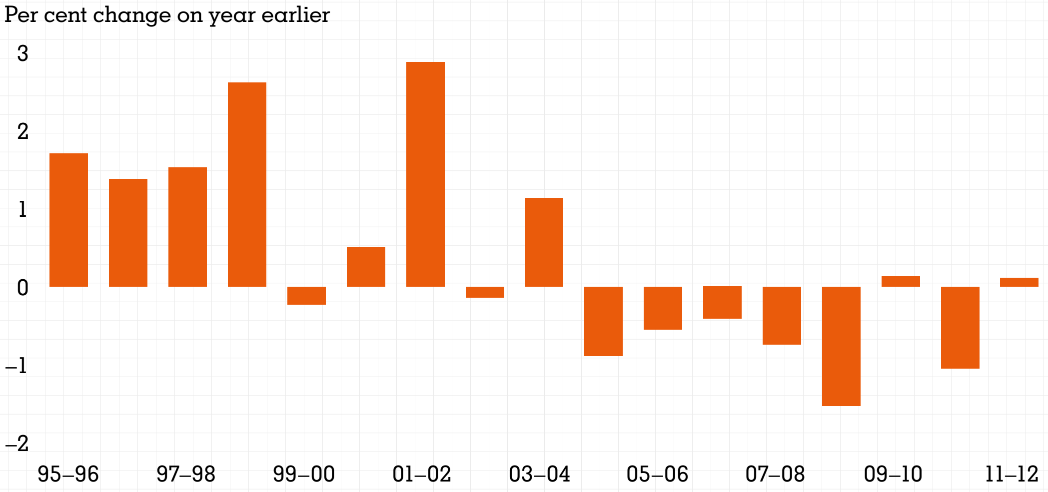
While the terms of trade remain above historical levels, the inherent volatility of commodity prices and the terms of trade has been apparent with the terms of trade down 13.7 per cent over the past year. With the continued surge in the terms of trade being the key driver of increasing national incomes over the 2000s, as the terms of trade come off, this will have implications for living standards.

At this stage, productivity is yet to fill the growth gap in national incomes left by a weakening terms of trade. Multifactor productivity across the market sector barely grew in 2011–12 (up just 0.3 per cent) and has been negative in six of the last eight years (Figure 5).

Nominal GDP

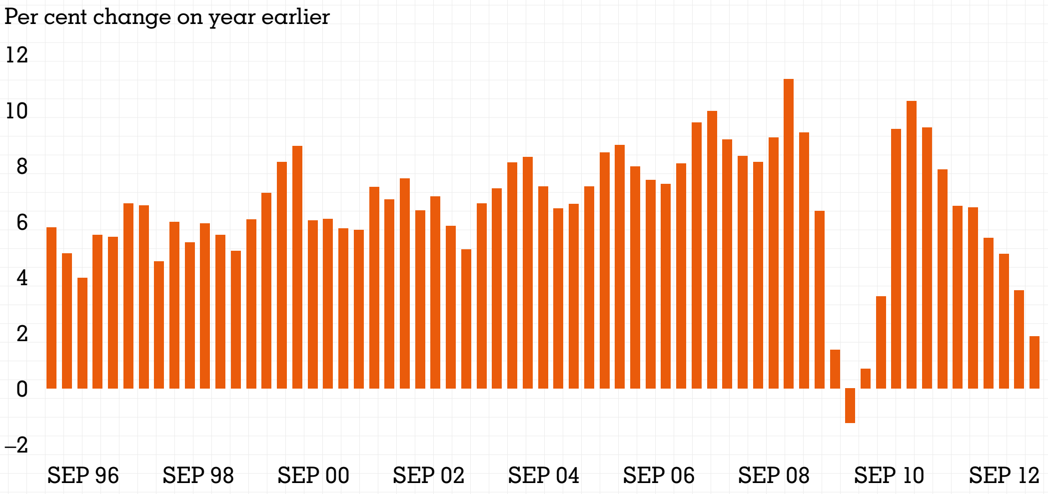
The recent fall in the terms of trade is having clear effects on the economy. Nominal GDP growth – which influences earnings and revenue collections – has slowed considerably to just 1.9 per cent on an annual basis. Leaving aside the global financial crisis, nominal growth has not been this low in over 20 years.

Figure 5: Multifactor productivity



Source: ABS, *Australian System of National Accounts*, cat. no. 5204.0, 2011–12.

Figure 6: Nominal GDP



Source: ABS, *Australian System of National Accounts: National Income, Expenditure and Product*, cat. no. 5206.0, September 2012.

Conclusion

An expectation of continuing economic headwinds in 2013 underlines the importance of having macroeconomic policy settings geared to enhance confidence for business and consumers. This year's budget will provide a critical opportunity to enhance confidence by demonstrating that the government is living within its means and steadily improving the budget position to begin to provision for any future economic setbacks and the longer-term pressures that we confront.

PART TWO

AUSTRALIA'S CURRENT FISCAL POSITION

Key points

- Fiscal policy in Australia is predicated on a strategy that includes achieving a budget surplus on average over the medium term. At this stage of the economic cycle the budget remains significantly in deficit and more should have been achieved to place it on a more sustainable footing.
- A policy of delivering a surplus at all costs in 2012–13 is not warranted, but this budget must lay out a clear strategy for repairing the fiscal position over the medium term.
- We also need to lay a foundation for addressing the long-term fiscal gap that will arise as the population ages and additional spending pressures around health and aged care intensify.
- There are a number of immediate risks and concerns around the current fiscal position:
  - Commodity prices remain volatile and this in turn is having an effect on revenue.
  - While the government has made some genuine structural savings, the quality and durability of savings measures announced recently have not been high. The majority of savings in last year's budget and the Mid-Year Economic and Fiscal Outlook were 'timing adjustments' (largely aimed at producing a budget surplus in 2012–13) and they do not have an ongoing effect on the fiscal position.
  - Discrete stimulus spending associated with the policy response to the global financial crisis has now been largely unwound, but in the meantime other new discretionary spending measures have been announced.
  - Recent revenue measures (including the MRRT and proceeds from the carbon tax) have been largely allocated to expenditures. It seems clear that actual receipts from these measures will now not match earlier projections, thereby placing further pressure on the budget.
  - A number of material new spending commitments have been made but are yet to be fully reflected in the budget forward estimates period, including most notably the increase in the superannuation guarantee, the National Disability Insurance Scheme and the Gonski education reforms.
- The BCA supports in principle the NDIS, the Gonski reforms to school funding and reform of the Newstart Allowance. They are all worthy aspirations but it is not possible to fund them without an examination of how other spending programs can be reprioritised.

The task of fiscal repair

Against the challenging economic backdrop set out in Part One, Australia faces the task of fiscal repair.

The focus of this part of our submission is on whether the current fiscal position and recent decisions taken in support of that position provide a strong foundation for the steady repair of the budget over the medium term. This will entail building up sustainable surpluses in coming years to pay down debt and beginning to provision for future economic shocks and the intergenerational fiscal gap.

Exhibit 1: The government's fiscal strategy

The government's current stated fiscal strategy is to:

- achieve budget surpluses, on average, over the medium term
- keep taxation as a share of GDP, on average, below the level for 2007–08 (23.7 per cent)
- improve the government's net financial worth over the medium term.

In addition, a number of intermediate goals have been outlined over recent years, including:

- allowing tax receipts to recover naturally as the economy improves, while keeping taxation as a share of GDP below the 2007–08 level on average
- building growing surpluses by holding real growth in spending to 2 per cent a year, on average, until the surplus is at least one per cent of GDP, and while the economy is growing at or above trend.

Appropriate and disciplined fiscal policy is critical to promoting long-term economic growth. A sustainable fiscal position reduces Australia's vulnerability to economic shocks and can help act as a buffer against volatility including the volatility associated with unpredictable commodity price fluctuations.

Balancing the budget over the medium term maintains fiscal discipline. But it does so in a way that allows the automatic stabilisers to operate and also allows for the possibility for discretionary fiscal stimulus to be deployed if the circumstances warrant it.

Australia's finances are in better shape than other economies, but we should be doing more now to build up the nation's long-term strength and resilience. We cannot afford for Australia to squander its relative fiscal advantages in the future.

The budget remains significantly in deficit and more should have been achieved to place it on a more sustainable footing

Instead, a deliberate and steady fiscal path must be set that ensures that, barring economic shocks, the government does not stray markedly from the central task of improving the budget bottom line over time, paying down debt and beginning to provision for future budgetary pressures.

The government should hold to its commitment to expenditure restraint without slippage, to build sustainable and credible surpluses in the medium term.

In building a coherent fiscal strategy for the medium term, the government must look beyond the current four-year time horizon.

It is an established practice in Australia for the detailed budget figures to extend over a four-year forward estimates period (comprising the current financial year and the three following financial years). This practice is also fully consistent with the requirements of the Charter of Budget Honesty.

However, in recent times there has been a growing tendency for new spending measures to be announced that either commence or move to full budget impact in the years well beyond the forward estimates.

We have seen this with the decision to gradually increase the age at which eligibility for the age pension occurs from 65 to 67 from 1 July 2017, as well as the decision to sequentially increase the superannuation guarantee to 12 per cent by 1 July 2019.

New spending programs (which have been supported by the Business Council) such as the NDIS and Gonski education reforms also fall into this category. They will place significant demands on the budget in later years when they take full effect. At this stage, various estimates suggest that these reforms could require up to $17 billion of new funding annually, depending on the extent to which states that are under considerable budgetary pressure themselves are able to provide funding.

The exact magnitude of these commitments is not yet widely appreciated because they are largely outside of the forward estimates period in the budget and in some instances also place equal funding obligations on states. Further transparency is essential about the longer-term budgetary impacts of these measures.

The size of the task

Our assessment is that the government has considerable work ahead of it if it is to meet its stated fiscal strategy, particularly the commitment to achieve budget surplus on average over the medium term.

Given a starting point of four years of accumulated deficits from 2008–09 to 2011–12 – equal to more than 12 per cent of GDP in aggregate – it will be necessary to produce consistent and growing surpluses through to the beginning of the next decade if an average surplus position is to be achieved over the medium term.

