Business Council of Australia

submission

BCA Budget Submission 2014–15

FEBRUARY 2014

Working to achieve economic, social and environmental goals that will benefit Australians now and into the future

Contents

The Business Council of Australia (BCA) is an association of the chief executives of Australia's leading companies, which researches and promotes economic growth policies for the benefit of the nation and all Australians.

This is the BCA Submission to the 2014–15 Budget. The BCA Submission to the National Commission of Audit, made in December 2013, is included as an attachment to this submission.

SUMMARY

- This is the Business Council of Australia's submission to the 2014–15 Commonwealth Government budget process.
- This year's budget will need to mark a significant change in direction for fiscal policy in Australia, complemented by bold economic policy to support growth.
- This budget must bring much-needed credibility to the task of budget repair. Past budgets have committed to major expenditures beyond the forward estimates while relying too heavily upon optimistic revenue forecasts, efficiency dividends, ad hoc tax changes and timing adjustments without sufficient attention on reprioritising existing expenditures.
- This year's budget will have the benefit of being able to draw upon a systematic review of the scope, size and efficiency of government undertaken by the National Commission of Audit (NCOA).
- The government must use the findings and recommendations of the audit to break from the trend of recent budgets and bring a structural solution to what is a structural budget problem.
  - Based on current estimates, the Commonwealth Government will have run consecutive deficits of almost 17 per cent of GDP by 2013–14, with average real expenditure growth of over 4 per cent a year over this period.
  - Achieving budget balance across the economic cycle is critical to putting the budget in a strong position to respond to economic shocks, with consecutive deficits putting this capacity at risk.
- Credible budget repair will involve taking structural steps to begin to correct expenditure in the first instance and undertaking comprehensive tax reform in the longer term that improves the tax mix and reduces the volatility of Australia's tax base. All of this must be backed up by broad economic reform to drive increased economic growth.
  - Commonwealth Government expenditure is expected to be 25.9 per cent of GDP this financial year – its second highest level in 20 years.
  - Slower economic growth is placing ongoing pressure on tax revenues, with tax receipts expected to remain below the 2007–08 level of 23.6 per cent across the forward estimates.
- The task of budget repair will be complicated by a deteriorating economic outlook, with economic growth running below trend as the economy transitions to a greater reliance on drivers of growth beyond the resources sector.
- These immediate economic challenges highlight the considerable longer-term challenges for Australia's economy to grow stronger and faster. Fiscal repair will need to commence in this budget to be credible, but it will need to be measured and progressive across the forward estimates and beyond by continuing to invest in productive capacity:
  - Extraordinary policy effort will be required if Australia is to achieve the growth rates of the past. For example, Australia has had average annual growth of 3.5 per cent over the past 50 years.
  - The impacts of an ageing population that have been much talked about and analysed are beginning to materialise, with a significant proportion of the recent drop in labour force participation explained by demographic pressures.
  - Taking the 2010 Intergenerational Report as a starting point, which projected 2.7 per cent average annual growth without policy changes, it is clear that Australia will need a substantive suite of policies that encourage increased participation and productivity to achieve the kind of growth we have achieved in the past.
  - As an illustration, applying the assumed contribution to growth from participation and population used in the Intergenerational Report, achieving growth of 3.5 per cent would imply

labour productivity growth of 2.4 per cent per annum – labour productivity has averaged 1.6 per cent per annum over the past two decades.

- It is clear that Australia would benefit from a bipartisan approach to fiscal discipline, acknowledging the considerable pressures on the expenditure side of the budget, along with uncertainty around future revenues and the need to grow the economy. In the lead-up to this year's budget there should be no disagreement on the fact that Australia has a serious fiscal problem that requires difficult trade-offs and decisions to be made in this and future budgets.
  - The earlier that Australia begins to take concrete steps to repair its fiscal position, the greater the ability for the government to progressively reduce the growth of spending programs, providing time for the community to adjust rather than taking drastic actions amidst a crisis.
- We call on the government to institute a three-pillar strategy for repairing the fiscal position and growing the economy that encompasses:

  1. Correcting expenditure: The government must take concrete steps to begin to reprioritise its activities in light of what is affordable, reduce inefficiency in government spending, and claw back growth through structural changes in major spending programs.

  2. Strengthening the revenue base: The government must undertake a process of comprehensive tax reform to improve the efficiency and stability of the tax system so that it raises adequate revenue while better supporting economic growth.

  3. Strong economic reform: Extraordinary policy effort is now required to drive long-term economic growth in light of structural headwinds and long-term challenges. Robust economic growth will assist in strengthening the budget position and better equip the country for dealing with the challenges of an ageing population.
- With this in mind, the BCA has six key priorities for the budget and economic policy in 2014.

1. Comprehensively respond to the National Commission of Audit's findings and recommendations by:
   - Reducing the most inefficient outlays in the short term.
   - Setting out a series of measures to be progressively rolled out across the next decade to slow the growth of expenditure in major government programs.
   - More clearly delineating the roles of the Commonwealth and state governments in areas such as health and education, as the administrative inefficiency associated with unnecessary overlap in responsibilities can no longer be afforded.
   - Outlining directions for major service delivery reform that will follow the budget, including any plans for privatisation, outsourcing, increased use of technology and reducing Commonwealth–state duplication.
2. Outline a realistic, indicative timeline for returning the budget to surplus, including the extent to which alternative assumptions around nominal GDP growth and the terms of trade could impact the timing of a return to surplus or the policy change that would be necessary to maintain that timeline.
3. Outline a refreshed fiscal strategy, including fiscal rules that will define the boundaries within which fiscal policy will be conducted by the government. As a starting point, this should include:
   - A hard cap of the size of government. The BCA has previously suggested a cap on Commonwealth Government taxation of 23.7 per cent of GDP.
   - A commitment to achieve a substantial average surplus position over the medium term.
   - A strong commitment to restrain real spending growth to 2 per cent consistently each year until the budget returns to a substantial surplus.

4. In order to promote stability and certainty for business, refrain from introducing any new changes to the business tax system. This is in line with the intention of the government's recent actions to clear the backlog of recently announced but unenacted tax measures.
5. Use the tax white paper process to begin the process of removing inefficient state taxes and improving the tax mix with a view to moving, over time, to a system less reliant on capital and income taxes and more reliant on efficient and less volatile indirect taxes.
6. Frame the budget with a bold and comprehensive long-term economic reform agenda that will provide a strong foundation for the kind of sustained long-term economic growth that Australia has experienced historically.

   This is what the BCA argued for in its *Action Plan for Enduring Prosperity*, released in July 2013. Beginning to implement substantive structural reform now will be necessary to achieve the kind of economic growth and continued improvement in living standards to which the community has become accustomed.

   The kind of priority and foundational actions set out in the first phase of the BCA's action plan can no longer be avoided. Throughout 2014, there will be a number of steps that the government can take through the budget and established processes to set this foundation for stronger growth:

   – Roll out the first tranche of reforms to deliver on the government's annual target of reducing the cost of regulation by $1 billion to reduce business costs and remove barriers to investment. Priorities should include reforming environmental regulation (including the 'Water Trigger'), implementing Fair Work Amendments, repealing the Australian Jobs Act 2013, removing labour market testing for 457 visas, and removing restrictions on foreign ships providing coastal shipping services.
   – Support infrastructure investment by:
     – Working with the states and territories to speed up the planning and prioritisation of high-value public infrastructure projects that can be brought to market.
     – Committing to taking unfettered advice from Infrastructure Australia (IA) on Australia's national infrastructure priorities and where the federal government should provide funding support.
     – Setting aside a substantial funding envelope in the budget available for investment in IA-approved infrastructure projects.
     – Expanding the funding and financing options open to the federal government, for example, sharing in funding availability payments, public sector subordinated notes, public sector minimum guarantees that provide minimum patronage or revenue guarantees for a defined period, loan guarantees and concessional loans.
   – Bring the resources and priority necessary to progress Australia's contribution to the nine free trade agreements currently under negotiation, in addition to multilateral trade liberalisation efforts, to fully represent Australia's diverse interests in these negotiations and achieve outcomes in the national interest.
   – Coordinate reform across the federation through a focused medium-term agenda for the Council of Australian Governments (COAG) in infrastructure, national tax reform, environmental regulation, major project approvals, energy market reform, and competition and regulation reform. The COAG Business Advisory Forum process may assist in bringing increased accountability and prioritising reforms.
   – Support increased participation rates for mothers by rebalancing family assistance in favour of greater childcare subsidies that specifically support work, study and training and less untied cash payments in the form of family payments.
   – Implement proposed changes to the Fair Work Act 2009, including the re-establishment of the Australian Building and Construction Commission (ABCC) with its previous powers. The

government should also pursue additional amendments to arrangements for greenfields projects and matters pertaining.

– Continue to provide adequate funding and support for the vocational education and training (VET) system.

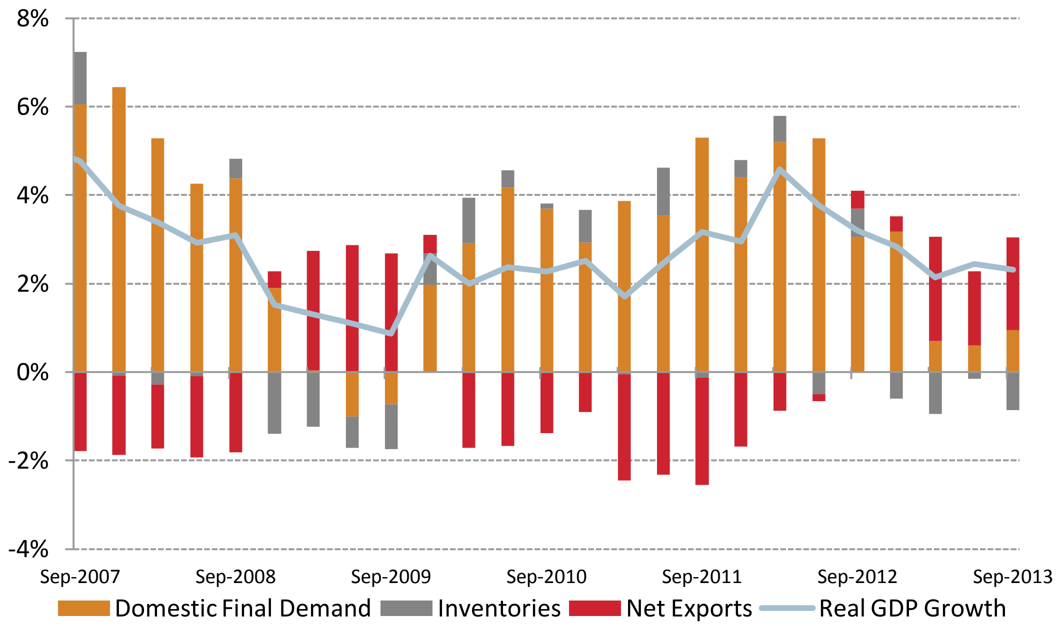
ECONOMIC CONTEXT

The economy continues to face headwinds in 2014, with the most recent National Accounts showing an economy growing below trend at 2.3 per cent through the year to September 2013.

Growth over the past year has largely relied upon net exports (contributing 2.1 percentage points of the 2.3 per cent growth), while domestic demand remains subdued and new business investment is 2.5 per cent lower through the year as mining investment comes off.

Figure 1: Drivers of recent economic growth

Through the year



Source: ABS, *Australian National Accounts, September 2013*, cat. no. 5206.0. Note: statistical discrepancy accounts for the difference between contributors and real GDP growth.

Official forecasts expect below-trend growth over 2013–14 and 2014–15 as the economy transitions to a greater reliance on drivers of growth beyond the resources sector and the international outlook gradually improves.

Recent data releases out of the United States have been encouraging, while the Chinese economy is expected to remain relatively strong with growth forecast to continue at over 7 per cent in 2014. Japan is embarking on a period of structural reform to complement recent fiscal and monetary stimulus in order to kick-start its economy, although the impact of this may take some time to work its way through the economy.

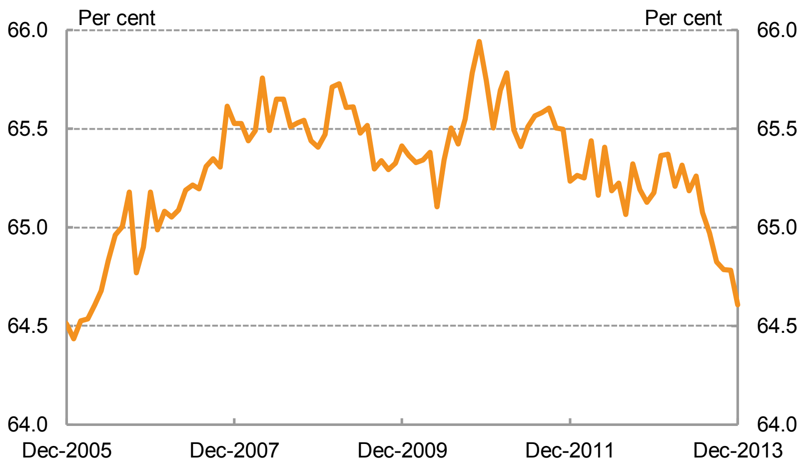
The BCA Budget Submission 2013–14 foreshadowed the risks of further declines in the terms of trade, a slowdown in resources-related investment and the continuation of the cautious approach of households and consumers in their spending and borrowing behaviour. Even with low interest rates continuing to flow through the economy following 225 basis points of cuts since November 2011 these risks remain and will continue to have implications on revenue collections and the fiscal position.

As mining investment comes off, lower capital flows may place further downward pressure on the currency, which could assist in bringing more balanced growth across the economy. However, a sustained lower exchange rate will remain highly dependent on the process around the US Federal Reserve's exit from the latest round of quantitative easing. A depreciation in the Australian dollar will also need to flow through as a real reduction in input costs if it is to lift Australia's lagging competitiveness. Productivity-enhancing reforms could assist in this regard.

The terms of trade is now down 18 per cent on the September 2011 peak. This continues to have implications for nominal GDP, which is 3.6 per cent higher through the year, well below historical average growth rates of around 7 per cent a year. This will continue to weigh on government revenues.

The labour market also remains soft, with growth in hours worked remaining subdued and the participation rate falling to its lowest level since early 2006. The ageing population has been the main driver as the share of the population aged 65 and over, with relatively low rates of participation, has increased. There has also been a fall in the participation rate of younger workers, which likely reflects economic conditions and a shift from the labour force into full-time education.

Figure 2: Participation rate

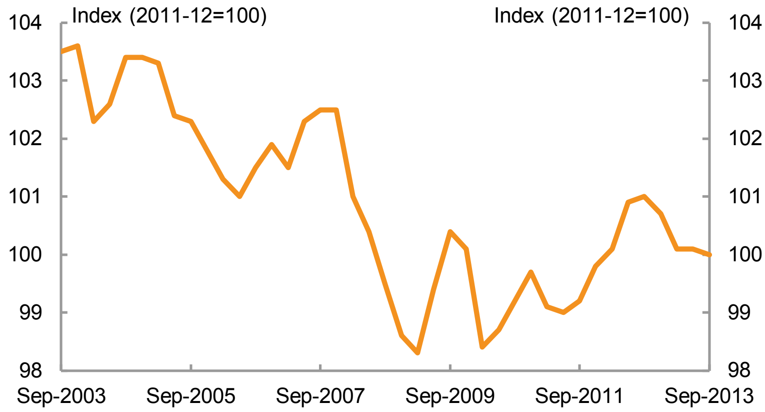


Source: ABS, *Labour Force, Australia, December 2013*, cat. no. 6202.0.

On a more positive note, continued improvement in labour productivity and the modest improvement in nominal GDP growth have seen real unit labour costs decline over the last year. This trend will need to continue if we are to see an improvement in Australian competitiveness, which will be critical in supporting the economy's transition to broader-based growth.

Like many other advanced economies, Australia's multifactor productivity growth has remained stagnant in recent years. Without more concerted action, this will present major challenges for living standards in the period ahead as the terms of trade continues to come off.

Figure 3: Real unit labour costs



Source: ABS, *Australian National Accounts, September 2013*, cat. no. 5206.0.

Australia's current economic backdrop highlights the need for a confidence-boosting budget that maps out responsible savings over the medium term, complemented by ongoing policies that boost the productive capacity of the economy.

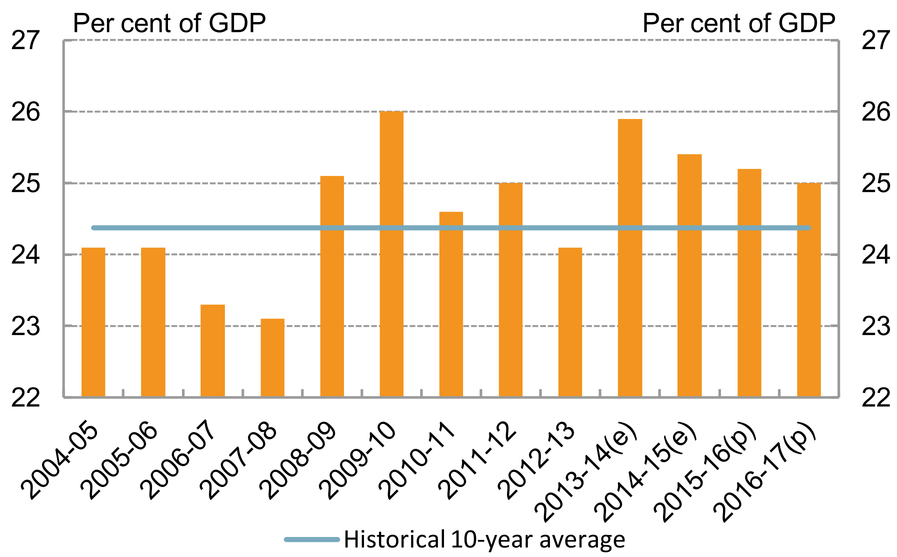
CURRENT FISCAL POSITION

The Commonwealth Government's fiscal position remains weak with a $47 billion deficit estimated for 2013–14. Continuing challenges on both the expenditure and revenue sides of the budget are placing the government in deficit across the medium term based on current estimates. Expenditure remains above historical averages, while tax revenues were written down another $37 billion over the forward estimates between the Pre-election Fiscal Outlook (PEFO) and the Mid-year Fiscal and Economic Outlook (MYEFO) due to the weaker economic outlook. At the same time, long-term fiscal pressures continue to grow based on an ageing population and a series of major commitments to a number of new Commonwealth Government programs commencing beyond the forward estimates.

Expenditure

Commonwealth Government expenditure is expected to be 25.9 per cent of GDP this financial year – its second highest level in 20 years. While it is important to acknowledge that Australia's size of government remains smaller than many other advanced economies, ongoing budget discipline will be necessary to maintain this.

Figure 4: Commonwealth Government expenditure



Source: MYEFO 2013–14.

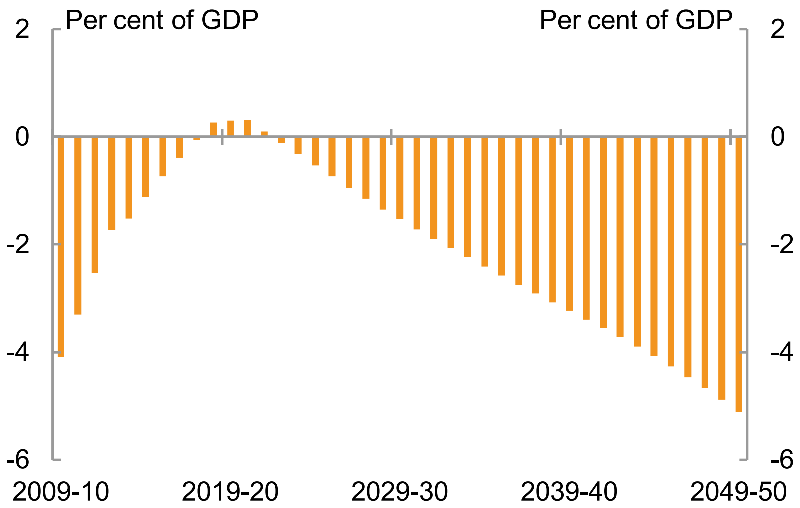
Successive budgets have relied heavily upon timing adjustments and efficiency dividends to rein in expenditures in the short term, while failing to provide a long-term solution. Policy decisions on spending, in aggregate, have not fully unwound over the period following the global financial crisis, despite the improvement in the economy. While most of the discretionary spending announced as part of the policy response to the global financial crisis has finished, between the 2008–09 and 2012–13 budgets, new discretionary spending decisions accumulated to total around $49 billion across the forward estimates in 2012–13.[1]

1. *BCA Budget Submission 2013–14*: *Towards Fiscal Repair*, based on Deloitte Access Economics analysis.

The long-term fiscal position

With an ageing population, the combined annual fiscal deficit across all levels of government in Australia could reach 5 per cent of GDP by 2050, or around $75 billion in today's terms.

Figure 5: Primary fiscal balance: Combined Commonwealth and state governments



Source: Deloitte Access Economics, 'An Intergenerational Report for the States', incorporated within the BCA Submission to the 2011 Tax Forum, October 2011.

At the same time, there are further challenges both known and emerging that will exacerbate this long-term challenge:

- New commitments taking effect beyond the forward estimates such as increased schools funding and DisabilityCare, could require an additional $17 billion a year around the end of the decade.[2] With the detailed models of delivering these programs still to be finalised, cost escalation remains a real risk.
- Lifting defence spending to 2 per cent of GDP will also require more than $6 billion of additional spending each year in today's dollars.
- At this stage, expenditure restraint is not within the assumed levels underpinning most intergenerational projections. Such projections are predicated on the government meeting its commitments around expenditure restraint – that is, real growth of 2 per cent in years when the economy is growing above trend until the budget is in surplus. However, as Macroeconomics has suggested in work prepared for the BCA (see Attachment 1 of this submission) there is no possibility that existing policy settings will allow for sustainable spending growth rates at or below 3 per cent each year, due to the susceptibility of spending programs to demand shifts.

Revenue

Previous BCA Budget Submissions have highlighted the risks of general weakness in revenue collections, alongside increasing volatility. This has implications for both collections and forecasts, as commodity price swings have increased in frequency and variability, in conjunction with an increased reliance on the resources and resources-related sectors as part of corporate tax collections. To illustrate, mining accounted for almost a quarter of corporate tax collected in 2010-11, compared with 7 per cent a decade earlier.

2. ibid.

As the resources boom transitions to the production phase, there will also be increased deductions for royalties, placing further downward pressure on tax collections, while swings in commodity prices will continue to place pressure on restoring budget balance.

In addition to volatility, the growth in the revenue base remains weak, with nominal GDP – a proxy for the tax base – growing just 3.6 per cent through the year to September 2013, driven by the continuing decline in the terms of trade and weaker real economic growth. These trends are estimated to continue across the forward estimates, with the tax-to-GDP ratio forecast to remain well below levels leading up to the global financial crisis.

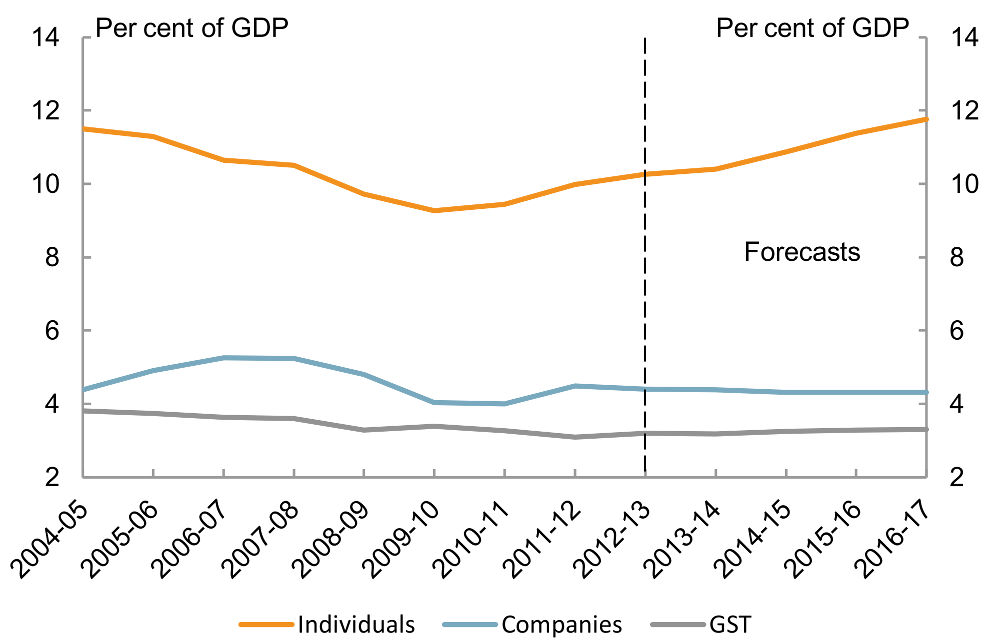
At the same time, the Commonwealth tax base is becoming more reliant on personal income taxes, while the contribution from more efficient tax bases such as the GST have declined and are expected to remain subdued.

Following a series of personal tax cuts and the global financial crisis, personal tax collections have improved, driven by the recovery, bracket creep and one-off factors such as the flood levy in 2011–12. Over the forecast period, bracket creep and the increase in the Medicare levy in 2014–15 will push individual tax collections to its highest level since 1999-2000, when it was 12.6 per cent of GDP.

GST collections have declined based on a range of factors, most notably through increased expenditure on GST-exempt items, subdued consumption growth and increased expenditure on GST-free imports.

To the extent that the tax base becomes more reliant on direct and less efficient taxes, then it is likely to be more volatile and detract more from economic growth by distorting decisions to work, save and invest. It will therefore be important that the government's white paper on tax reform examines the current tax mix and options such as abolishing inefficient state taxes and broadening the base of the GST.

Figure 6: Tax shares of GDP



Source: MYEFO 2013–14 and ABS, *Australian National Accounts, September 2013*, cat. no. 5206.0.

ACTIONS TO ADDRESS THE CURRENT FISCAL POSITION AND SUPPORT ECONOMIC GROWTH

We call on the government to institute a three-pillar strategy for repairing the fiscal position and growing the economy that encompasses:

1. Correcting expenditure: The government must take concrete steps to begin to reprioritise its activities in light of what is affordable, reduce inefficiency in government spending, and claw back growth through structural changes in major spending programs.

2. Strengthening the revenue base: The government must undertake a process of comprehensive tax reform to improve the efficiency and stability of the tax system so that it raises adequate revenue while better supporting economic growth.