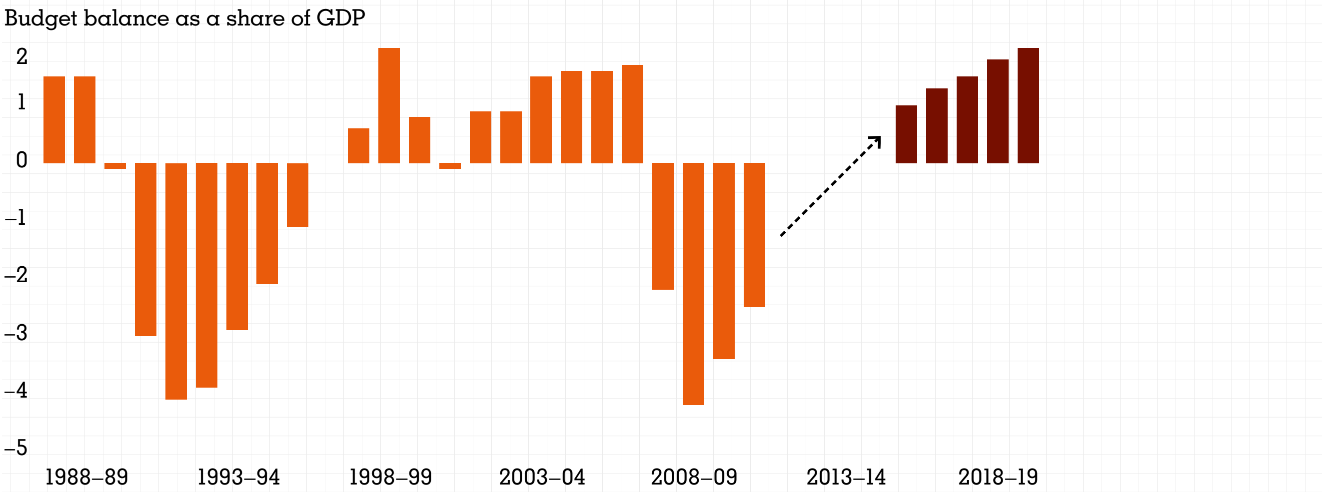
At a minimum, we believe that budget surpluses growing to 1 to 2 per cent of GDP will be consistently needed. This is going to require considerable discipline from governments.

Figure 7 provides an illustration of the challenge of fiscal repair for Australia. Taking account of the need to deliver large and growing surpluses over the medium term, the task for the government is to use the 2013–14 Budget to lay out a pathway that will turn around the budget position from a deficit of 2½ per cent of GDP in 2011–12 to ultimately deliver a surplus of 1 per cent or more in the years beyond the forward estimates (i.e. from 2016–17 onwards).

The path and structure of the budget through the forward estimates period (i.e. from 2012–13 to 2015–16) will be fundamental. This is the real challenge. A budget strategy that returns to surplus and then builds growing surpluses – and does so in a way that is credible and achievable – is required now. This is what the business community expects.

If the nation's finances can be managed in a strong and prudent way, not only will this provide the buffer when difficult economic times are encountered, but it will also play a role in helping to build confidence among households and businesses more generally.

Figure 7: A medium-term path to fiscal stability



Source: Commonwealth Budget Papers for balances up to 2011–12.

Assessment of current fiscal position

For this year's submission, the BCA commissioned Deloitte Access Economics to assess the current risks to Australia's fiscal position and we have drawn upon this analysis throughout this part of the submission.

The Deloitte Access Economics analysis notes there are a number of vulnerabilities in the current budget position that put at risk the achievement by the government of its fiscal goals.

- **There is likely to be further revenue volatility ahead.** Achievement of the government's fiscal goals is based on official forecasts at a time when forecasting the budget is increasingly difficult. The likelihood and frequency of commodity price swings have increased in recent times and it is inevitable that there will be further volatility ahead. As previous analysis for the BCA has shown, a 7 per cent fall in commodity prices could open up a $36 billion shortfall in revenue across the forward estimates.
- **Many recent savings measures will not have an enduring impact on the budget bottom line.** While the government has made some genuine structural savings, the majority of savings in the most recent budget and Mid-Year Economic and Fiscal Outlook were 'timing adjustments' aimed at producing a surplus in 2012–13 and they do not have an ongoing effect on the fiscal position.
- **A bias towards spending remains in place.** While discrete stimulus spending associated with the policy response to the global financial crisis has been unwound, other new discretionary spending measures have been announced. Some recent revenue measures (including the MRRT and proceeds from the carbon tax) have been largely allocated to expenditures. It seems clear that actual receipts from these measures will now not match earlier projections, thereby placing further pressure on the budget. In addition, a number of material spending commitments have been made but are yet to be fully reflected in the budget forward estimates period, including most notably the NDIS and the Gonski education reforms.
- **The long-term fiscal gap remains.** A lack of preparedness to pursue genuine structural savings while at the same time committing to new programs without a source of funding only makes the task of plugging the significant long-term intergenerational fiscal gap more difficult.

The analysis below draws on material from Deloitte Access Economics and elaborates on these points. It examines recent movements in the revenue and expenditure sides of the budget, the composition of recent savings measures and the long-term fiscal gap.

Revenue

Recent trends

As noted in Part One, nominal GDP growth has slowed in the last two years, bringing further revenue downgrades from Treasury which now amount to a loss of $160 million in revenue across the forward estimates. The impact of these revenue revisions on the budget position over time is illustrated in Figure 8.

This figure demonstrates that in the wake of the global financial crisis, revenue forecasts were significantly downgraded by some $180 billion. This was then followed by a series of upgrades as the Australian economy emerged from the global financial crisis stronger than expected. Higher commodity prices also eventuated, which were partly driven by the success of China's stimulus program in sustaining that economy.

Beyond 2010–11, revenue prospects changed again with a faltering global economic recovery and slower-than-expected growth in emerging economies.

Structural changes in the domestic economy including a continuing step-down to more cautious consumer spending, together with a more subdued housing market and sharemarket performance, have also had an impact on revenue collections.

Volatility

In addition to being generally weaker, revenues are increasingly volatile. As the Deloitte Access Economics analysis notes, variations in nominal income which drive revenues have increased across the last decade (due in part to significant short-term swings in coal and iron ore prices). The Treasurer acknowledged this volatility at the end of last year noting that Commonwealth revenues were down some $3.9 billion against budget forecasts in just the first four months of 2012–13.

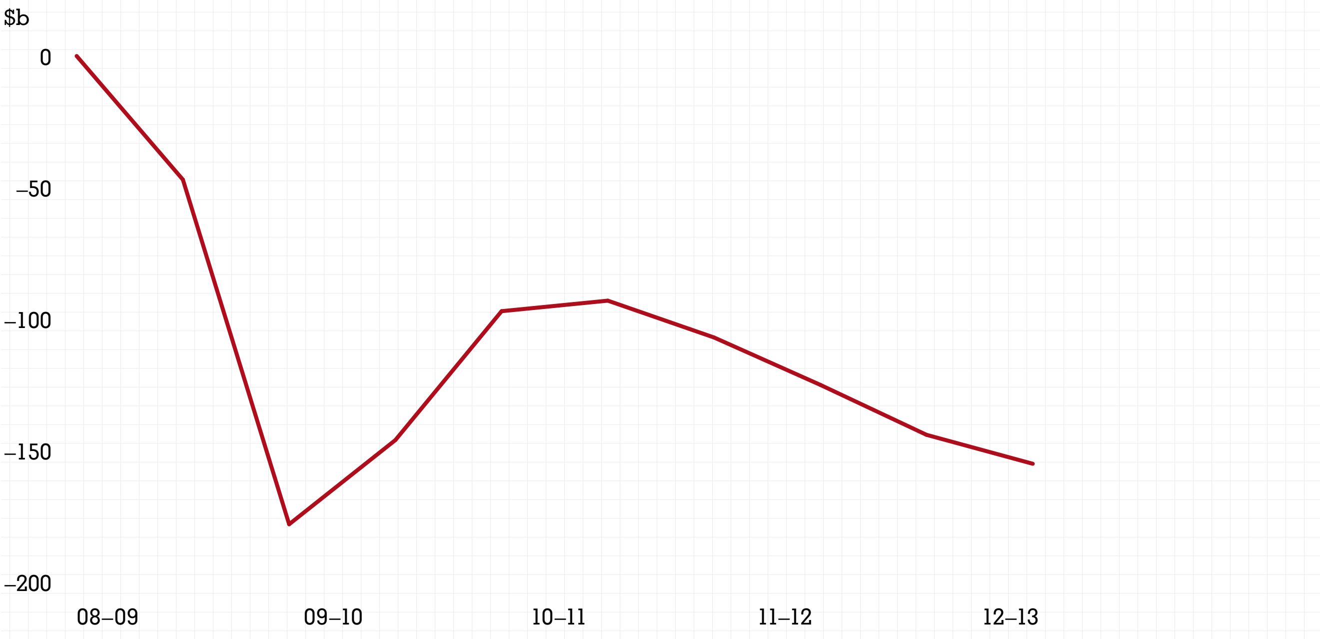
This increasing volatility has a number of important implications for fiscal policy. Firstly, forecasting budget revenues has become increasingly difficult. Commodity prices as the prime driver of revenues are much more difficult to forecast reliably than traditional indicators of the economic cycle such as unemployment and economic growth. While before the global financial crisis forecasters were consistently underestimating prices, more recently they have been overestimating commodity prices.

Such revenue volatility has major implications for budget planning. It will become increasingly difficult to meet the expectations of the community when volatile revenue sources are earmarked to fund announced programs and less volatile recurrent expenditure. Revenue volatility will also make it difficult to achieve very specific budget targets in a given year.

Previous budget analysis undertaken by Access Economics highlighted that in 2011, a budget shortfall of between $7½ billion and $36 billion could open up across the forward estimates if commodity prices were to weaken by 4 per cent and 7 per cent respectively.[7]

For much of the past decade the boom in demand from commodities has been accompanied by a boom in price, but as supply catches up with demand in the longer term, some reversion to more normal price levels could be expected. In light of this and the recent falls in commodity prices, Deloitte Access Economics concludes that 'a degree of fiscal pain resulting from falls in the terms of trade will continue over coming years'.[8] We believe that these circumstances now more than ever demand a prudent and cautious approach to fiscal policy.

Figure 8: Cumulative revenue revisions due to changes in the economic parameters since 2008–09



Source: Deloitte Access Economics, 'Risks around Australia's Fiscal Position', report for the Business Council of Australia, January 2013, p. 20. Chart shows fiscal impacts cumulated over four-year periods.

New revenue measures

While revenues have been revised down on account of economic impacts, it's important to note that deliberate policy measures have also increased revenue-raising capacity in recent years. This is evident in Figure 9. The chart compiled by Deloitte Access Economics shows the cumulative additional revenue expected from new policy measures since the 2008–09 Budget. The pronounced increase from 2011–12 reflects previously projected revenues associated with the MRRT and the carbon tax.