3. Strong economic reform: Extraordinary policy effort is now required to drive long-term economic growth in light of structural headwinds and long-term challenges. Robust economic growth will assist in strengthening the budget position and better equip the country for dealing with the challenges of an ageing population.

It is clear that Australia would benefit from a bipartisan approach to fiscal discipline, acknowledging the considerable pressures on the expenditure side of the budget, along with uncertainty around future revenues. In the lead-up to this year's budget there should be no disagreement on the fact that Australia has a serious fiscal problem that requires difficult trade-offs and decisions to be made in this and future budgets.

Correcting expenditure

Recent BCA Budget Submissions have expressed concern at a lack of consistent discipline on the expenditure side of the budget, with new discretionary spending decisions continuing to grow. At the same time, many savings decisions were characterised by 'timing shifts' that do not have an enduring impact on the budget bottom line. Enduring structural changes such as the decision to progressively lift the age pension age were limited.

In slowing the rate of expenditure growth, the BCA considers that the following principles for efficient government outlined in its submission to the National Commission of Audit (see Attachment 1) are also relevant to the government's budget deliberations.

1. **Governments must prioritise**: If government is to be efficient, the starting point must be an expenditure base that aligns with carefully targeted functional and strategic priorities.
2. **Maintain a sustainable safety net:** Government should provide a strong and sustainable core safety net for the most disadvantaged in society.
3. **Lift productive capacity:** Outside of delivering a core social safety net, government spending should be focused as far as possible on lifting the productive capacity of the economy through areas such as infrastructure, education, tax reform and deregulation.
4. **Make the federation more efficient:** Wherever practicable, a function of government should be undertaken at the lowest level of government.
5. **Recover costs where possible:** Wherever practicable and affordable, those with adequate means in the community should pay for infrastructure and services.
6. **Regulate carefully**: Government should only regulate where there is a clear market failure and when benefits exceed costs.
7. **Deliver services efficiently:** Government service delivery should as far as possible follow market principles and be fully contestable to drive innovation.
8. **Maintain intergenerational equity:** Government budgetary decisions should as far as possible maintain a reasonable level of intergenerational equity.

9. **Minimise administrative costs:** The administrative cost of delivering government programs and policy should not be excessive relative to the community benefits.

With the NCOA delivering its reports in the lead-up to the budget, the BCA urges the government to draw on the NCOA's work to set out a sensible and sustainable plan for medium-term budget repair. This should involve:

- Reducing the most inefficient outlays in the short term.
- Outlining structural measures to restrain growth in major government outlays over the next decade.
- Clearly delineating the role of the Commonwealth and state governments.
- Setting out a credible path for returning the budget to sustainable surpluses over the medium term.
- Resetting the Commonwealth Government's fiscal strategy to clearly define the boundaries within which the budget will be set.

With economic growth below trend and the magnitude of fiscal repair required, it is clear that while the task of fiscal repair should commence with this budget to be credible, it should also be phased over a number of years across the medium term to lessen any short-term negative impacts on the economy.

Reducing the most inefficient outlays in the short term

The government has already taken a number of early steps to consolidate some agencies and abolish others as part of its machinery of government changes. While the savings achieved from individual changes may be small, on a cumulative basis they can be significant and can contribute to a streamlined and more efficient interface for delivering public services. The BCA considers these savings to be good budget housekeeping and would support the government continuing to implement savings that:

- Streamline the number of small government programs where administrative costs may be disproportionate to the value of the program.
  - There are some 480 government programs that account for just 5 to 6 per cent of spending in a typical year.
- Streamline the machinery of government.
  - At last count, the Commonwealth Government consisted of 932 bodies, including 136 "advisory" bodies outside of core agencies.
- Remove the administrative expenditure associated with regulation that is repealed or streamlined under the government's $1 billion deregulation agenda.

Structural measures over the medium term

The most substantial savings are likely to occur through structural measures to restrain growth in major government outlays over the next decade through better targeting of payments and improved service delivery. Consideration of various reforms in these areas are likely to be contentious and involve difficult trade-offs, but it is also necessary to control expenditure.

The magnitude of the challenge can be illustrated in the context of the 2 per cent real spending growth target. Real expenditure growth for social security, welfare, health and education has averaged around 4 per cent a year over the last decade. Even if real expenditure growth in these areas was restrained to 2.7 per cent a year, the rest of the budget will have to grow at just ½ a per cent a year in order to maintain average aggregate real spending growth of 2 per cent a year through to 2050.[3]

[3] Indicative estimate based on BCA calculations.

As noted in the BCA's submission to the NCOA, relevant questions that will arise in the task of assessing the sustainability and intergenerational equity of the social safety net may include:

- whether it is fair and affordable for families with a combined income of up to around $170,000 to receive family tax benefits when the median family income of couples with children is around $120,000[4]
- whether older households that have accumulated significant savings through superannuation and other concessionally taxed savings should also receive support for cost of living expenses through payments such as the age pension, Seniors Supplement and Commonwealth Seniors' health card
- whether arrangements around the age pension, including assets and age requirements, should be revisited in light of the ageing of the population
- whether there is room for greater use of co-payments and cost recovery in the delivery of services and infrastructure
- whether Australia can get better value for money from the Pharmaceutical Benefits Scheme.

While the budget may not include final reform proposals, it should outline directions for major service delivery reform including privatisation, outsourcing, increased use of technology and reducing Commonwealth–state duplication. For example, we believe that the Commonwealth Government may benefit from:

- Accelerating the co-location of human services customer outlets and the volume of transactions undertaken online.
- Considering opportunities for privatisation beyond Medibank Private.

Clearly delineating the role of the Commonwealth and state governments

Australia's Constitution permits a high degree of concurrency between the Commonwealth and states, which has led to confused roles and responsibilities and inefficient delivery of services where the two levels of government share responsibility. This has been exacerbated by the fiscal imbalance between the Commonwealth and states, with the Commonwealth using its role in funding services and reforms to establish detailed monitoring and oversight responsibilities. There is also potential for overlap between state and local governments.

The 2008 Intergovernmental Agreement on Federal Financial Relations (IGA FFR) attempted to better define the roles and responsibilities of each level of government. It also sought to streamline administration of Commonwealth grants to the states by removing input controls on expenditure and removing prescriptive reporting and accountability requirements.

However, the intent of the IGA FFR has not been fully realised and inefficiencies and duplication continue to arise from blurred roles and responsibilities between governments. For example:

- As of 2011 there were over 230 regulations, programs and policies across all levels of government for reducing carbon emissions.[5]
- The Commonwealth and states administer 125 National Partnerships, with $12.8 billion of funding attached to them, demonstrating the administrative inefficiency of intergovernmental funding arrangements.[6]
- Despite the best intentions, cooperative reforms have often simply increased the potential for unnecessary duplication and overlap. Australia has one national consumer law administered by 10 different regulators. The national Work Health and Safety scheme has left in place all of the pre-existing state regulators and expanded the role of the Commonwealth regulator.

4. Based on 2011 Census data.
5. Productivity Commission, *Carbon Emission Policies in Key Economies*, May 2011, p. xvi.
6. COAG Reform Council, *COAG Reform Agenda: Report on Progress 2012*, September 2012, p. 25 and estimated National Partnership payments for 2013–14 as per Budget Papers.

- The 2011 health reform package saw the Commonwealth inject an additional $16.4 billion of funding over five years along with three new government agencies, employing around 130 staff in 2013–14.

The government's responses to both the NCOA reports and federalism white paper will need to focus on achieving a clearer demarcation of roles between the Commonwealth and state governments, including:

- Establishing a clear lead coordination role in areas where responsibility for services is shared. Where it makes sense to do so, the lead jurisdiction should administer services on behalf of the other level of government in order to achieve full integration. The current policy to accredit state government environmental assessment and approvals processes is a good example of this.
- Critically examining the Commonwealth's role in the delivery of social services, such as health and education, and whether there is an excessive level of involvement and duplication with the state governments' role in these areas.

A credible path to surplus

Taking into account the advice of the NCOA, this year's budget should outline a realistic indicative timeline for returning the budget to surplus.

The BCA accepts that this timeline will be highly dependent on the strength and speed with which revenue recovers. Therefore a credible path to surplus will not only need to outline the actions that the government will take on the expenditure side to return budget balance, but also the risks on the revenue side and the impact this may have on the return to surplus if they are realised. This is consistent with the BCA's previous calls for greater transparency in the budget documentation on the sensitivity of tax revenue to factors such as the movement in commodity prices to support better fiscal management.

Resetting the fiscal strategy

The government is yet to explicitly outline its fiscal strategy, but the budget repair task will be assisted by refreshing and re-committing the government to a clear fiscal strategy, including fiscal rules and a detailed plan for executing on them.

At a minimum, the strategy should – barring major shocks to the economy – include commitments to:

- A hard cap of the size of government. The BCA has previously suggested a cap on Commonwealth Government taxation of 23.7 percent of GDP.
- A commitment to achieve a substantial average surplus position over the medium term.
- A strong commitment to restrain real spending growth to 2 per cent consistently each year until the budget returns to a substantial surplus.

In recent times the achievement of the first of these commitments has required little effort from government as the revenue base weakened substantially in the wake of the global financial crisis. Other commitments have proven difficult to execute in practice. For example, the 2 per cent real spending growth target was weakened over time to be 'on average', which saw real spending growth fluctuate both well above and well below the 2 per cent target.

The BCA has previously advocated for fiscal rules that seek to target surpluses as a share of GDP for the purposes of:

- Recharging fiscal readiness 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.
- Provisioning for the fiscal gap that is expected to arise as a consequence of demographic pressures.

These rules remain sensible and prudent but the ongoing deterioration of the budget means that they are a second-order concern where the priority is substantial fiscal repair to return to a sustainable surplus and then to begin to pay down debt. Unfortunately, it will be some time yet before the Commonwealth Budget is in a position to provision for the future from surpluses. However, it is worth noting that to the extent that the government slows the growth in expenditure, particularly in areas of intergenerational pressure such health and age-related payments and services, it will be taking steps to address the long-term fiscal gap that should reduce the quantum of future provisioning required.

Strengthening the revenue base

Australia's current tax base is subject to a number of structural pressures outlined earlier in the submission. They include increased volatility as we become increasingly reliant on the resources sector, demographic pressures and an increase in expenditure on GST-exempt items.

The BCA's *Action Plan for Enduring Prosperity* highlighted the importance of a competitive tax system alongside prudent fiscal policy and reform of the federation as being central to Australia's ability to maintain a strong economy and raise living standards.

The main role of the tax system must be to raise sufficient revenue, but in a way that least distorts incentives and harms Australia's growth prospects. There is a strong body of evidence that changing the tax mix for a medium-sized open economy such as Australia so that it is less reliant on direct taxes and increasingly reliant on indirect taxes would result in a more optimal tax system. This is especially important in an increasingly competitive international economy where investment and talent are increasingly mobile.

The government's tax reform white paper should provide the opportunity for a coherent, comprehensive and holistic tax reform process that builds consensus for change and demonstrates that tax reform need not be a zero-sum game. Ad hoc changes to tax measures in the interim will undermine the process of substantial tax reform, harm business confidence and destabilise an already weak economy.

A key focus of the white paper should be on facilitating the removal of inefficient state taxes such as stamp duties and insurance levies. It should also consider how to improve the tax mix with a view to moving, over time, to a system where there is less reliance on capital and income taxes and more reliance on efficient and less volatile indirect taxes. Such a tax system will provide both economic and fiscal dividends.

Boosting long-term economic growth

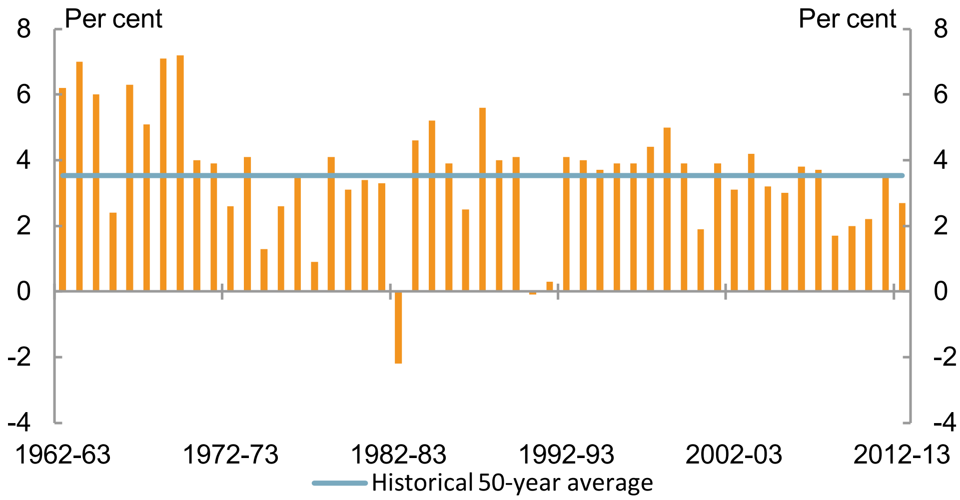
These immediate economic challenges highlight the longer-term challenge for Australia to maintain strong economic growth and rising living standards.

Extraordinary policy effort will be required if Australia is to achieve the growth rates of the past.

The ongoing high terms of trade masked many of Australia's economic vulnerabilities, and these are materialising both through lagging international competitiveness and softening domestic conditions in what could be a difficult period of adjustment for the Australian economy. At the same time, the challenges of an ageing population are beginning to take hold, most notably through falling participation.

Over the last 50 years, Australia has averaged annual growth of 3.5 per cent, with this success flowing through to substantially increased incomes and a better standard of living.

Figure 7: Australia's economic growth over the past 50 years



Source: ABS, *Australian National Accounts, September 2013*, cat. no. 5206.0.

At the time of the 2010 Intergenerational Report, continuing with the same policies of the day with an ageing population was likely to see growth of around 2.7 per cent a year and a substantial fiscal gap across the federation. These demographic pressures have already emerged – as discussed earlier, much of the recent decline in the participation rate is due to demographic pressures.

The cost of ongoing complacency will very clearly be a lower standard of living for future generations. As highlighted in the BCA's *Action Plan for Enduring Prosperity*, what is needed is a comprehensive and ambitious policy platform for long-term economic prosperity.

The extent to which Australia needs bold and comprehensive economic reform should not be underestimated. Achieving the kind of growth we've achieved in the past will require ambitious policies that offset as far as possible the declining proportion of the population in the labour force due to ageing and that provide a basis for unprecedented productivity growth.

As an illustration, applying the assumed contribution to growth from participation and population used in the Intergenerational Report, achieving growth of 3.5 per cent would imply labour productivity growth of 2.4 per cent per annum – labour productivity has averaged 1.6 per cent per annum over the past two decades.

Since the global financial crisis, much of the global economy has struggled with the implementation of growth-boosting policies, with budget repair and political challenges consuming much of the focus of governments. Australia, on the other hand, has the potential to implement sensible fiscal repair, accompanied by broad economic reforms.

Our history has shown that structural reform applied to an economy with a number of natural advantages and enterprising businesses and individuals can set it up for strong and sustained economic growth. Our action plan sets out nine key actions to achieve this:

1. Australia's fiscal policy settings and long-term budget discipline must be strengthened, we have to adopt a more competitive and sustainable tax system and provide for a fairer sharing of money between the Commonwealth and the states.
2. We must continue – and continue to plan for – sustainable population growth in our cities and regions.
3. We must provide the right infrastructure for a modern, liveable and productive economy.
4. We must equip all Australians with the right skills and education and boost labour force participation so that we have more productive and innovative workplaces and a better workplace relations system that strengthens the relationship between employer and employee.

5. We must rethink our approach to regulation and strengthen our institutions and governance arrangements with greater accountability and transparency from our regulators.
6. We must realise a deeper engagement with the world both economically and politically.
7. We must preserve a strong and stable financial system and make it more competitive and capable of funding our future growth.
8. We must adopt a coherent and comprehensive energy policy that enhances Australia's competitive advantage.
9. We must create the right environment and systems to foster and drive innovation, diversify our economy and play to our strengths.

While many of these actions and the detailed recommendations that sit underneath them will entail adjustments for the community in the short term, they will unambiguously lift Australia's long-term economic growth and competitiveness. This will place Australia in a much better position to realise the rates of economic growth and associated improvements in living standards to which the community has become accustomed.

Immediate actions

The benefit of beginning this task now is that it will assist the structural transition in the economy as it rebalances towards more non-resources growth. Policies that reduce barriers to investment and facilitate the re-skilling and movement of workers across industries should speed up the adjustment process.

Throughout 2014 there will be a number of steps that the government can take through the budget and existing policy processes it has established to set the foundation for stronger growth.

Deregulation

Identifying the first tranche of reforms to deliver on the government's target of reducing the cost of regulation by $1 billion every year will be an important step in reducing business costs and removing barriers to investment. The BCA has already highlighted a number of early priorities in this regard, including:

- reforming environmental regulation, including removing the 'Water Trigger'
- implementing the Fair Work Act amendments (outlined further below)
- repealing the Australian Jobs Act 2013
- removing the need for labour market testing for 457 visas
- removing restrictions on foreign ships providing coastal shipping services.

Further to these opportunities, the review of competition policy has the potential to establish a new microeconomic reform agenda and the right institutions for progressing pro-competitive reforms across the federation. Potentially anti-competitive regulation at the state level, including areas like retail trade restrictions and planning and zoning, are likely to present opportunities to increase productivity and boost jobs.

Infrastructure

Innovative Commonwealth funding and financing support for new infrastructure investment should be a feature of the 2014–15 Budget.

The Commonwealth has an increasingly important role to ensure its policies are supporting the provision of productive infrastructure that can raise productivity, assist workforce participation, grow export income, meet social objectives for the provision of basic utility services to all Australians and grow the economy.

Wherever possible, Commonwealth policies should facilitate and promote private funding and financing of infrastructure investment to maximise the efficient supply and use of infrastructure and also to relieve the financial burden on governments.

However, governments will continue to have an important infrastructure funding role where it is not feasible for the private sector to fully provide infrastructure needs. Within the federation this funding and financing responsibility is shifting towards the Commonwealth Government given its larger balance sheet, lower borrowing rates and more efficient tax base. There is a need to redefine intergovernmental relations to reflect this greater federal government role.

The federal government in this budget should:

- Work with the states and territories to speed up the planning and prioritisation of high-value public infrastructure projects that can be brought to market.
- Commit to taking unfettered advice from Infrastructure Australia on Australia's national infrastructure priorities and where the federal government should provide funding support.
- Set aside a substantial funding envelope in the budget available for investment in IA-approved infrastructure projects.
- In addition to traditional grant funding of projects, expand the funding and financing options open to the federal government, for example, sharing in funding availability payments, public sector subordinated notes, public sector minimum guarantees that provide minimum patronage or revenue guarantees for a defined period, loan guarantees and concessional loans.
- Build the capability in the public sector to design funding and financing models most suited to the cost and risk profile of each project and be flexible to avoid a one-size-fits-all approach.
- Enter into a long-term infrastructure funding agreement with the states and territories that sets out:
  - how projects will be prioritised and funding and financing support allocated
  - responsibilities of the states to provide robust cost–benefit analysis of projects
  - states to recycle capital tied up in mature infrastructure businesses and redirect funds into new infrastructure
  - how user-pays and value-capture options should be exhausted before public funding for new investments.

Labour market

Given the softening labour market conditions, it is clear that the budget and government policy more broadly will need to focus on strengthening labour force participation, productivity and training systems. As outlined in the BCA's action plan, this should include:

- Supporting increased participation rates for mothers by rebalancing family assistance in favour of greater childcare subsidies that specifically support work, study and training and less untied cash payments in the form of family payments.
- Providing adequate funding and support for the VET system by:
  - Strengthening Commonwealth strategic oversight of VET to be comparable to the oversight of higher education.
  - Subsidising VET students comparably to higher education students.
  - Removing gaps and duplication between the Commonwealth and the states to increase education provider autonomy within a rigorous quality framework.
- The government implementing its proposed changes to the Fair Work Act 2009, including the re-establishment of the Australian Building and Construction Commission (ABCC) with its previous powers. Additional reforms within the current term of government should include:

– greenfields projects amendments to provide more efficient and timely outcomes and help overcome impasses, including:
  – creating more employment options such as employer-only agreements
  – requiring the good-faith bargaining principles to apply to greenfields project negotiation
  – lowering the threshold for the application of the public interest test to allow earlier intervention for cases of significant harm.
– Matters pertaining to amendments to reduce the range of matters that can be bargained over to ensure they truly pertain to the employment relationship.

Foreign investment and trade

The BCA supports the continuing priority that the government is placing on global trade and investment.

As a medium-sized open economy with one in five jobs related to trade, Australia's economic future is reliant on ensuring access, on a level playing field, to regional markets for our goods, services and investment.

Australia is currently negotiating nine free trade agreements, including with two of our three largest trading partners – China and Japan. While negotiations with Korea, our fourth largest trading partner, have concluded, there is still a lot of work to be done on finalising the formal agreement and ensuring smooth implementation. There are also two major plurilateral agreements covering the Asia Pacific (the Trans-Pacific Partnership Agreement and the Regional Comprehensive Economic Partnership Agreement).

It will be important that the government brings the resources and priority to these deliberations, in addition to the ongoing multilateral liberalisation efforts, to fully represent Australia's diverse interests, and achieve outcomes in the national interest.

Federal–state relations

Late last year, COAG agreed to pursue a productivity-focused agenda focused on outcomes rather than process with rationalised machinery to support it. It is clear from the reforms outlined in this submission that it will be important to coordinate reform across the federation in areas such as infrastructure, national tax reform, environmental regulation, major project approvals, energy market reform and competition and regulation reform.

Many of these reforms were considered as part of the COAG Business Advisory Forum process, which brought together business representatives to canvass issues that COAG needs to tackle in order to lift productivity and economic growth. The BCA supports the continuation of this forum and the reform agenda associated with it as part of future COAG deliberations.

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Business Council of Australia

Submission to the National Commission of Audit

DECEMBER 2013

About this submission

The Business Council of Australia is an association of the chief executives of Australia’s leading companies, which researches and promotes economic growth policies for the benefit of the nation and all Australians.

For several years, we have been recommending a comprehensive audit of the scope, size and efficiency of government as an essential first step towards putting the Australian Budget on a more sustainable footing.

We welcome the government’s decision to undertake the Commission of Audit, and the opportunity to make a submission outlining what we view as priority issues for the commissioners, and ultimately the government, to address.

The Business Council of Australia has prepared the submission independently of the Commission of Audit and its chairman.

Jennifer A. Westacott
Chief Executive

December 2013

SUMMARY

- This is the Business Council of Australia submission to the National Commission of Audit (NCOA). It has been developed with the assistance of background analysis and research undertaken by Stephen Anthony of Macroeconomics.

Current fiscal challenges

- After 22 consecutive years of economic growth, Australia's fiscal position is weaker than it should be.
  - The most recent budget figures suggest that Australia will have an underlying deficit of around $30 billion in the current financial year or around 2 per cent of GDP.
  - The most recent estimates also suggest cumulative consecutive deficits of almost 18 per cent of GDP by 2015–16, making it effectively impossible to achieve the Commonwealth Government commitment to run budget surpluses on average over the medium term.
  - Over the same period, government debt is expected to reach a peak of $370 billion while net debt will pass $200 billion.
  - Despite this, the Commonwealth Government's expenditure remains above historical levels at 25.3 per cent of GDP this financial year, or about one percentage point higher than historical levels.
- This weak starting position and the need for repairing it over the medium term must also be seen in the context of a long-term budget position that will see age-related pressures on all governments build. Australia will reach a combined annual deficit of 5 per cent of GDP across Commonwealth and state governments by 2050 without policy change.
  - Governments will need to come to terms with the considerable demographic pressures of an ageing of the population that will see the ratio of working-age people to those aged 65 and above decline from around 5 today to 2.7 by 2050, based on current intergenerational projections.
  - This will place pressure on economic growth, increase health related costs and place increased demands on the social safety net.
  - While economic policies that lift productive capacity will be important, delivering health and aged care more efficiently and maintaining targeted social security will be critical to avoid a future fiscal blowout.
- Another way to think about the size of the task is in terms of the government's 2 per cent real spending growth target.
  - Real expenditure growth for social security, welfare, health and education has averaged around 4 per cent a year over the last decade. Even if real expenditure growth in these areas was restrained to 2.7 per cent a year, the rest of the budget will have to grow at just ½ a per cent a year in order to maintain average aggregate real spending growth of 2 per cent a year through to 2050.[1]
  - The corollary of this is that other important areas of spending like infrastructure could be squeezed out of the budget.
- Addressing these issues now through a thorough Commission of Audit and committed government response will avoid the fiscal position becoming intractable over time. Seeking to rapidly change the course of expenditure amidst a future crisis would require far more difficult trade-offs for the community than doing it now.
- Laying a strong foundation for future economic growth will also assist Australia's long-term fiscal position. In addition, future white papers on tax reform and Commonwealth–state relations will be critical to boosting government efficiency and future economic growth prospects, but the

1. Indicative estimate based on BCA calculations.

starting point must be a critical examination of expenditure as this will ultimately determine the revenue task and the scope of Commonwealth–state relations.

- Australia would benefit from a bipartisan approach to fiscal discipline, acknowledging the considerable pressures on the expenditure side of the budget, along with uncertainty around future revenues.
- The challenge for the audit is to balance efficiency measures and structural reform. That is, whilst programs can be trimmed and efficiencies achieved, the real task is to identify those structural changes to priorities, the role and size of government, the scope and function of programs that will pull back the rate of growth and increase the effectiveness of spending so that the budget can be truly sustainable.

Restraining growth in expenditure

- The NCOA represents a once in a generation opportunity to map out how Australia gets the expenditure side of the budget back on track and how we respond to the ongoing pressures on revenue, many of which are emanating from the external environment.
- There are six key tasks that the NCOA must complete if it is to successfully map out a path for sustainable expenditure over the medium and longer term:

1. Set the overall parameters for fiscal policy over the next decade, including revisiting the Commonwealth Government’s fiscal rules and establishing an indicative timeline in which the government should return to sustainable surpluses.
2. Undertake a stocktake of expenditure and identify the main growth drivers and risks.
3. Repair the budget as much as possible in the short term by reducing the most inefficient outlays.
4. Identify strategies to restrain growth in major government outlays over the next decade through better targeting of payments and improved service delivery.
5. Identify areas of overlap, duplication and potential inefficiency between the Commonwealth Government and the states for further investigation.
6. Identify how services can be improved in respect of outcomes.