Even had expected collections materialised, these increased revenues would not have improved the budget bottom line because that had been largely allocated to fund new measures mostly on the spending side of the budget.

For example, the carbon tax has been allocated through compensation to households and to adjustment assistance to affected workers and industries. The mining tax, which was initially set to fund a company tax cut, ultimately funded the company loss carry-back measure, an increase in some family tax benefits and funded a supplementary allowance for some income support recipients.

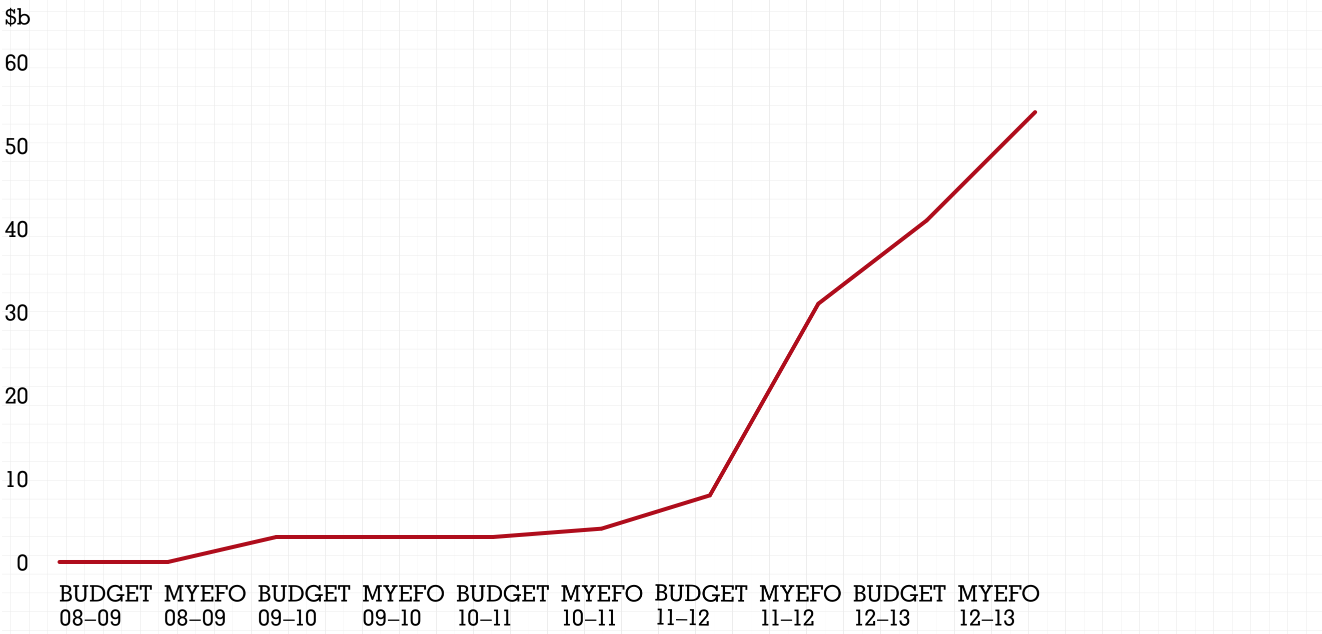
Expenditure

On the expenditure side of the budget, policy decisions on spending, in aggregate, haven't fully unwound over the period following the global financial crisis. While most of the discrete stimulus measures announced as part of the policy response to the global financial crisis have finished, new discretionary spending decisions have been taken.

This is evident in Figure 10, which shows the accumulation of **new expenditure measures** since 2008–09 over the four-year period in each budget. These measures have accumulated to have an **impact of around $49 billion across the forward estimates** in the most recent MYEFO.

It is also apparent in Figure 11, which shows the recent movement of expenditure as a percentage of GDP, with expenditure as a percentage of GDP in 2011–12 at levels similar to those during the global financial crisis.

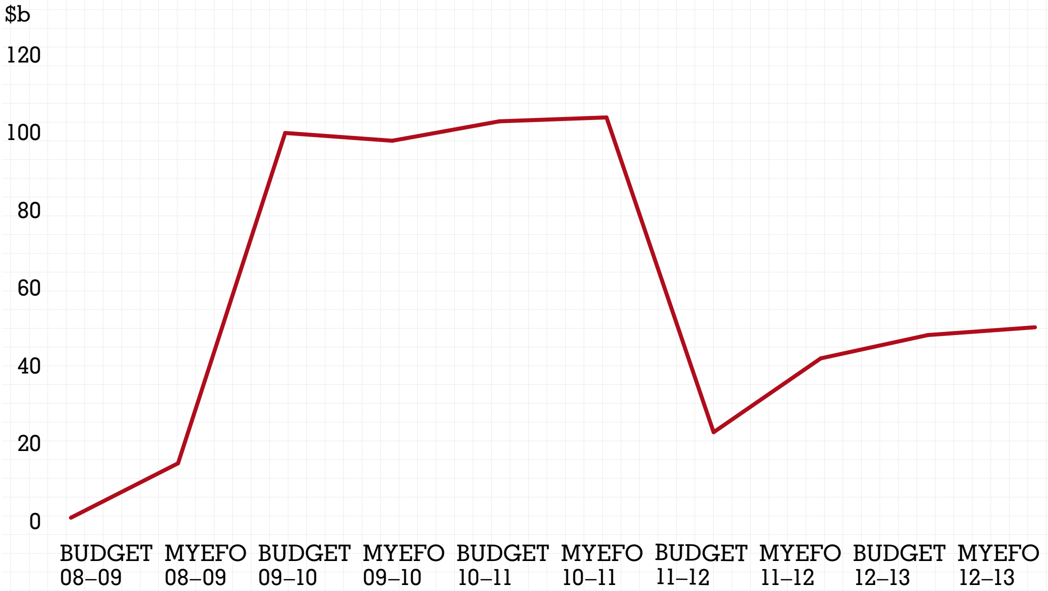
Figure 9: Cumulative variations in revenues due to new policy decisions since 2008–09



Source: Deloitte Access Economics, 'Risks around Australia's Fiscal Position', January 2013, p. 22.
Chart shows fiscal impacts cumulated over four-year periods.

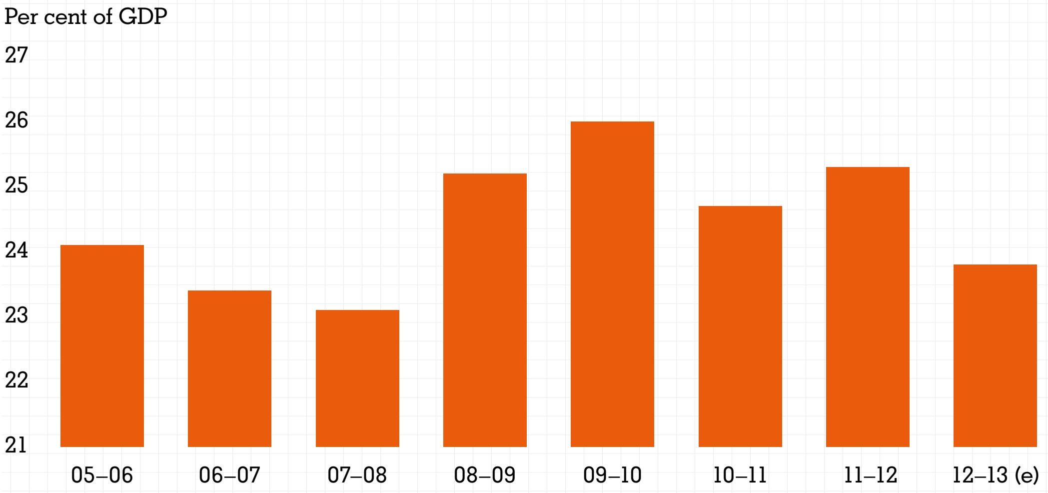
Figure 10: Government expenditure: cumulative new discretionary spending since 2008–09

Fiscal impacts over four-year period of each budget/MYEFO



Source: Deloitte Access Economics, 'Risks around Australia's Fiscal Position', January 2013, p. 21.
Chart shows fiscal impacts cumulated over four-year periods.

Figure 11: Recent expenditure



Source: Commonwealth of Australia, Mid-Year Economic and Fiscal Outlook 2012–13.

Demographic and fiscal pressures are mounting, and there is a risk that future generations of Australians will be required to bear a disproportionate burden

Quality of recent savings measures

In order to compensate for the fall in revenues due to changing economic conditions as the 2012–13 surplus target approached, the government increased its focus on achieving savings.

As Figure 12 shows, the government went from being a net spender in the 2011–12 Budget (i.e. the net impact of new discretionary decisions was to add to the budget) to a forecast position in the 2012–13 MYEFO of projected net savings of $11 billion.

A closer examination of the quality and robustness of the 'savings' highlights how they are overwhelmingly characterised by 'timing shifts' that do not constitute real policy reform nor have an enduring impact on the budget bottom line.

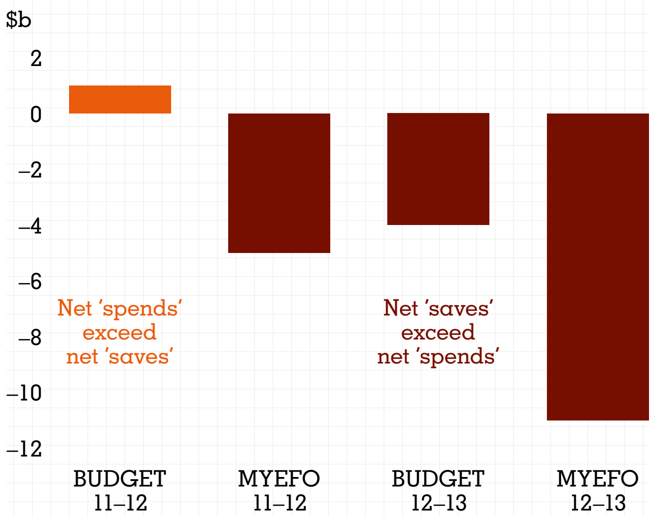
Timing shifts that involve deferral of expenditure merely put off the consideration of permanent spending cuts on the assumption that revenues may eventually improve in future years to fund these expenditures.

Timing shifts have contributed to the recent swings in real expenditure growth.