- In undertaking these tasks, the NCOA should be guided by the following principles for efficient government:

1. **Governments must prioritise**: If government is to be efficient, the starting point must be an expenditure base that aligns with carefully targeted functional and strategic priorities.
2. **Maintain a sustainable safety net**: Government should provide a strong and sustainable core safety net for the most disadvantaged in society.
3. **Lift productive capacity**: Outside of delivering a core social safety net, government spending should be focused as far as possible on lifting the productive capacity of the economy through areas such as infrastructure, education, tax reform and deregulation.
4. **Make the federation more efficient**: Wherever practicable, a function of government should be undertaken at the lowest level of government.
5. **Recover costs where possible**: Wherever practicable and affordable, those with adequate means in the community should pay for infrastructure and services.
6. **Regulate carefully**: Government should only regulate where there is a clear market failure and benefits exceed costs.
7. **Deliver services efficiently**: Government service delivery should as far as possible follow market principles and be fully contestable to drive innovation.

8. **Maintain intergenerational equity**: Government budgetary decisions should as far as possible maintain a reasonable level of intergenerational equity.
9. **Minimise administrative costs**: The administrative cost of delivering government programs and policy should not be excessive relative to the community benefits.

- These principles if applied diligently to the task of slowing expenditure growth and making government more efficient will present a range of implications and tradeoffs**.**
  - ***If Australia is to afford a strong core safety net then government will need to continue to assess the universality of some payments and the need for tighter targeting. If there is to be a sustainable safety net for the most disadvantaged in society then some government programs will need to grow more slowly over time and others will need to be more tightly targeted.***
    - It may be necessary to more tightly target programs such as Family Tax Benefits and Seniors Supplements, if we are to afford the increasing cost of core safety net programs for the most disadvantaged such as DisabilityCare and pensions.
  - ***If the Commonwealth Government is to provide the kind of services that the community expects affordably over time, then it will need to fundamentally rethink the service models and technology driving its services.***
    - Where services can be delivered more efficiently and effectively by the non-government sector they should be and services that continue to be delivered by government should be periodically benchmarked against the private sector and other jurisdictions.
    - The government may need to accelerate existing efforts to move transactional services online through further investment in adding services to the secure online MyGov account.
  - ***The Commonwealth Government may better support efficient expenditure in the federation by withdrawing from the detailed micromanagement of state service delivery.***
    - This requires a clearer demarcation of roles and responsibilities, scaling down Commonwealth Government resources involved in the oversight of state service delivery and rationalising the administration and governance associated with transfers to the states.
  - ***Those with adequate means may also need to take greater financial responsibility for some services through increased co-payments and greater reliance on private funding mechanisms.***
    - For example, while the level of private contributions to aged care has increased through recent reforms, there remains potential to improve means testing and increase private contributions over time.
    - Australia's infrastructure should be paid for by users or beneficiaries wherever feasible, and there is more that can be done to increase user charges as a funding source.
  - ***While people should have a decent income, appropriate supports and social connectedness in retirement, the government may need to adjust the funding mechanisms. Without these adjustments, future generations could be left with higher taxes that stifle growth and opportunity along with reduced capacity for an effective safety net.***
    - This may entail reassessing whether it remains fair and affordable for the family home where it is of considerable value to be only included in means testing for the age pension at a low notional value and whether the age pension age should be indexed to increases in life expectancy.
  - ***The case for industry subsidies will need to be continually reassessed, to ensure that they are well targeted, temporary in nature and contributing to the enhanced long-term productive capacity of the economy. Subsidies must facilitate adjustment rather than providing passive support.***

      – The Productivity Commission should assess all proposals for industry assistance prior to budgetary decisions being made.
    – ***Excessive government administration and bureaucracy can no longer be sustained.***
      – The 932 bodies at the Commonwealth level will need to be rationalised in the short term and the benefits of small government programs reassessed against their administrative cost.
      – Deregulation initiatives against the government's $1 billion annual red tape target must also eliminate the associated government machinery that administers those regulations.
  – These implications and trade-offs are illustrated through more specific examples throughout this submission.

- By identifying these issues and mapping out a path for government and the community to restrain future spending growth, the NCOA will allow governments to begin to tackle Australia's expenditure problems today.
- This will facilitate progressive adjustment over the next decade to bring expenditure back to sustainable levels. Alternatively, putting off the task could see disruptive adjustment in the future through dramatically higher taxes and reduced government services.

The audit in context

- The Business Council believes the audit must be seen as one pillar in the overall strategy to grow the economy and repair the fiscal position. The two other pillars are tax reform, which must improve the stability and efficiency of the tax system, and the broader policy environment, which must drive growth.
  – As the budget papers illustrate a one per cent increase in real GDP driven by an equal increase in both productivity and participation would improve the underlying cash balance by around $3 billion in the current year.[2]

Effective implementation

- The Business Council sees the NCOA as the starting point for a much more comprehensive rethink and implementation of efficient government in Australia.
  – The five months of detailed consideration by the NCOA will provide a solid foundation, but it will need to be backed up by detailed execution. The government must respond effectively, implement recommendations in a staged manner, conduct more detailed audits in areas like health and education as necessary and oversee changes by agencies.
- This will provide the best prospect of making fiscal discipline business-as-usual for Australian Governments.

2. *Pre-Election Economic and Fiscal Outlook 2013*, p. 52.

THE NEED FOR MORE SUSTAINABLE EXPENDITURE

It has now been over 17 years since the Commonwealth Government undertook a full review of the size and efficiency of its spending. In this time, Commonwealth Government outlays have almost tripled in absolute terms and the scope of the Commonwealth Government has expanded including into areas such as health, disability care and broadband.

The NCOA therefore provides a timely opportunity to thoroughly review and consider how governments respond to the changing needs and priorities of the Australian community and deliver on these in the most efficient, effective and fiscally sustainable manner into the future.

While the tax system and economic growth will also play a key role in achieving this, the starting point must be achieving more efficient, effective and well-targeted government expenditure. In this regard, the BCA is of the view that a thorough and considered audit along with effective government implementation of its recommendations will be necessary if Australia is to meet the challenges outlined below.

▶ Preserving a sustainable social safety net for the most disadvantaged

One of Australia's strengths, as acknowledged by bodies such as the OECD, has been our tightly means-tested social safety net. If we are to expand this safety net to include deserving areas such as disability care while maintaining affordability, then it is inevitable that there will be trade-offs. An audit allows these trade-offs to be made transparent and provides a basis for making sensible decisions now to tighten eligibility and growth over time, rather than waiting until the growth of programs becomes intractable and requires more sudden adjustments.

We would argue that dispersing payments across wide cross sections of the community over time will limit that capacity of governments to provide the right level of assistance to the people who need it the most. Welfare, by definition cannot be all things to all people.

Putting off these challenges too long could require dramatic expenditure reductions or tax increases. For example, filling the future $75 billion future fiscal gap in today's terms from lower spending would require cutting over 80 per cent of all payments from the Commonwealth to the states.[3] The earlier and more sensibly that Australia begins to address its fiscal challenges, the better our chances of meeting them without major dislocation.

▶ Bolstering confidence across the economy

Based on current estimates, Australia will have run cumulative consecutive deficits of almost 18 per cent of GDP by 2015–16,[4] making it effectively impossible to achieve the Commonwealth Government commitment to run budget surpluses on average over the medium term. This loss of fiscal credibility ultimately impacts household and business confidence, increases uncertainty and works against a business environment conducive to investment and innovation.

If governments seek to improve the budget position through ad hoc tax measures each year in the budget and budget updates, business and the community's expectations will be for constant change in their financial affairs and an unstable platform for making decisions to work, save, invest and innovate.

On the other hand, setting out a coherent and credible long-term path for restoring the budget position progressively over time and sticking to that path will provide a clear and consistent signal to business and the community for making decisions. The audit can be the cornerstone for mapping out this path.

3. Based on total estimated payments to the states for 2012–13 of approximately $92 billion.
4. Commonwealth Government, *Economic Statement 2013–14*, August 2013.

▶ Addressing the long-term impacts of an ageing population

We are yet to make substantive in-roads to dealing with the spending pressures in health and ageing. By 2050 almost half of all Commonwealth Government spending will be allocated to health and ageing programs while 40 per cent of state and territory budgets will be allocated to these areas.[5]

▶ Rebuilding our fiscal buffer for times of crisis

Australia entered the global financial crisis in a strong fiscal position, which afforded the flexibility to deploy considerable fiscal stimulus in response. While Australia maintains considerable capacity in terms of monetary policy, its capacity to deploy fiscal stimulus is now more constrained and could place the budget in a precarious position.

▶ Responding to weaker revenues

As the Treasury Secretary has pointed out on a number of occasions, our tax base is now much weaker than we expected a decade ago.[6] Despite this the expectations of the community of what governments can and will provide have grown leading to a widening gap between what the community expects and what we can afford. While in the longer-term we should seek to strengthen our tax base by shifting the tax mix towards more indirect and less volatile sources of revenue, expenditure must also adjust.

▶ Addressing growing overlap and inefficiency in the federation

Around two-thirds of expenditure across the federation is attached to shared expenditure responsibilities between the Commonwealth and state governments, bringing considerable potential for duplication, overlap and inefficiency of administration.[7] This level of shared expenditure has grown over time.

5. Deloitte Access Economics, ‘An Intergenerational Report for the States: Health and Aged Care Expenditure’, report incorporated in *Long-term Funding of Health and Ageing: The Rising Pressure on Commonwealth and State Budgets*, Business Council of Australia, May 2013.
6. For example, M. Parkinson, ‘Australia’s Place in the New Global Economy’, Address to CEDA State of the Nation 2012, 18 June 2012.
7. Indicative estimates based on ABS, *Government Finance Statistics, Australia, 2011–12*, cat. no. 5512.0. Estimated using a rough rule-of-thumb, with any expenditure where there is less than a 90:10 expenditure split between the two levels of government considered to be a shared area of responsibility.

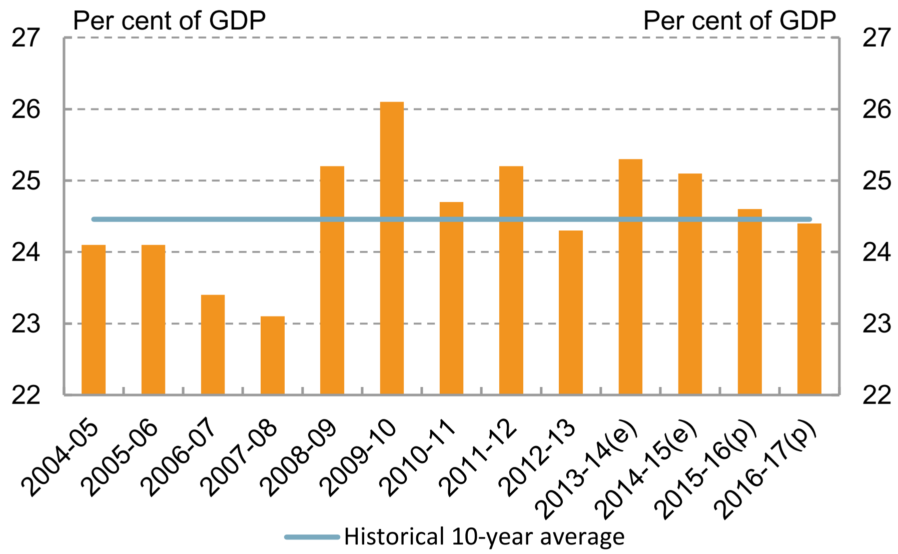
RECENT TRENDS IN EXPENDITURE

Commonwealth expenditure trends

Commonwealth Government expenditure rose from around 18½ per cent of GDP in the early 1970s and is expected to be 25.3 per cent of GDP this financial year. This increase represents a number of factors, including the introduction of new programs (such as Medicare), changes in the roles and responsibilities of Commonwealth and state governments, and demographic factors. Notwithstanding this expansion, it is important to acknowledge that Australia's size of government remains smaller than many other advanced economies, but ongoing budget discipline will be necessary to maintain this.

Five years after the global financial crisis, Commonwealth Government expenditure remains above historical averages. This is expected to continue over the forward estimates with forecast average real expenditure growth of around 2½ per cent a year – above the government's 2 per cent target.[8]

Figure 1: Commonwealth Government expenditure



Source: Economic Statement 2013.