The government previously committed to hold real spending to 2 per cent per year until the budget returns to surplus and to restrain spending growth to 2 per cent *on average* once the budget has returned to surplus and until surpluses are at least 1 per cent of GDP and while the economy is growing at or above trend.

Real expenditure growth was 4.8 per cent in 2011–12, due in part to the bringing forward of expenditures from 2012–13 to assist the surplus target in that year. Real expenditure growth is then expected to decline by 4.4 per cent in 2012–13, but as timing adjustments wear off expenditure is expected to grow again by 4.4 per cent in 2013–14. In the two out-years of the forward estimates real spending growth is forecast at 1.6 per cent and 2.7 per cent.

Figure 12: Net discretionary policy decisions in recent budgets



Source: Deloitte Access Economics, 'Risks around Australia's Fiscal Position', January 2013, p. 35. Chart shows fiscal impacts cumulated over four-year periods.

Some recent examples of such major timing shifts and their impact[9] include:

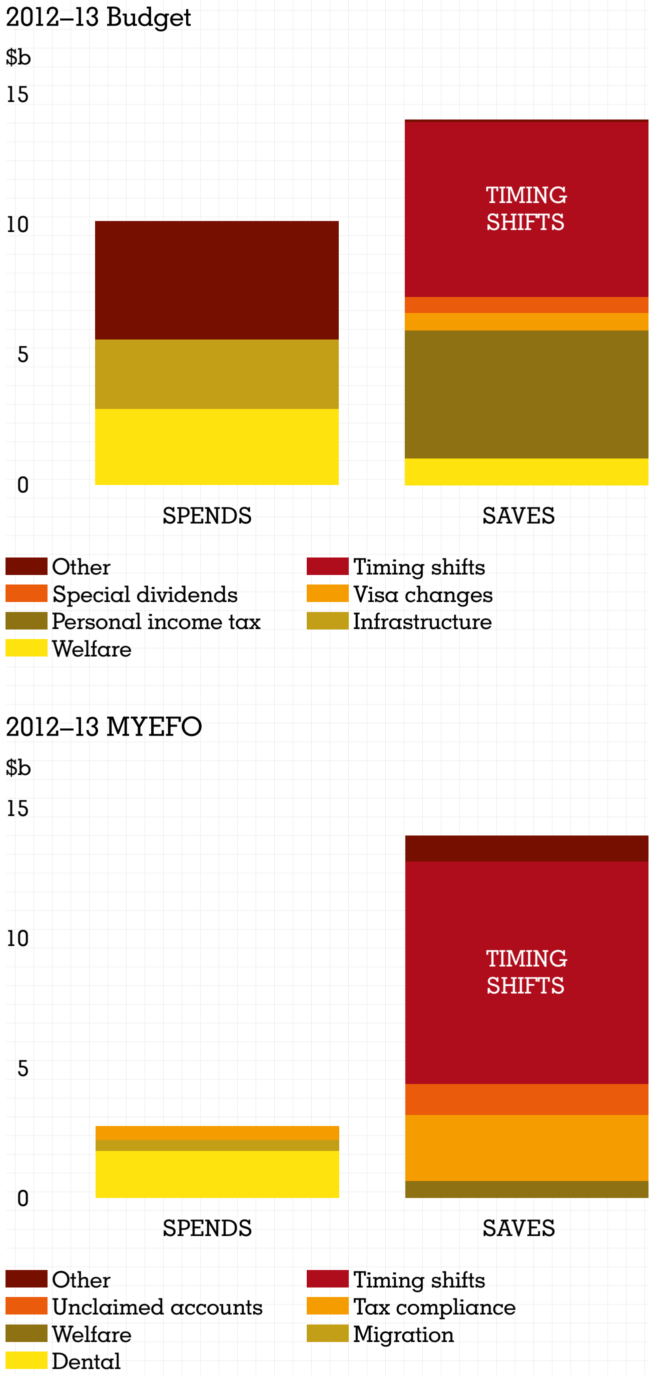
- a $1.1 billion acceleration in payments to local governments shifted out of 2012–13 and into 2011–12
- $2.9 billion from the deferral of Australia's growth target for foreign aid
- $1.4 billion from deferring the introduction of the higher superannuation contribution caps for members aged 50 and over with low balances
- $8.3 billion from the company tax timing change
- $1.0 billion due to getting unclaimed money from superannuation and bank accounts earlier.

It should also be noted that timing shifts are not the only measures to have only a temporary impact on the budget bottom line. For example, there was also a temporary increase in the efficiency dividend for 2011–12 and 2012–13 ($465 million). There were also special dividends of $300 million from the Australian Reinsurance Pool Corporation and the Export Finance and Insurance Corporation in the 2012–13 Budget.

Deloitte Access Economics analysed the makeup of spending and saving decisions in recent budgets and allocated those measures into broad groups including 'timing shifts'. As they note in their report, such analysis does involve a high degree of judgement, particularly where measures are complex or address more than one policy purpose.

The deterioration in the quality of savings measures is most apparent in the 2012–13 Budget and 2012–13 MYEFO, as illustrated in Figure 13. This chart highlights how timing shifts represent the largest contributor to announced savings. In fact, of the approximately $28 billion of savings announced across the forward estimates, more than half or some $15 billion were timing adjustments.

Figure 13: Impact of budget policy decisions across forward estimates



Source: Deloitte Access Economics, 'Risks around Australia's Fiscal Position', January 2013, pp. 39 and 41. Figure shows fiscal impacts cumulated over four-year periods.

New spending commitments

Just as many savings measures will not have an enduring effect on the budget, there are a range of new or recently committed expenditures that, while significant, do not have a substantial effect on the budget in the current forward estimates period (i.e. out to 2015–16). This includes most notably the increase in the superannuation guarantee from 9 to 12 per cent, the NDIS and the Gonski reforms to school funding.

Table 1: New spending commitments that will have a growing budget impact

Policy announcement	Impact on budget to date	Future impact
Increase in superannuation guarantee from 9 to 12 per cent	Existing estimates in the 2012–13 MYEFO cover the first year of transition to 12 per cent	The full impact of **$3.6 billion per annum will occur from 2019–20** after the final increase to 12 per cent occurs
'Living Longer Living Better' aged care reform package	Total net cost of $285 million over the four-year estimates period	Estimated **net cost of $292 million from 2016–17**
National Disability Insurance Scheme	Current funding allows for limited trials in five states and territories at a cost to the Commonwealth Budget of $1 billion over four years	**Net cost of $10.5 billion per annum** from 2018–19, some of which will fall on state and territory budgets
Gonski reforms to school funding	Legislation has passed through parliament but no funding allocated to date	**Net cost of $5 billion per annum** (2009 school year). More recent estimates by the Victorian Government suggest the net cost could be closer to $6.5 billion. Some of the net cost will fall on state and territory budgets
New aircraft for RAAF	Nil	Unknown
New submarines for the navy	Nil	Australian Strategic Policy Institute estimates suggest the cost could range from around $6 billion to $36 billion depending on choice of European 'off-the-shelf' or Australian designed and built models

Source: Deloitte Access Economics, 'Risks around Australia's Fiscal Position', January 2013, pp. 43–44.

In addition to the policies in Table 1, there has also been growing community debate about the adequacy of the Newstart Allowance and whether it should be increased.

The BCA has supported in principle, as worthwhile aspirations, the NDIS, the Gonski reforms to school funding and reform of the Newstart Allowance. This is based on the view that:

- If implemented effectively and accompanied by structural changes to the market for disability care and support, the NDIS will place Australia in a better position to fund an adequate level of disability care and support at a reasonable cost in the longer term.
- Lifting the quality of the education system will be critical to increasing the skills of Australia's workforce and lifting productive capacity across the economy. The key reform in Gonski – that all Australian schoolchildren will have an entitlement to a basic level of funding regardless of the school they attend – is one that the BCA has been calling for over a number of years to improve the quality of outcomes.
- People should be able to return to work as quickly as possible, which means ensuring that support payments like Newstart do not fall so low that they act as an impediment to returning to work.

In supporting these reforms, we do not underestimate the difficult fiscal choices that must be made to fund and implement them. These reforms illustrate the importance of reprioritisation of spending.

They are all worthy reforms and therefore other government programs deemed to be of lesser priority must be cut or reduced in scope to make way on the expenditure side of the budget.

One of the strengths of Australia's welfare, income support and tax benefit arrangements relative to other jurisdictions has been that they are well targeted to those most in need, with tight eligibility requirements. This must be a continuing focus if we are to sustainably fund a reasonable safety net and fund these new reforms.

Before the government gets further into the implementation of the NDIS and the Gonski reforms, a major reprioritisation of expenditure is necessary. If this doesn't occur then these programs will be fiscally unsustainable. Part Three outlines in greater detail how this reprioritisation should take place through a review of the size, scope and efficiency of government.

Infrastructure

In the competition for scarce funds in the 2013–14 and future budgets, it is essential to keep in mind the economic and social benefits that flow from well-managed infrastructure investment. This includes its potential to raise productivity, assist workforce participation, grow export income, meet social objectives for the provision of basic utility services to all Australians and through its contribution to growing the economy and the tax base.

Prioritising public spending on increasing Australia's productive capacity has been a consistent theme in BCA Budget Submissions in recent years. Two key ways this can be achieved are through spending on economic infrastructure, particularly transport infrastructure, and spending on education and training programs, which was a feature of last year's budget.

This year's budget should support an improved climate for infrastructure in Australia through:

- a commitment to improve the planning and prioritising of capacity-building infrastructure. While the government should set the public funding envelope, a critical role remains for Infrastructure Australia to help in identifying priority projects suitable for both public and private investment. The criteria for national projects should be driven by competitiveness and productivity
- a commitment and action to fast-track planning approvals with major development approvals processes streamlined
- the development of a new federal–state infrastructure agreement to address infrastructure funding imbalances
- an openness to explore new sources of funding and financing for infrastructure.

A number of recent reports have pointed to Australia's substantial future infrastructure investment needs and the desirability of tapping into private finance to deliver those projects. The main barriers to this investment occurring are a lack of a pipeline of vetted, quality projects and deficiencies in the infrastructure funding that is necessary for providing a reasonable return on investment on each project.

Australia's infrastructure planning systems have improved in recent years and with Infrastructure Australia up and running we now have a solid and growing list of priority infrastructure projects eligible for funding.

To address the infrastructure funding shortfall, in principle, Australia's infrastructure should be paid for by users wherever feasible, and there is more that can be done to increase user charges as a funding source.