Successive budgets have relied heavily upon timing adjustments and efficiency dividends to bring spending back within historical norms while failing to provide a long-term solution. Policy decisions on spending, in aggregate, have not fully unwound over the period following the global financial crisis, despite the improvement in the economy. While most of the discretionary spending announced as part of the policy response to the global financial crisis has finished, between the 2008–09 and 2012–13 budgets, new discretionary spending decisions accumulated to total around $49 billion across the forward estimates in 2012–13.[9]

Commonwealth expenditure trends by function

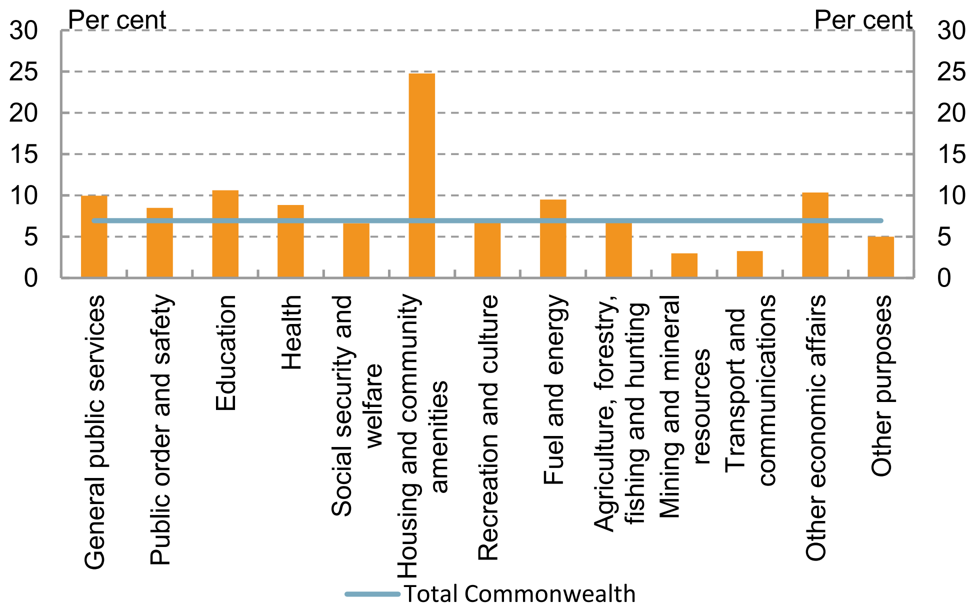
Expenditure on social security and welfare, health and education have been the key drivers of growth in Commonwealth expenditure over the past 50 years. Together, their share of total budget spending has doubled over this period, from around 30 per cent to around 60 per cent today.

8. Based on *Economic Statement 2013–14*.
9. *BCA Budget Submission 2013–14*, based on Deloitte Access Economics analysis.

The key drivers of growth in each category have been:

- Social security and welfare – assistance to people with disabilities, the aged, and families with children.
- Health – community health service programs (including Medicare), public health service programs (population health, hearing services, blood products, e-Health etc), the Pharmaceuticals Benefits Scheme, and medical research funding.
- Education – primary and secondary education
- Housing and community amenities – public housing, indigenous policy and as part of the response to the global financial crisis.
- Other economic affairs – growth primarily relates to labour market assistance and asylum seekers.

Figure 2: Average annual growth in Commonwealth Government expenditure by function, nominal, 2002–03 to 2011–12



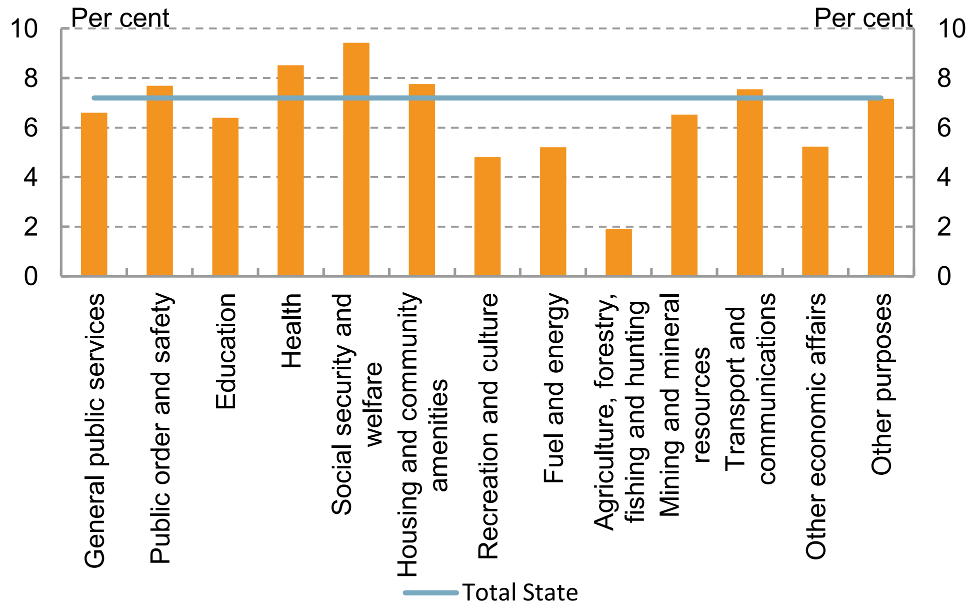
Source: ABS and Macroeconomics estimates. Note: Commonwealth spending is adjusted for grants payments to the states.

State expenditure trends by function

Expenditure on health and education have been the key drivers of growth in state expenditure over the past decade. Together they account for around half of total state budgets – a share that has remained relatively stable over the past decade.

The fastest growing areas over the past decade have been social security and welfare, health, and housing and community amenities. While education was not among the fastest growing areas of expenditure, its size relative to other functions means it has been a large contributor to absolute expenditure growth.

Figure 3: Average annual growth in state government expenditure by function, nominal, 2002–03 to 2011–12



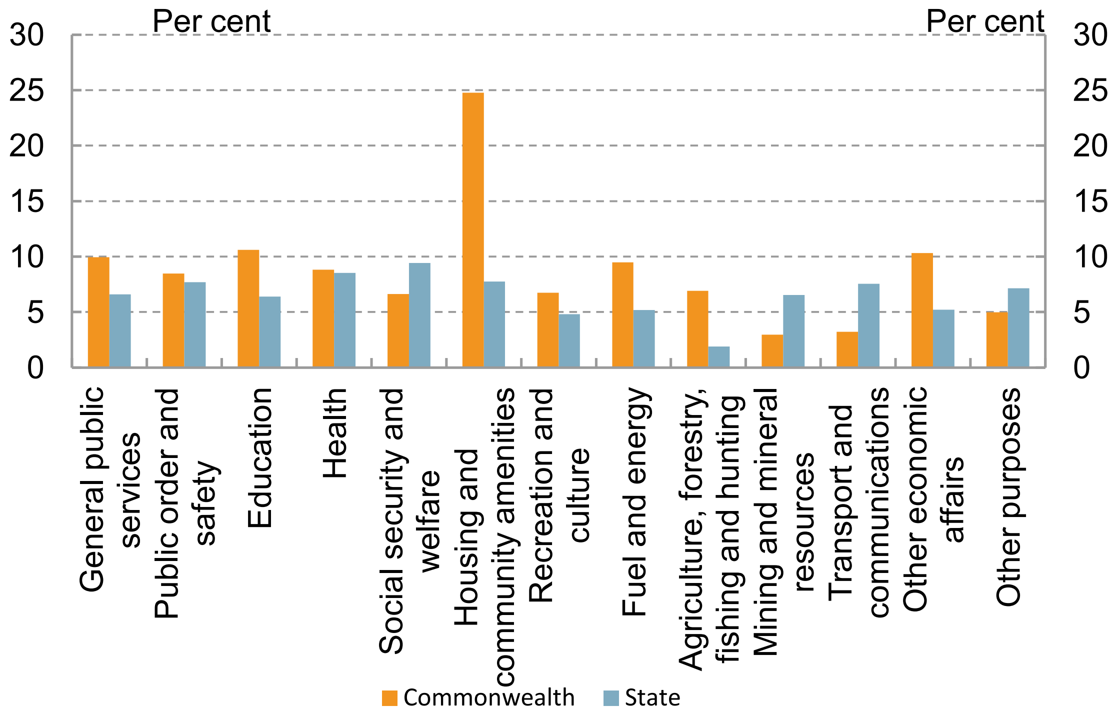
Source: ABS and Macroeconomics estimates.

Overlaps between Commonwealth and state expenditure

Health expenditure at both the Commonwealth and state levels has exceeded the average growth of all budget spending. The increase at the state level reflects continued expenditure on core service delivery areas such as public hospitals, and highlights the importance of finding improvements and efficiencies in the way these services are delivered.

However, at the Commonwealth level, the increase reflects a move on the part of the Commonwealth into the delivery of new services such as public health service programs (including preventative health, population health, hearing services, blood products, e-Health, immunology, and medical research), while failing to contain costs in more traditional areas of Commonwealth responsibility such as the Pharmaceuticals Benefits Scheme and Medical Benefits Scheme.

Figure 4: Average annual growth in Government expenditure by function, nominal, 2002–03 to 2011–12

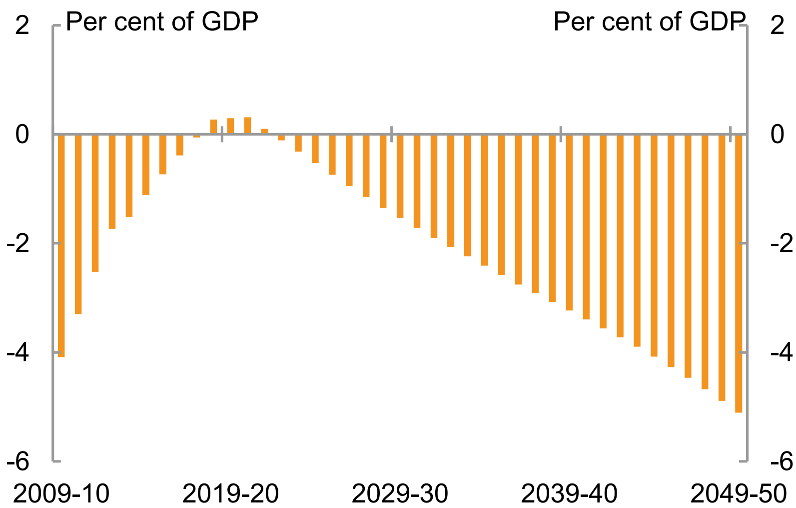


Source: ABS and Macroeconomics estimates. Note: Commonwealth spending is adjusted for grants payments to the states.

The long-term fiscal position

With an ageing population, the combined annual fiscal deficit across all levels of government in Australia could reach 5 per cent of GDP by 2050, or around $75 billion in today's terms.

Figure 5: Primary fiscal balance: Combined Commonwealth and state governments



Source: Deloitte Access Economics, 'An Intergenerational Report for the States', incorporated within the BCA Submission to the 2011 Tax Forum, October 2011.

At the same time, there are further challenges both known and emerging that will exacerbate this long-term challenge:

- Revenue has proven volatile in the face of recent commodity price swings, and while it is inevitable that there will be further volatility ahead, resilience has not been developed to accommodate these swings.
- New commitments taking effect beyond the forward estimates such as increased schools funding and DisabilityCare, could require an additional $17 billion a year around the end of the decade.[10] With the detailed models of delivering these programs still to be finalised, cost escalation remains a real risk.
- Lifting defence spending to 2 per cent of GDP will also require around $6 billion of additional spending each year in today's dollars.
- Most intergenerational projections are predicated on the government meeting its commitments around expenditure restraint – that is, real growth of 2 per cent in years when the economy is growing above trend until the budget is in surplus. However, as Macroeconomics suggests there is no possibility that existing policy settings will allow for sustainable spending growth rates at or below 3 per cent each year, due to susceptibility of spending programs to demand shifts.

Further information on trends in government expenditure over the last 50 years is provided in analysis prepared by Stephen Anthony of Macroeconomics for the BCA at Attachment 1.

10. *BCA Budget Submission 2013–14: Towards Fiscal Repair*, based on Deloitte Access Economics analysis.

RESTRAINING GROWTH IN FUTURE EXPENDITURE

The BCA has not sought to conduct an exhaustive audit of current government spending and identify fully formed proposals for controlling future expenditure growth. Instead we have set out below the key tasks that we believe the NCOA must complete if it is to be successful, along with 9 principles for maintaining efficiency of government and thereby restraining growth in future expenditure. In articulating these principles, the submission highlights their implications including some of the key questions and fiscal trade-offs that they present for government and the community given current expenditure settings.

The task of the audit

There are six key tasks that the NCOA must complete if it is to successfully map out a path for sustainable expenditure over the medium and longer term.

1. Set the overall parameters for fiscal policy over the next decade

The NCOA should establish the broad set of fiscal parameters, under which fiscal policy will be set over the next decade. This should include establishing an indicative timeline in which the government should return to surplus in order to define the size of the fiscal task in Australia over the medium term, complementing the long-term view established by the Intergenerational Report.

A critical re-examination of the Commonwealth Government's fiscal policy rules will also be imperative in establishing the overall parameters for 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.

2. Undertake a stocktake of expenditure

The audit should outline in detail the current composition of government outlays including those areas that are growing the fastest along with a critical assessment of where some of the greatest inefficiencies may exist. It should also identify the size of expenditure, which is currently committed beyond the forward estimates that has not had a sizeable impact on the budget to date.

There is also a need to 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 but may ultimately impact expenditure.

3. Repair the budget as much as possible in the short term by reducing the most inefficient outlays

This could include reducing staffing levels in some areas, removing whole functions, bodies or programs not central to the key priorities of the Commonwealth Government. Programs that are not achieving their objectives or that are too small to justify their administrative costs should be removed as a matter of course. All programs must be demonstrated to be achieving their intended outcomes, with some requiring a business case for continuation.

4. Identify strategies to restrain growth in major government outlays over the next decade through better targeting of payments and improved service delivery

These could be the most politically challenging gains to achieve but must be considered on the basis that they could deliver the most important contribution to improving the budget position over the long term.

The audit will need to devote considerable time to identifying steps that governments can take to deliver services more efficiently in areas like health, education and disability. It should also outline opportunities to privatise assets and outsource service provision while maintaining a strong safety net for those who most need it.

It will also need to facilitate long-term structural budget changes through effective transitional arrangements, including phased introduction and some preservation of existing arrangements for those most in need. The previously announced phased increase in the age at which the aged pension becomes available is an example of such arrangements.