Australia faces the task of fiscal repair

However, governments will also continue to have an important role to provide funding for significant national public infrastructure investments where user pays is not always the best option. With state governments facing fiscal and borrowing constraints, the federal budget's contribution to funding nationally significant infrastructure projects becomes increasingly important.

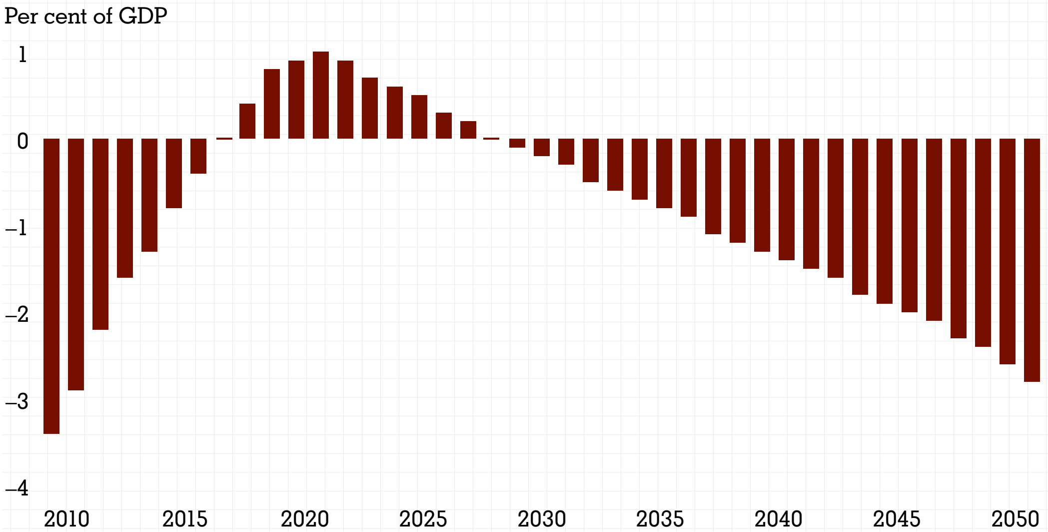
Long-term fiscal gap

The effects of demographic ageing are going to have substantial implications for major public spending programs.

Increased demand for age-related payments and services, along with expected technological advancement in health and demand for higher-quality health services, will create substantial pressure on governments' fiscal balances at both the Commonwealth and state levels.

At a Commonwealth level the most recent Intergenerational Report was produced in early 2010. This report was based on the assumption of a stable tax to GDP ratio of 23.5 per cent as well as certain assumptions about population growth. It suggested that by 2050 total Commonwealth spending as a share of GDP would increase significantly, resulting in a projected primary fiscal gap (excluding interest payments) of around 2¾ per cent of GDP by that time.

Figure 14: Primary fiscal balance: Commonwealth Government



Source: Deloitte Access Economics, 'An Intergenerational Report for the States', report incorporated in the Business Council of Australia Submission to the 2011 Tax Forum, *Preparing for a Better Future: Progressing Comprehensive Tax Reform in Australia*, October 2011.

This result relies on the assumption that the government achieves its goal of constraining real spending growth to two per cent (in years where the economy is growing above trend until the budget is in surplus) and that this delivers permanent structural savings to the budget of around one percentage point of GDP from 2015–16.

These estimates are somewhat dated and considerable uncertainties surround the projections. An associated risk is the extent to which the budget has become significantly more exposed to the movements in commodity prices. The historically high terms of trade and growth in the mining sector as a share of the economy have meant that the budget is more sensitive to developments in commodity and currency markets than in the past. Given the continuing uncertainty around the growth prospects for many of the world's major economies, this is a potential source of volatility for budget estimates.

To date the Commonwealth's Intergenerational Reports have focused on federal finances. However, the most recent report noted that while the Australian Government provides over 40 per cent of the total health funding (and is the major source of public funds) the state and local governments fund around one quarter of the cost of health services, with non-government sources contributing around one third.

Intergenerational fiscal modelling shows that although pressures on the states are not quite as notable as those on the Commonwealth Government, they are considerable – and have not been widely recognised. The states, for example, bear a considerable load on the healthcare cost front.

Whereas the shortfall on primary balances for the Commonwealth is projected to reach 2¾ per cent of GDP by 2050, previous modelling commissioned by the Business Council indicates that the combined position of the states will see a shortfall of much the same size: almost 2½ per cent of GDP by 2050.

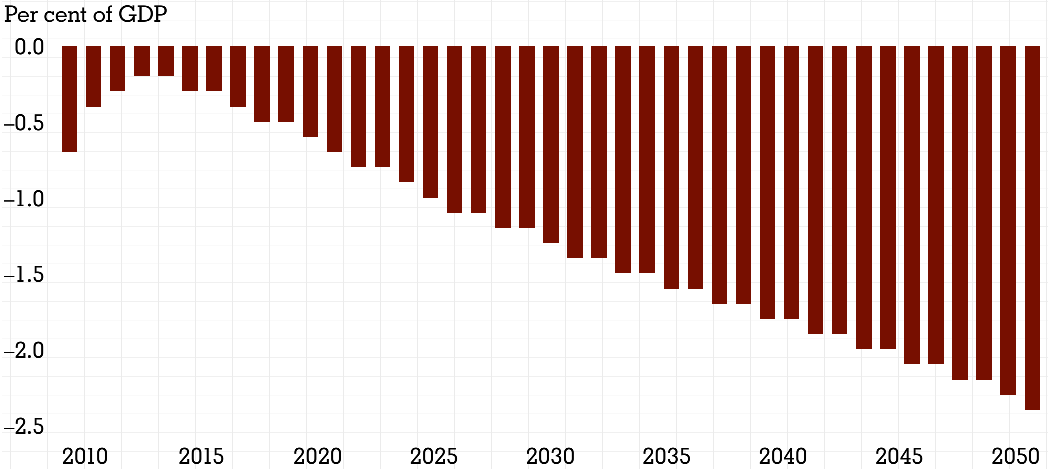
It is possible to combine the results of the fiscal modelling to obtain a sense of what the total shortfall in national fiscal finances could be by 2050.

When the states' position is added to that of the Commonwealth, Deloitte Access Economics finds that by 2050 the total shortfall reaches just over 5 per cent of GDP (excluding interest payments). Today a budget deficit of 5 per cent of GDP would be equivalent to around $70 billion.

Such an outcome will present Australia with some stark choices and as a nation we will have to decide what we can do about this. If anything, these pressures are growing with the ABS recently releasing the highest life expectancy estimates ever recorded – higher than estimates considered in the 2010 intergenerational report.[10]

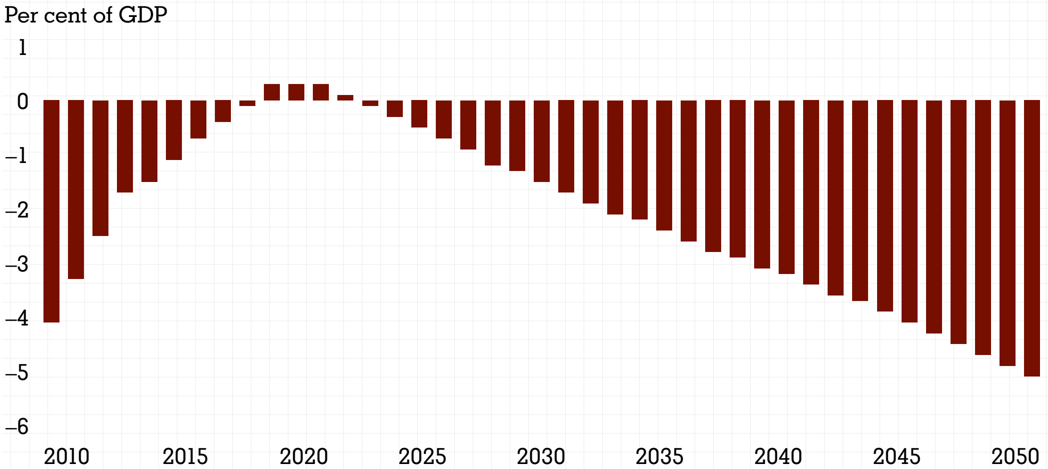
If steps aren't taken now to begin to deal with these types of issues then future generations of Australians will be required to bear a disproportionate burden, raising questions over intergenerational fairness.

Figure 15: Primary fiscal balance: combined state governments



Source: Deloitte Access Economics, 'An Intergenerational Report for the States', October 2011.

Figure 16: Primary fiscal balance: all governments



Source: Deloitte Access Economics, 'An Intergenerational Report for the States', October 2011.

PART THREE

RETURNING TO A MORE SUSTAINABLE FISCAL POSITION

Key points

- The government's decision to withdraw from its commitment to achieve a surplus in 2012–13 was driven by significantly lower-than-expected tax revenues for the year to date. The BCA supports the decision to reassess the return to surplus in 2012–13.
- The BCA expects the government to hold to its commitment to expenditure restraint without slippage, and would prefer to see more consistent achievement of the 2 per cent spending cap each year until the budget returns to surplus.
- The BCA is calling on the government to commission an independent review of the size, scope and efficiency of government. There are a number of strong drivers for a review and reprioritisation of expenditure, including:
  - In the current subdued revenue environment and given the projected long-term fiscal gap, the reality is that the government must stop doing or funding certain activities to make room for new programs such as the NDIS and the Gonski education reforms.
  - With each new reform progressed by COAG, the fundamental roles and responsibilities of the Commonwealth and state governments are changing without properly understanding the fiscal consequences. An increasing centralisation of policy at the Commonwealth level has significant fiscal implications and will impact the efficiency and effectiveness of the federation.
  - A detailed look at the quality and composition of spending is well overdue. It is notable that since the last review of Commonwealth finances was undertaken in 1996, the broad composition of spending has changed little despite considerable economic and social changes.
- With the fiscal target of returning to surplus in 2012–13 recently reassessed, the time is right to refocus on a medium-term anchor for fiscal policy.
- Medium-term fiscal policy would be best served by the government committing to a refreshed set of fiscal rules that provide increased discipline on the size of government, ensure counter-cyclical readiness and provision for intergenerational pressures.
- Fiscal rules would give certainty that barring economic shocks, the government will not stray markedly from the central task of improving the budget bottom line steadily over time, paying down debt and beginning to provision for future pressures. This could provide a major shot to confidence.
- Attempts to make the expenditure side of the budget more efficient must be matched by similar attempts on the revenue side. A more robust and efficient revenue base will enhance economic growth and make the fiscal task more manageable in the coming decades.
- In addressing challenges on the revenue side of the budget, the government should develop a blueprint for long-term comprehensive tax reform over the next decade, as outlined in the BCA's submission to the 2011 tax forum. The focus should not be on ad hoc, narrow-based tax reform, which is unlikely to deliver net benefits.

The inherent weaknesses in the current fiscal position outlined in Part Two highlight the need for a refreshed fiscal strategy.

The recent confirmation of a write-down in tax revenues as economic conditions soften does mean that a return to surplus in the current financial year is not the right policy. However, the BCA would be concerned if abandoning the commitment to return to surplus in 2012–13 left a gap in the government's fiscal strategy. This is a legitimate risk given that recent budgets have been very strongly geared to this short-term target.

Australia's finances are in better shape than other economies, but more should be done to build long-term strength and resilience. Instead, continuing on the current path presents a real risk of Australia squandering its relative fiscal advantages in the future.

If the government is to meet the challenge of fiscal repair and set Australia up to deal with future shocks and intergenerational pressures so that we can continue to meet Australia's social compact, then as the Deloitte Access Economics report suggests, we need an approach to fiscal policy organised around five fundamental objectives:

1. **Affordable:** ensuring fiscal sustainability
2. **Prepared:** ensuring readiness for countercyclical action for any major shock
3. **Future-proofed:** ensuring readiness for intergenerational pressure
4. **Disciplined:** enforcing discipline on the size of government
5. **Effective:** ensuring value for money.

The BCA is calling on the government to commission an independent review of the size, scope and efficiency of government

We believe it is the right time for the government to outline a refreshed medium-term fiscal strategy in the upcoming budget. This strategy should:

- maintain discipline around expenditure in order to build sustainable and credible surpluses in the medium term. At a minimum, we believe that budget surpluses growing to 1 to 2 per cent of GDP will be consistently needed over the medium term
- undertake a review of the size and scope of government to make room on the expenditure side of the budget if the government is to fund programs such as the NDIS. This will underpin a more credible approach to expenditure restraint and the government's 2 per cent cap on real spending growth
- establish new fiscal rules that place discipline on the size of government, begin to prepare the budget for future economic shocks, and begin to provision for the intergenerational fiscal gap
- undertake a long-term program of tax reform to better equip the tax system to deal with volatility and encourage economic growth.

Each of the recommended elements of this strategy and the rationale for them are outlined below.

Maintaining discipline around expenditure

The government's decision to withdraw from its commitment to achieve a surplus in 2012–13 was driven by significantly lower-than-expected tax revenues for the year to date.

While current economic conditions are challenging in many respects as outlined in Part One, at this stage they do not warrant any loosening on the expenditure side of the budget. The government must live within its means.

The government's original fiscal target for spending discipline was to hold real growth in spending to 2 per cent a year until the budget returns to surplus. This has since been amended to a target of holding real growth in spending to 2 per cent a year, *on average*, until the budget surplus is at least 1 per cent of GDP, and while the economy is growing at or above trend.

The use of the term 'on average' has allowed greater flexibility and as noted in Part Two, this has led to greater variability in real expenditure growth from year to year and enabled the use of 'timing adjustments' in an attempt to reach surplus in 2012–13. For example, as short-term expenditure adjustments wear off after 2012–13, expenditure is expected to increase by 4.4 per cent in real terms in 2013–14.

The BCA expects the government to hold to its commitment to expenditure restraint without slippage, and would prefer to see more consistent achievement of the 2 per cent spending cap each year until the budget returns to surplus. In this context, we would like to see the government reassess its plans for real spending growth across the forward estimates.

In an election year, the pressure for increased spending will be especially acute, but we would urge both sides of politics to offset the cost of all election commitments through savings in other areas.

As noted in Part Two, there are already a range of spending commitments not built into the forward estimates including the increase in the superannuation guarantee, aged care reform, the NDIS, the Gonski education reforms, new aircraft for the RAAF and new submarines for the Navy. We would question the capacity of the budget to absorb further unfunded commitments, particularly given softer revenues.

The challenge for the government will be to demonstrate how it will restrain expenditure growth in the face of softer revenues to restore the budget to surplus across the forward estimates. This will then put Australia in a better position to reduce net debt and begin to strengthen the budget to deal with future volatility and long-term pressures.

Recommendation 1

That the government hold to its commitment to expenditure restraint without slippage, including more consistent achievement of the 2 per cent spending cap each year until the budget returns to surplus.

A review of the size, scope and efficiency of government

We believe that providing a credible plan to strengthen the budget in both the short and medium term will require clear actions directed at changing fundamental structural elements of expenditure. The government has shown a willingness to tackle some structural elements of expenditure through increasing the pension age and means testing the private health insurance rebate. It is now time to go further.

Restraining real spending growth while implementing commitments in areas like education and the NDIS in future years will require highly disciplined reprioritisation of other expenditures. In the current subdued revenue environment and given the projected long-term fiscal gap, the reality is that the government must stop doing or funding certain activities to make room for these new programs.

No amount of rephasing or accounting adjustments will create the capacity required. If we continue to put off addressing this fundamental tension in the budget then there is a real risk that underlying long-term structural issues build and become intractable.

As we have seen in Europe, in these circumstances countries are forced to take drastic measures to repair government budgets even as their economies decline. Amidst a crisis there is little time for considered reviews and the gradual implementation of measures to strengthen government finances. While our finances are much healthier than those in Europe and the US, we must be attuned to the lessons of their crises, by taking early preventative action to address the structural vulnerabilities in the budget.

On this basis, it is inevitable that the Commonwealth Government will need to undertake a review of the size, scope and efficiency of government. Undertaking such a review now provides greater time and scope for its analysis as well as time and flexibility in how its recommendations are implemented.

The rationale for undertaking a review

The key reasons and urgency for undertaking such a review are outlined below, along with suggested terms of reference for how it should be conducted. These terms of reference draw on analysis undertaken for the BCA by former senior Department of Finance official, Stephen Bartos of ACIL Tasman.

A review is long overdue

While there have been a range of budget reviews at the state government level over recent years, it is now over 16 years since the last such exercise was undertaken at the Commonwealth Government level.

The government's financial affairs have changed considerably in a number of respects during this time. For example, Telstra has been privatised, the government has invested in a significant new Government Business Enterprise to build a National Broadband Network, we now have a goods and services tax and a carbon tax, and the government has completed the transition from cash to accrual accounting.

The National Commission of Audit undertaken in 1996 rightly recognised that the performance of government programs can deteriorate markedly over time despite the best of intentions. Given that government outlays have almost tripled in absolute terms over this time, the scope for inefficiency in programs has, if anything, increased.

The composition and quality of fiscal measures deserve further attention

Supporting better-quality budget measures

While the BCA supported the government in its commitment to achieve a surplus in 2012–13, unfortunately some of the measures taken in support of that commitment highlighted the shortcomings of an ad hoc approach of seeking to improve the fiscal position.

As highlighted by the Deloitte Access Economics analysis, in the 'sprint to surplus' the quality of both savings and revenue-raising measures suffered. Further, we believe that some of these measures, such as changes to the timing of company tax payments, have undermined the very credibility and certainty that fiscal policy should promote.

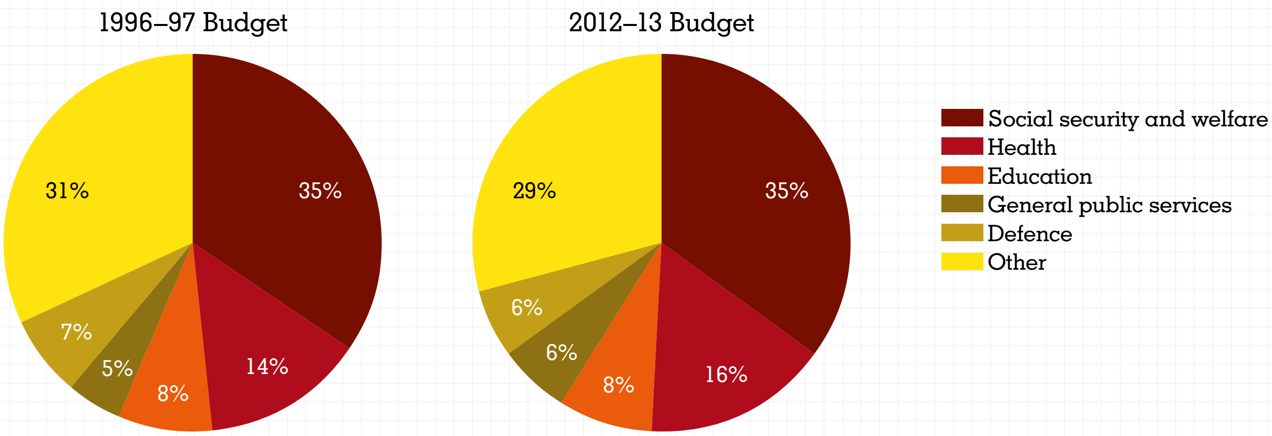
The quality of measures would be greatly enhanced by having an independent review identify a strategic list of priorities and ongoing audits that the government could draw upon each year for the budget. It should obviate the need for relatively blunt measures like efficiency dividends and seeking savings from ministers who may have little incentive to identify savings.

The composition of spending deserves further attention

In the absence of a periodic review of Commonwealth finances or an independent fiscal authority to review areas of public spending, there is little tangible evidence to give Australians confidence in whether the composition of expenditure in Australia is about right and providing value for money.

It is notable that since the last review of Commonwealth finances was undertaken in 1996, the composition of spending has been relatively stable across the major spending areas, as illustrated in Figure 17. For example, social security and welfare spending has remained at just over a third of government outlays. The notable exception is health, which has risen from 13.76 per cent to 16 per cent.

Figure 17: Composition of expenditure over time



Source: Commonwealth of Australia, 1996–97 Commonwealth Budget, pp. 3–12 and Budget Paper No. 1, 2012–13, pp. 6–7.

Government commitment to a refreshed set of fiscal rules would provide increased discipline on size of government, ensure counter-cyclical readiness and provision for intergenerational pressures

This demonstrates that at a high level, the composition of spending in the largest areas has changed little from budget to budget despite considerable economic and social change over this time. It also highlights the need to periodically review spending outside of the budget process to ensure that the composition and quality of spending are about right. This involves promoting government expenditure that enhances economic growth such as human capital and economic infrastructure while ensuring that social security and welfare expenditure is appropriately targeted so as not to impede labour market flexibility.