5. **Identify areas of overlap, duplication and potential inefficiency between the Commonwealth Government and the states for further investigation.**

Around two-thirds of expenditure across the federation is attached to shared expenditure responsibilities between the Commonwealth and state governments, bringing considerable potential for duplication, overlap and inefficiency of administration.[11] This level of shared expenditure has grown over time.

The Commonwealth Government needs to retreat from the detailed micromanagement of state service delivery by simplifying its administration of funds to the states and focusing on the high-level strategic reforms that will create the right institutions for efficient service delivery.

6. **Identify how services can be improved in respect of outcomes**

There is a need for ongoing initiatives and institutions that focus on delivering improved public services within a constrained fiscal environment including public sector productivity targets.

This will be the most effective way of ensuring the public service innovates and fundamentally changes the way that it delivers services do that it can better meet public expectations within fiscal constraints. Initiatives such as New Zealand's Better Public Services have shown the possible gains in this regard.

Suggested principles for responsible expenditure

Audit exercises conducted in Australia and other jurisdictions have developed clear principles for the role of government and more efficient expenditure to assist in these tasks. Such principles provide a useful anchor for identifying proposals to reduce expenditure growth. The BCA's proposed principles are outlined below.

1. **If government is to be efficient, the starting point must be an expenditure base that aligns with carefully targeted functional and strategic priorities.**

Description

Determining what government should and should not do is an inherently subjective task, and the answer will change over time to reflect the priorities of the government of the day, changing community attitudes and societal and technological progress. However, it is generally accepted that there are basic functions that government (both Commonwealth and states) must do, these include:

- Uphold the law and property rights
- Provide a sound, stable financial system and provide the means of exchange
- Ensure a minimum standard of living below which citizens should not fall
- Provide for the defence and security of the nation
- Ensure the community is provided with public goods that cannot be provided by private markets

Current issues

The current fiscal position necessitates a greater focus on the prioritisation of expenditure and the NCOA should provide an informed basis for making decisions on those priorities.

With the release of each budget, the focus is primarily on new spending programs, with very little assessment of existing base expenditure. Program-specific budget estimates were effectively removed from budget papers in 1998–99 with the start of accrual accounting. As a result, there is

11. See Footnote 7.

limited information in assessing the policy performance of government programs and how these programs align with government priorities.

Possible implications

The careful prioritisation of expenditure should have a number of implications for government:

- When the government chooses to introduce a new program into the budget, the first question must be how existing spending could be re-prioritised to accommodate the new program.
- The urgency of new proposals must also be assessed, including whether the proposal needs to be introduced or committed in the current budget.
- For high-priority government functions, the focus of savings efforts will be on delivering these more efficiently or more effective targeting. Restoring or increasing levels of funding for a particular area of the budget may have merit in some instances, but the efficiency of existing spending should be the first concern.
- For lower-priority government functions, there may be a need for restructuring or rationalisation.
- There is also a need for increased scrutiny and reporting of existing program expenditures on a periodic basis. Government should not wait another 17 years to conduct a review of existing program expenditures. Increasing the transparency of existing program expenditures and conducting more frequent reviews of expenditure may need to become part of the budgetary framework.

2. Government should provide a strong and sustainable core safety net for the most disadvantaged in society.

Description

The Australian social compact is predicated on having an acceptable social safety net. If this safety net is to be affordable over time then it must be tightly targeted to the most disadvantaged in society. The core safety net should include items such as disability care and support, Newstart, support for carers and pensions.

Current issues

Social security and welfare has grown from around a fifth of the budget in the 1960s to just over a third of the budget in the last two decades.[12] Drivers of the growth in absolute levels of payments in the last decade have included payments to people with disabilities, the aged and families with children. For example, welfare payments for the aged have almost doubled as a proportion of the budget in the last two decades. The ongoing growth of expenditure in social security and welfare while remaining relatively stable as a proportion of the overall budget in the last two decades has been facilitated by the strong economic growth, which cannot necessarily be assured over coming years.

Recent examples such as the introduction of DisabilityCare have shown little appetite from governments to explicitly explore trade-offs from existing expenditure with the community when seeking to fund worthy new programs for the most disadvantaged in our society. For example, it would be difficult to argue that there are not lower priority expenditures in the Commonwealth Budget or people less deserving than those who would benefit from DisabilityCare.

Possible implications

If Australia is to continue to have a strong and sustainable safety net without increasing taxation then government will need to be vigilant in ensuring that its payments are tightly targeted and grow at a reasonable rate. This will involve confronting issues that have proven to be contentious in the past.

12. Macroeconomics estimates. See Attachment 1.

As the population ages it will become increasingly important to ensure that age pension arrangements are well targeted and appropriately means tested to take account of people's capacity to fund their retirement based on income from superannuation and other assets.

Reforms to social security and welfare should not involve leaving the most disadvantaged Australians in the lurch, but rather slowing down the rate of growth of payments and more tightly targeting payments so that we have the capacity to respond to social issues and help those most in need. For example, to enable an increase to the rate of Newstart.

In approaching this task, relevant questions that will arise are:

- Is it fair and affordable for families with a combined income of up to around $170,000 to receive family tax benefits when the median family income of couples with children is around $120,000?[13]
- Should older households that have accumulated significant savings through superannuation and other concessionally taxed savings also receive support for cost of living expenses through payments such as the age pension, Seniors Supplement and Commonwealth Seniors' health card?
- Have the risks of cost escalation for DisabilityCare been rigorously tested and plans to mitigate these risks been developed?

3. **Outside of delivering a core social safety net, government spending should be focused as far as possible on lifting the productive capacity of the economy through areas such as infrastructure, education, tax reform and deregulation.**

Description

Discretionary spending needs to be firmly focused on areas that have the greatest potential to lift the productive capacity of the economy, including infrastructure and education and training, especially where these investments cannot be sufficiently paid for by the users or beneficiaries. This will assist in the contribution that economic growth can make to an improving budget position.

Current issues

We will need to invest in new infrastructure to service urban and regional areas of Australia experiencing population and economic growth. Infrastructure services are important for growing productivity and workforce participation as well as lifting standards of living. How we pay for our future infrastructure needs is a critical question for public policy. In principle the users and beneficiaries of infrastructure should pay for its provision wherever feasible. However, there remains a need for governments to fund infrastructure where user-pays does not lead to sufficient infrastructure provision, because there are additional benefits to society to be gained or because of social equity reasons.

An additional consideration is that resources investment is estimated to have peaked at 7½ per cent of GDP in 2012–13[14] and is now expected to fall, which will detract from employment and growth. This can potentially be offset with new investment in high quality infrastructure.

Education and training will also be important for lifting productive capacity. The COAG Reform Council has found that while workforce qualification levels have risen in recent years, many adults still do not have the literacy and numeracy skills needed in a modern economy. In 2011–12, 12.4 per cent of working age Australians were at the lowest level of literacy and over 19.9 per cent had the lowest level of numeracy.[15] Therefore education and training must remain a focus of spending to lift the productive capacity of the economy.

13. Based on 2011 Census data.
14. RBA, *Statement on Monetary Policy*, November 2013, p. 33.
15. COAG Reform Council, *Education in Australia 2012: Five Years of Performance*, October 2013.

With the terms of trade coming down and population ageing starting to impact labour utilisation, national incomes are likely to come under pressure in the coming decade. It is now more important than ever that as much of Australia's government spend as possible is focused on lifting the productive base of our economy.

Possible implications

Sources of funding for infrastructure beyond traditional government spending need to be considered. Governments should recycle funds currently locked up in mature assets by selling them to the private sector (e.g. superannuation funds) and reinvesting the proceeds in new infrastructure projects.

Australia's infrastructure should be paid for by users or beneficiaries wherever feasible, and there is more that can be done to increase user charges as a funding source. Value-capture options should be pursued so that local landholders and businesses make a contribution based on the increases in property values.

Governments will continue to have an important role to provide funding for significant national public infrastructure investments where user-pays is not the best option, so a minimum amount of spending on infrastructure should be maintained and federal borrowing should be considered for infrastructure with high net social rates of return, as demonstrated by cost-benefit analysis. Subject to the same rigorous evaluation of projects, the federal government should also consider offering debt or revenue guarantees to support projects which would appear as a contingent liability.

Governments will need to take concerted action to design, fund and deliver projects, in order to maximise gains to productivity and future growth prospects for each dollar spent. There is a critical role for Infrastructure Australia to help in identifying priority projects suitable for both public and private investment. An openness to explore new sources of funding and financing for infrastructure will also assist in providing a reasonable return on investment on each project.

To mitigate the effects on the economy from slowing mining investment, academics such as Bob Gregory and Warwick McKibbin, conclude that infrastructure investment can play a critical role in offsetting some of the gap created by declining resource investment. In terms of education, spending has increased by an annual average of 7.7 per cent in real terms over the last decade[16] but without a commensurate improvement in outcomes. The focus of future reforms here must be on improving the efficiency and effectiveness of current spending as part of any further funding increases.

Industry subsidies must also be scrutinised to ensure that they are well targeted, temporary in nature and contributing to enhanced long-term productive capacity of the economy. Subsidies must facilitate adjustment rather than providing passive support. The Productivity Commission should assess all proposals for industry assistance prior to budgetary decisions being made.

4. Wherever practicable, a function of government should be undertaken at the lowest level of government.

Description

The Australian federal system of government offers great potential to drive reform and growth. Where responsibilities and powers are divided across multiple jurisdictions constructive competition is possible and governments are able to be more efficient, responsible and accountable to their communities.

However, without vigilance and the right institutional and governance mechanisms these benefits can be outweighed by overlapping regulatory and legal systems, duplication of effort and poor coordination of complementary services delivered by differing level of governments.

16. Macroeconomics estimates, see Attachment 1.

Shared responsibilities and the system of Commonwealth grants to the states can also lead to a breakdown in accountability. This in turn drives the 'blame game' and often results in arguably unnecessary accountability regimes and reporting requirements.

Current issues

Australia's constitution permits a high degree of concurrency between the Commonwealth and states, which has led to confused roles and responsibilities and inefficient delivery of services where the two levels of government share responsibility. There is also potential for overlap between state and local governments

The 2008 Intergovernmental Agreement on Federal Financial Relations (IGA FFR) attempted to better define the roles and responsibilities of each level of government. It also sought to streamline administration of Commonwealth grants to the states by removing input controls on expenditure and prescriptive reporting and accountability requirements.

However, the intent of the IGA FFR has not been fully realised and inefficiencies and duplication continue to arise from blurred roles and responsibilities between governments. For example:

- As of 2011 there were over 230 regulations, programs and policies across all levels of government for reducing carbon emissions.[17]
- The Commonwealth and states administer 125 National Partnerships, with $12.8 billion of funding attached to them demonstrating the administrative inefficiency of intergovernmental funding arrangements.[18]
- Despite the best intentions, cooperative reforms have often simply increased the potential for unnecessary duplication and overlap. Australia has one national consumer law administered by 10 different regulators. The national Work Health and Safety scheme has left in place all of the pre-existing state regulators and expanded the role of the Commonwealth regulator.
- The 2011 health reform package saw the Commonwealth inject an additional $16.4 billion of funding over five years along with 3 new government agencies, employing around 130 staff in 2013–14.

Possible implications

A failure to come to grips with overlapping roles and responsibilities in the federation will lead to ever increasing inefficiencies as spending on health and education grows, and will stifle vital reform.

Improvements in this area must focus on:

- Achieving a clearer demarcation of roles between the Commonwealth and state governments.
  - A clear lead coordination role needs to be established in areas where responsibility for services is shared. Where it makes sense to do so, the lead jurisdiction should administer services on behalf of the other level of government in order to achieve full integration. The current policy to accredit state government environmental assessment and approvals processes is a good example of this.
  - The Commonwealth's role in the delivery of social services, such as health and education, needs to be critically examined.
  - In areas of economic regulation of national markets, there is a need to assess if the push to national harmonisation, through the National Partnership to deliver a Seamless National Economy has delivered the outcomes that were desired. While several national schemes have been established, a number of state regulators have been left in place to administer these schemes and national regulatory oversight has been added. It is an open question if the

17. Productivity Commission, *Carbon Emission Policies in Key Economies*, May 2011, p. xvi.
18. COAG Reform Council, *COAG Reform Agenda: Report on Progress 2012*, September 2012, p. 25 and estimated National Partnership payments for 2013–14 as per Budget Papers.

benefits of regulatory competition embedded in this model do indeed outweigh a truly national approach.

- Establishing reform payments to the states that are linked to productivity and achieving reform outcomes.
- Reducing the level of expenditure particularly at the Commonwealth level, associated with oversight of service delivery.
  - It is appropriate to question whether the operational cost of around $1.5 billion for the Commonwealth departments of Health and Education is excessive when so much of their role entails oversight of service delivery conducted by the states and other providers. This is especially the case when there are substantial bureaucracies already at the state level supporting the health system. For example, in NSW there are over 27,000 non-clinical staff supporting over 77,000 clinical staff.[19]
  - Better use could be made of state based accountability mechanisms (such as Ombudsman, public reporting arrangements, Auditors General, state parliamentary public accounts committees) to provide public accountability for Commonwealth payments to the states. This would assist in removing excessive reporting requirements and the need for Commonwealth public servants and agencies to monitor state public servants.

5. Wherever practicable and affordable, those with adequate means in the community should pay for infrastructure and services.

Description

If implemented effectively, co-payment or cost-recovery models can improve both the efficiency and equity of government service provision. It sends an important signal to the public about the costs of providing certain services by requiring individuals to contribute to at least some of the service cost as well as reducing overall government expenditure.