Proliferation of spending programs and government bodies

There has also been a proliferation of small spending programs – all too small on their own to warrant significant scrutiny but collectively making a sizeable impact on the budget bottom line. For example, between the handing down of the 2012–13 budget and the release of the Mid-Year Economic and Fiscal Outlook just five months later, 229 new expense measures had accumulated. The recurrent cost of small programs and the administrative inefficiency associated with them have never been analysed.

Based on the latest available information, the Commonwealth Government consists of 932 bodies including a range of agencies, authorities and other organisations.[11] The larger the number of bodies that a government has without regular review and consolidation, the greater the likelihood of administrative inefficiencies accumulating over time.

Long-term pressures are growing

As noted in Part Two, analysis undertaken for the BCA as part of its submission to the 2011 tax forum showed that by 2050, Australia will face a combined primary deficit of 5 per cent of GDP or $70 billion in today's terms.

These forecasts already factor in the Commonwealth achieving its goal of constraining spending growth to 2 per cent in years where the economy is growing above trend until the budget is in surplus but do not factor in a range of new spending commitments.

Avoiding such a shortfall will inevitably require a combination of tax reform, a systematic reprioritisation of expenditures and more user-pays options, including in areas such as health where the pressures are particularly pressing (Exhibit 2). A fundamental review of Commonwealth finances should provide a foundation for tackling the last two of these tasks and it is essential for an informed national debate.

Exhibit 2: Projected growth in government expenditure on health and ageing

The share of government expenditure on health and ageing would increase substantially from around a quarter to a half over the next 40 years if current health and ageing policies continue.

As this increased expenditure would need to be funded by more government debt, tax or a combination, it is projected that by 2050:

- close to half of total Australian government expenditure would be allocated to health and ageing
- the proportion of state and territory expenditures allocated to health and ageing would increase to around 40 per cent.

Projected government expenditure on health and ageing as a percentage of total government expenditure in each jurisdiction

	Australian Government		All state and territory governments	
	2009–10	**2049–50**	**2009–10**	**2049–50**
Health	12.5%	20.7%	25.2%	40.0%
Ageing	15.4%	25.1%	0.7%	1.0%
Total	27.9%	45.8%	25.9%	41.0%

The higher proportion of Australian Government expenditure projected to be spent on health and ageing is because the government is responsible for age pensions and most government aged care expenditure.

The state and territory shares of government expenditure allocated to health and ageing vary to some extent with differences in their demographic profiles and health and ageing policies.

Private expenditure on health (not ageing), which is health expenditure by individuals and insurers, is projected to stay around 2.8 to 2.9 per cent of GDP over the next 40 years, assuming current patient co-contribution rules continue.

The above projections are based on Deloitte Access Economics modelling of health and ageing expenditure by Australian, state and territory governments. The modelling is based on Treasury's 2010 Intergenerational Report and assumes that current health and ageing policies continue unchanged for the next 40 years.

Deloitte Access Economics, 'An Intergenerational Report for the States: Health and Aged Care Expenditure', report for the Business Council of Australia, January 2012.

Expectations of government are growing

As the Treasury Secretary has recently suggested, the already substantial long-term fiscal pressures are compounded by community expectations that the government will provide new services and spend more to reform existing ones.[12]

It is also notable that in the eyes of the community, this is not strictly confined to Commonwealth responsibilities, with a recent Constitutional Values survey finding that 74.8 per cent of people believed that where there is an important issue that state governments are not solving, the federal government should step in to resolve it.[13]

At a time when government revenues are softening, it is particularly important that the trade-offs that the community confronts if various expectations are to be met are analysed in a comprehensive and transparent fashion.

Roles in the federation are changing without regard to fiscal consequences

The BCA is concerned that with each new reform progressed by COAG, the fundamental roles and responsibilities of the Commonwealth and state governments are changing, without an understanding of the broader fiscal implications on the efficiency and effectiveness of the federation.

The extent of vertical fiscal imbalance in the federation, and the unravelling of the 2008 reforms to the intergovernmental agreement on federal financial relations, are driving the increasing centralisation to the Commonwealth level of policy responsibility and detailed administration of areas of service delivery conducted by the states.

Revenue assistance to the states and territories represents the largest expenditure program in the federal budget and it is projected to remain that way for the foreseeable future. Providing the right conditions for the states to deliver services with the maximum level of autonomy and in the most efficient manner possible is therefore imperative to the long-term strength of both Commonwealth and state budget positions.

Recent trends

With the Commonwealth continuing to collect around 83 per cent[14] of taxes in the federation, state service delivery and fiscal positions remain critically dependent on COAG funding agreements and the manner in which reform is pursued through COAG.

Recent COAG developments seem to be undoing much of the good work of the 2008 reforms to the intergovernmental agreement on federal financial relations, which were directed at reducing prescriptions on states and clarifying the roles and responsibilities of the Commonwealth and states.

This was apparent in a recent speech by the outgoing Chairman of the COAG Reform Council, who lamented that 'COAG has not only failed to champion the National Agreement model, it has in fact moved away from the outcomes model of the National Agreements'[15]. He highlighted that despite the best of intentions, it ultimately became an agreement for funding for specific services and activities at the local level rather funding high-level outcomes. He also expected upcoming agreements for funding of the NDIS and Gonski education reforms to follow this more prescriptive trend.

The reintroduction of a high degree of Commonwealth direction over funding is also apparent in the proliferation of national partnership agreements. Following the rationalisation of 92 specific purpose payments in 2008, these more prescriptive, specific purpose payments have in effect re-emerged with the finalisation of 125 national partnership agreements in the last four years.[16]

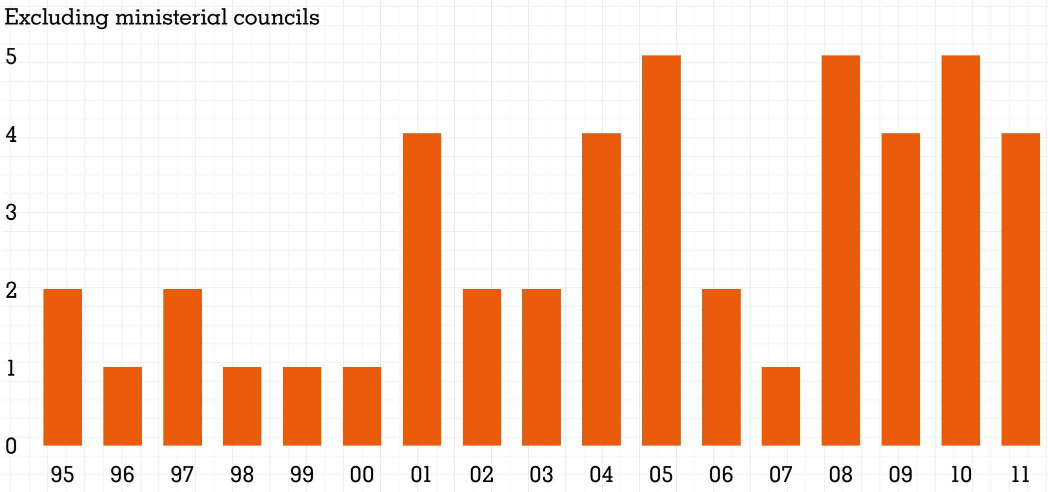
Fiscal implications

This increasing centralisation to the Commonwealth level of policy responsibility and detailed administration of areas of service delivery conducted by the states have a range of fiscal consequences that could exacerbate the already significant fiscal gap projected across the federation by 2050. We believe that the current trend of centralisation is leading to:

- **A locking in of increased expenditure for the states:** as has been seen with the NDIS, there is a tendency for the Commonwealth Government to commit to implementation of new policies that will be substantively delivered by the states without a detailed funding agreement in place first.
- **Increasing potential for duplication of effort:** a prescriptive and detailed approach to administering funds at the Commonwealth level is likely to be much more resource-intensive than a high-level outcomes and monitoring approach.

- **Inefficient administration:** the administrative effort involved in 125 national partnerships at both the state and Commonwealth level is likely to be significant. As evident in Figure 18, there has also been a proliferation of intergovernmental bodies including authorities and policy councils. The recent National Health Reform Agreement is illustrative of this, establishing the National Health Performance Authority, Independent Hospital Pricing Authority, Health Funding Administrator, and National Health Funding Body to distribute funding to the states and monitor service delivery.
- **Reduced incentives for innovative service delivery:** by prescribing services and inputs rather than outcomes, there is a risk that states lack the flexibility to deliver services utilising more efficient service delivery models that could deliver better quality or lower-cost services.

Figure 18: New intergovernmental bodies



Source: KPMG, *Report on Intergovernmental Institutions*, prepared for the Council for the Australian Federation, November 2011.

Undertaking the review

In building on last year's Budget Submission, the BCA has drawn upon the work commissioned from Stephen Bartos of ACIL Tasman to develop suggested terms of reference for an independent review of the size, scope and efficiency of government. Our proposed terms of reference are detailed at Exhibit 3.

The independent review could provide both immediate and long-term benefit to the budget position by providing both an interim report and final report. The interim report by the end of 2013 would focus on immediate actions that can be undertaken in the 2014–15 Budget, while the final report would focus on detailing a program of audits that should be undertaken on a rolling basis to tackle areas such as health and education.

We would envisage such a review focusing primarily on the expenditure side of the budget, with the Henry review already providing a comprehensive review of the tax system.

Recommendation 2

That the government commission an independent review of the size and scope of government in line with the terms of reference outlined in Exhibit 3 of this submission, with an interim report to be delivered by the end of 2013, in time for implementation of immediate actions recommended by the review through the 2014–15 Budget.

Exhibit 3: Review of the size, scope and efficiency of government: suggested terms of reference

Objectives and scope

The review should examine in detail and report on the size, scope and efficiency of the Commonwealth Government, in order to advise the government on how best to manage expenditure and fiscal risks in the future with a view to improving fiscal sustainability.

The review should address the following matters.

Stocktake of expenditure and health of government finances

1. Undertake a stocktake of current government programs in order to identify the composition and distribution of expenditure according to program, portfolio, function and size of outlay.
2. Focus on the outputs being achieved in these programs against the assumptions at the time they were funded.
3. Identify the fastest-growing areas of expenditure and the underlying drivers of that growth.
4. Identify the quantum of committed expenditure beyond the forward estimates period.
5. Critically analyse the current position of the government balance sheet, including any emerging risks or contingent liabilities that are not reflected in the current position.

Expenditure responsibilities in the federation

6. Analyse the current split of roles and responsibilities between the Commonwealth Government and state and territory governments, including areas of duplication, overlap and inefficient administration.

Efficiency and effectiveness

7. Assess the current efficiency and effectiveness of government in fulfilling its policymaking, administration and program delivery functions with reference to comparable public service benchmarks. The focus should be on outputs rather than inputs.
8. Identify opportunities for the implementation of alternative service delivery models employing the latest technologies and emerging innovations.
9. Examine the potential for greater contestability in government services by identifying current government activities where there is not a strong case for continued direct involvement in service delivery on the basis that it could be undertaken more efficiently and effectively by the private sector.

Adequacy of budgetary institutions

10. Assess the adequacy of current institutions and budgetary practices in promoting efficient and effective government, disciplined expenditure, focus on outputs, long-term fiscal sustainability and budget transparency
    - This should include the role of mechanisms such as the Parliamentary Budget Office, Expenditure Review Committee, Australian National Audit Office, Intergenerational Reports and the efficiency dividend.

Exhibit 3 (continued)

Recommended actions

11. The review should outline recommendations with an associated implementation plan under three key strands of reform:

    11.1 near-term actions: steps that the government can readily take in the near term to reduce expenditure or increase efficiency

    11.2 medium-term actions: develop a program of rolling detailed audits to be undertaken, with priority placed on the largest and fastest growing areas of expenditure along with those that are the most inefficient

    11.3 institutional reforms: actions that will improve the range and effectiveness of permanent mechanisms that promote the transparency of expenditure and incentives for expenditure discipline and efficient service delivery. This should include a set of fundamental principles for upholding and assessing the efficiency and effectiveness of government in the future.

Composition and consultation

- The review should consult widely with ministers, the public service and the community in developing its reports. Its interim and final reports should be publicly released, with comment invited on its interim report.
- The review should be overseen by a suitably qualified chair and panel, supported by a small secretariat. Those engaged in the review should bring a mix of different backgrounds and experience, including:
  - » senior-level public sector experience in both the Commonwealth and the states and territories
  - » experience leading a high-performing private sector or not-for-profit organisation
  - » experience in overseas jurisdictions
  - » change management and other experience involved in the implementation of major reform programs
  - » appropriate accounting and economics expertise.

Timing

- The review should provide its interim report, focusing on near-term actions that can be undertaken in the 2014–15 Budget, by the end of 2013.
- Its final report should be delivered by no later than the end of March 2014.

> In an election year, the pressure for increased spending will be especially acute, but we would urge both sides of politics to offset the cost of all election commitments through savings in other areas

Refreshing the fiscal rules

The recent challenges faced by the US and other global economies highlight the difficulties of balancing the twin objectives of fiscal repair and providing medium-term macroeconomic stability.

On the one hand, doing too little to repair the budget position can undermine confidence and reduce the credibility of the government's fiscal plans as decisions are deferred to future years and in some cases future governments. On the other hand, taking dramatic steps to repair budgets can reduce stability and predictability and hurt growth by reducing the confidence of consumers and businesses to make decisions to invest, innovate, save and work.

Australia is well placed relative to other economies and need not take either of these paths.

The government could refresh its fiscal rules to reinforce the parameters in which it will undertake fiscal policy. These rules could in effect define a set of boundaries in which fiscal policy will work to provide a corridor of confidence for the long-term budget position.

It would provide considerable flexibility for the government in each budget but give certainty that barring economic shocks the government will not stray markedly from the central task of improving the budget bottom line steadily over time, paying down debt and beginning to provision for future pressures.

A buffer against volatility

The uncertainty of the global economic situation and falling terms of trade that have placed pressure on revenues and precipitated the pullback from the commitment to surplus in 2012–13 only reinforce the need for a medium- to long-term anchor for fiscal policy that provides a buffer against terms of trade volatility and other pressures.

Nominal GDP growth has fallen to just 1.9 per cent over the last year, compared to growth of 4 per cent envisaged in MYEFO. While not as serious as major economic shock, it is a reminder of just how quickly downside risks can materialise and impact the budget position.

In order to effectively manage extreme economic circumstances, governments have to create the capacity through prudent fiscal management in normal times. Expenditure restraint in the short term and a review of the size, scope and efficiency of government should enable the government to begin to anchor the budget to this medium-term objective.

On this basis, the BCA reiterates its call from last year's Budget Submission to refresh its fiscal rules in line with those outlined in further detail at Exhibit 4. It is important to note that the purpose of having fiscal rules should not be to restrict flexibility at all costs but to enhance the role of fiscal policy as a contributor to medium-term fiscal stability. The rules are not designed to limit the flexibility of government budget settings in any particular year, but to provide a medium-term anchor for fiscal policy.

Budget surplus over the medium term

In line with the size of the fiscal task outlined in Part Two, there is a need to produce consistent and growing surpluses through to the beginning of the next decade if an average surplus position is to be achieved over the medium term.

At a minimum, we believe that budget surpluses growing to 1 to 2 per cent of GDP will be consistently needed. This is going to require considerable discipline from governments.

Exhibit 4: Proposed fiscal rules

Size of government

Suggested rule

- Placing a hard cap on the size of government by holding tax as a share of GDP below 23.7 per cent, such that future budgets do not see any slippage.

Rationale

While empirical research suggests that there is no definitive answer on the optimal size of government, the common finding is that an overly large and growing size of government is not conducive to higher productivity growth and economic performance.

The slippage that has occurred over the last 15 years demonstrates that once tax as a share of GDP increases it is rarely clawed back, highlighting the need for a hard cap.

Counter-cyclical readiness

Suggested rule

- Specify a new objective that targets a percentage surplus based on 'recharging' fiscal readiness around every 13 years such that fiscal policy is able to make a 3 per cent of GDP contribution to the economy should the need arise.

Rationale

Work undertaken by Mercer incorporated in the BCA's 2012–13 Budget Submission demonstrates that it is reasonable and prudent to assume that the Commonwealth Government will be required to make a contribution to the economy through counter-cyclical fiscal policy on average every 13 years or so. The size of this contribution is estimated to be 3 per cent of GDP. Previous downturns have been accompanied by a deterioration in the budget deficit of 2 to 4 per cent of GDP, comprising both automatic stabilisers and discretionary loosening.

The benefit of having these reserves ready to deploy is that the government should not find itself in the position of having to implement dramatic fiscal consolidation after the stimulus has been applied, when the economy may still be weak and recovering from the shock.

Intergenerational equity

Suggested rule

- Target a modest proportion of the surplus – to be known as an 'intergenerational surplus' – to provision for the projected fiscal gap that is expected to arise as a consequence of demographic pressures.

Rationale

If nothing is done to provision for the fiscal pressures associated with an ageing society, then fiscal policy will be relegated to an unsustainable position. It is prudent to instil discipline now by beginning to provision for the projected fiscal gap arising from intergenerational pressures. This would contribute to future stability by reducing the need for sharper fiscal adjustments in the future to address intergenerational pressures.

Source: *BCA Budget Submission 2012–13: Preparing for a Better Future.*

Recommendation 3

That in the forthcoming budget, the government commit to a refreshed set of fiscal rules that:

- place a hard cap on the size of government by holding tax as a share of GDP below 23.7 per cent, such that future budgets do not see any slippage
- target a percentage surplus based on ‘recharging’ fiscal readiness around every 13 years such that fiscal policy is able to make a 3 per cent of GDP contribution to the economy should the need arise
- target a modest proportion of the surplus – to be known as an ‘intergenerational surplus’ – to provision for the projected fiscal gap that is expected to arise as a consequence of demographic pressures.

Tax reform

The BCA recognises that attempts to make the expenditure side of the budget more efficient must be matched by similar attempts on the revenue side. A more robust and efficient revenue base will enhance economic growth and make the fiscal task more manageable in the coming decades.

Similar to the expenditure side, Australia should begin to progressively improve the tax system now rather than waiting until economic shocks or demographic pressures require dramatic adjustments to the tax system, as outlined in our submission to the 2011 tax forum.

The experience of the Business Tax Working Group confirmed the difficulty of pursuing narrow-based tax changes while realising reasonable economic gains.

While we continue to support reducing relatively inefficient taxes such as company tax, this requires broad-based reform implemented over a 10-year period as fiscal circumstances permit.

This should begin with a comprehensive roadmap for improving the tax mix by gradually reducing our reliance on direct taxes such as personal tax and company tax as well as inefficient state taxes and increasing reliance on indirect taxes such as consumption tax.

In light of the current issues associated with roles and responsibilities in the federation outlined previously, such a roadmap would also need to consider how revenue-raising powers could be matched more closely with expenditure responsibilities. As the GST Distribution review concluded late last year, this ‘... could lead to improvements in the efficiency of service delivery and make all levels of government more accountable and responsible for their actions’.[17]

Recommendation 4

That the government develop a blueprint for long-term comprehensive tax reform over the next decade, as outlined in the BCA’s submission to the 2011 tax forum.

CONCLUSION

Australia comes to these fiscal tasks in a much stronger economic and budgetary position than many other advanced economies at present. Our task of fiscal repair is also much smaller than other advanced economies.

In addition, we have considerable experience and institutions capable of putting these plans into action if there is political will. Doing more now to build the long-term strength and resilience of the budget and economy will help Australia avoid the risk of squandering its relative fiscal advantages in the future.

NOTES

1 IMF, *World Economic Outlook Update*, January 2013.
2 ibid.
3 ibid.
4 ibid.
5 OECD, *Economic Outlook*, November 2012.
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10 ABS, *Deaths, Australia, 2011*, cat. no. 3302.0, November 2012.
11 Department of Finance and Deregulation, List of Australian Government Bodies and Governance Relationships as at 1 October 2009.
12 Dr Martin Parkinson PSM, 'Challenges and Opportunities for the Australian Economy', Speech to the John Curtin Institute of Public Policy, 5 October 2012.
13 Newspoll, *Australian Constitutional Values Survey 2012*, conducted for Professor A J Brown, Griffith University, November 2012, p. 13.
14 BCA calculation based on ABS, *Taxation Revenue 2010–11*, cat. no. 5506.
15 Paul McClintock AO, 'Harnessing Federalism: The Missing Key to Successful Reform', Public Lecture presented by the Sir Roland Wilson Foundation and the Crawford School of Public Policy, Canberra, 19 November 2012.
16 COAG Reform Council, *COAG Reform Agenda: Report on Progress 2012*, September 2012, p. 25.
17 Commonwealth of Australia, *GST Distribution Review Final Report*, October 2012.

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