This also increases the accountability of government for the quality of the service it provides for a clearly identified price. It also serves the objective of equity by placing the cost of the service on those who are receiving the private benefit and are able to pay.

Current issues

While there have been no recent public reports on cost recovery by Commonwealth Government agencies, Productivity Commission work in this area conducted at the beginning of the decade showed negligible cost recovery undertaken at agencies such as Defence; Education, Training and Youth Affairs; Veterans Affairs; Health and Ageing; and Family and Community Services. For agencies that did undertake cost recovery, it ranged from 3.8 per cent all the way up to 51.1 per cent of agency expenditure.[20]

Possible implications

Prosperous societies tend to value health care highly, and Australia is no exception. As our incomes have grown, governments and individuals have tended to spend more on health care, and we continue to do so. While the benefit of this expenditure accrues to the community, such as when it is spent on public health measures, much of the benefit is private.

As Australians live longer and continue to take greater advantage of new medicines and treatments, it is logical to expect that they should allocate more of their budgets to paying for these services just as governments do. While private expenditure of health and ageing has already increased, there remain considerable opportunities for individuals that directly benefit to contribute more in the future.

19. NSW Government, *Annual Report 2012–13*, NSW Health, p. 32.
20. Productivity Commission, Report No.15, 2001, p. 68.

The Commonwealth Government will pay up to $8.8 billion in permanent residential aged care assistance subsidies in 2013–14 at an average subsidy of around $50,000 per year. This may become unsustainable with the number of permanent aged care places expected to increase to over one million.

In response to the Productivity Commission's review of aged care, the levels of fees, charges and bonds levied on aged care residents have expanded, although caps on fees are in place and the family home remains included in means testing only at a low notional value. While the response to the Productivity Commission review was a step in the right direction, there is broad consensus that the contribution that individuals make to their cost of care will need to be revisited as the aged population increases. Indeed, many retirees have significant private means and capacity to contribute to their care in later life. The earlier that individuals are called upon to make a greater contribution, the greater will be the ability of governments to apply new arrangements prospectively and provide time for people prepare their finances for this outcome.

In health, specific levies, taxes and charges hypothecated for health services tend to under-recover the cost, with the difference made up from the broader tax system. For example, the Medicare Levy will in 2013–14 raise just over $10 billion for around $19 billion of services.[21] In jurisdictions such as the Netherlands, government spending is in effect capped through direct hypothecation from payroll tax and health insurance premiums play a larger role in funding health services. While co-payments have the potential to be regressive by affecting the sickest in the community, Australia already has mechanisms in place like the Medicare safety net to assist those most in need.

6. Government should only regulate where there is a clear market failure and benefits exceed costs.

Description

The decision to regulate is often a trigger for new spending. New regulation will inevitably involve additional monitoring, oversight and data collection for new or existing regulatory agencies. Its design, particularly when overly complex and poorly scoped will require considerable legislative drafting and policy resources. The Commonwealth Government intervening in market failures best addressed at a state or local level will also result in additional costs incurred in obtaining new knowledge.

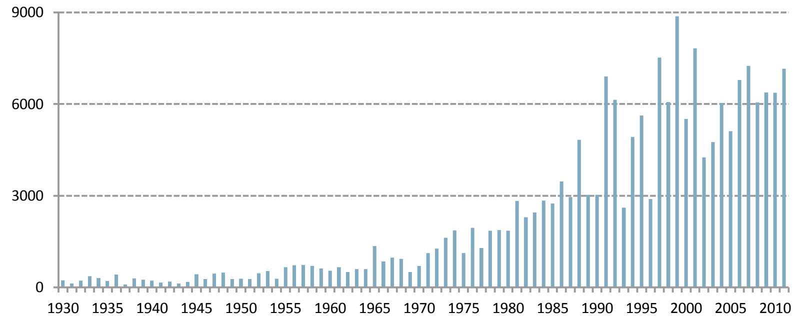
Properly understanding and identifying the nature and extent of a market failure is a task that is often abandoned in the interests of expediency when government introduces new regulation. Properly identifying and understanding the market failure and implementing a regulatory solution proportionate to the risks associated with that market failure will avoid unnecessary expenditure associated with the regulation.

Current issues

The recent growth in legislation at the Commonwealth level would suggest that if anything the potential for inefficiency of expenditure arising from regulation has grown.

21. Based on 2013–14 Commonwealth Budget papers.

Figure 6: Commonwealth Government: Pages of new legislation (Annual)



Source: Deloitte Access Economics, 'Reforming Australia's Regulatory Culture', unpublished, 2011.

While there is no consolidated information on the resources of Australia's different business regulators at the Commonwealth and state levels, the sample of 10 significant Commonwealth Government regulators outlined in Table 1, demonstrates the additional expenditure and resources that have been required to administer regulation over the last decade. Between 2001–02 and 2011–12, expenditure for these regulators grew by over 75 per cent, while the number of staff employed increased by around 27 per cent.

The current lack of transparency in this area is illustrated by the recent Commonwealth Government initiatives directed at the reform of regulators. These included a commitment to publish a consolidated list of Commonwealth regulators, which currently does not exist.

Table 1: Sample of 10 significant Commonwealth Government Regulators

Regulator	Expenditure ($000)		Total staff	
	2001–02	**2011–12**	**2001–02**	**2011–12**
Australian Customs Service^	706,842	1,135,400	4,891	5,671
Australian Maritime Safety Authority^	71,530	169,400	243	332
Australian Prudential Regulation Authority	59,231	121,119	424	624
Australian Securities and Investments Commission	159,900	384,488	1,284	1,738
Civil Aviation Safety Authority^	106,819	173,498	727	818
Australian Pesticides and Veterinary Medicines Authority^	20,623	30,332	129	181
Australian Taxation Office^	2,028,311	3,444,183	19,318	24,740
Australian Competition and Consumer Commission^	72,185	179,063	540	876
Australian Communications and Media Authority*^	57,357*	112,769	486	618
Australian Fisheries Management Authority^	27,688	38,378	128	205
Total:	**3,310,486**	**5,788,630**	**28,170**	**35,803**

Source: Regulator annual reports. Note: ^Total staff reported based on total employees as at the end of the financial year. For APRA, total employees applies to 2009–10, with full-time equivalent (FTE) excluding casuals reported from 2010–11 onwards. For ASIC, staff numbers are based on an FTE average over the year. *Based on combined expenditure of previously unmerged Australian Communications Authority and Australian Broadcasting Authority).

Possible implications

The Commonwealth Government must fundamentally rethink its approach to regulation by adopting a risk-based policy that sets realistic expectations in the community of what regulation can achieve and mandate rigorous Regulation Impact Statements that provide detailed quantification of the costs to business and government. Where the government chooses to streamline or repeal regulation in line with its $1 billion annual target, then the administrative expenditure associated with that regulation must also be removed. For example, if the Australian Jobs Act 2013 were to be repealed, then the Australian Industry Participation Plan Authority could be abolished.

7. **Government service delivery should as far as possible follow market principles and be fully contestable to drive innovation.**

Description

Government should only deliver services where it is best placed to deliver them efficiently and effectively. Cost-effective service providers from the private and community sectors should have the opportunity to tender to deliver services.

Even where government is best placed to deliver a particular service, it should be periodically benchmarked against other jurisdictions and the non-government and private sectors to ensure that this remains the case. This has the added benefit of providing 'competition by comparison' and the potential for service contestability, which should provide incentives for increased efficiency.

Some sectors that are heavily regulated do not operate as efficiently as they might in either the public or private sector. This is particularly the case where there is poor alignment between the incentives of providers and the desired outcomes – for example in parts of the health sector.

Current issues

As Gary Sturgess suggests, there are currently limited incentives for public servants to engage in the innovation of service delivery models.[22] In addition, a lack of real contestability and innovation is also likely to be opposed by those stakeholders who benefit from the insulation from competition. There would appear to be a range of opportunities to increase the efficiency of Commonwealth Government programs by better harnessing the forces of the market and contestability.
For example:

- Work by the Productivity Commission and work commissioned for the National Health and Hospitals Reform Commission suggests that there is scope for an improvement of 20 to 25 per cent in health sector efficiency, including both public and private sectors.
- The Pharmaceutical Benefits Scheme (PBS) is the Commonwealth's seventh largest spending program and is growing well in excess of the economy in real terms, and Australia pays more for generic drugs than many other countries. The eight generic drugs that receive the largest subsidies under the PBS were two to 30 times more expensive than those in comparable countries.[23] For example, New Zealand pays a sixth as much as the PBS for the same drugs. This is because unlike the PBS, New Zealand requires independent experts to decide on which medicines are subsidised within a capped pharmaceutical budget. The same New Zealand agency (Pharmaceutical Management Agency) directly negotiates pharmaceutical prices with suppliers, unlike the PBS.
- There remain areas where the ongoing case for government ownership could be revisited, including the Defence Housing Authority, Australia Post and Australian Rail Track Corporation.

Possible implications

The Commonwealth Government must provide an institutional framework and culture that incentivises greater innovation in program delivery. There are a range of opportunities for governments to either open up its operations to greater market forces or to dramatically innovate the way in which it delivers services.

- The government has plans to sell Medibank Private. It should also explore the case for privatising further Commonwealth Government assets where it is in the public interest to do so.

22. G. L. Sturgess, *Diversity and Contestability in the Public Service Economy*, NSW Business Chamber, June 2012.
23. P. Clarke, 'The Price Is Wrong: Pharmaceutical Expenditure in Australia over the Last Decade and Options for Reform', in CEDA, *Healthcare: Reform or Ration*, April 2013, p. 48.

- The Department of Human Services currently delivers Medicare, Child Support, Centrelink and Commonwealth rehabilitation services from 598 service centre locations.[24] This co-location program has seen a significant reduction in the number of physical outlets and could be even further accelerated as more services are accessible online.
- For new substantial programs such as DisabilityCare there will be a need to ensure that the incentives and service delivery framework developed up-front are right to deliver quality services at the most efficient price.
- The government should explore ways of ensuring that Australia gets better value for money from the PBS. For example, requiring PBS decisions to be subject to an overall budget cap, and enabling the PBS to negotiate directly with suppliers would strengthen PBS's accountability for managing the total cost of Commonwealth Government pharmaceutical subsidies.
- Govt should consider whether it can further accelerate the cost savings and user convenience of online service delivery through secure MyGov online accounts by:
  - Increasing the number of users beyond the current 2 million
  - Expediting negotiations with the private sector and state governments
  - Exploring opportunities to offer users a biometric as a third factor of authentication
  - Extending to other levels of government.

8. Government budgetary decisions should as far as possible maintain a reasonable level of intergenerational equity.

Description

In principle, current government budgetary decisions should not leave future generations worse off. That is, the current generation should not be able to receive the benefits of higher expenditure or lower taxes for a period if it then leaves future generations to face the fiscal consequences.

Current issues

The last Intergenerational Report in 2010 by the Commonwealth Government and intergenerational projections like those commissioned by the BCA demonstrate that without policy change to adapt to an ageing population, future generations will pay the substantial fiscal cost of current policy settings. That is, through combined annual fiscal deficit across all levels of government in Australia of 5 per cent of GDP by 2050, or around $75 billion in today's terms.

Possible implications

The preceding principles have outlined some areas that will require further policy attention if Australia is to fairly and affordably accommodate an ageing population.

In addition, we may need to accept further targeting of the retirement system over time to address the long-term fiscal gap. These are difficult issues to discuss and resolve but they will need to be confronted if future generations are not to be left with a substantial debt that must be paid through higher taxes or lower expenditure.

On the expenditure side, there may be a need to question whether it remains appropriate for the family home where it is of considerable value to continue to be included in the age pension assets test only at a low notional value. There would be a number of issues to resolve depending on the extent to which the value of owner-occupied housing was further incorporated into the assets test. For example, there would need to be consideration of mechanisms that still allowed pensioners to remain socially connected in their family home and receive an age pension.

The current male pension age is 65 and will slowly increase to 67 by 2023. The pension age has remained at 65 since 1909 despite life expectancy increasing from around 55 at the start of the

24. Department of Human Services, *Annual Report 2012–13*, p. ii.

century to around 82 today. In its 2012–13 Budget submission, the BCA supported indexing the age pension age to future increases in life expectancy. This proposal remains relevant and has been the subject of increasing discussion and analysis, including most recently from the Productivity Commission. It is important to acknowledge that any future increases in the pension age would need to consider the ability of some Australians to work beyond the age of 65 and the resulting movement of some older Australians into receiving Newstart, Disability Support Pension and the drawing down of superannuation balances more quickly.

While there is limited data available, it is estimated that around a third of retirees take lump sums from their superannuation.[25] Where these lump sums fund repayment of owner-occupied housing or current spending, then these people may subsequently be eligible for an age pension. Annuities will likely need to play a greater role and consideration will need to be given to linking lump sum payments to specific circumstances.

9. The administrative cost of delivering government programs and policy should not be excessive relative to the community benefits.

Description

Where the administrative cost of delivering a government program is excessive relative to the total value of the program, then it is likely the result of inefficient administration or administering a program that has a very narrow purpose and limited economic and social reach in the community.

Current issues

It appears that there are opportunities for the Commonwealth Government to achieve greater efficiencies in administration of its most important program and policies and to rationalise the number of programs it administers. For example:

- As Macroeconomics estimates show, there are some 480 programs in the budget that account for just 5 to 6 per cent of spending in a typical year.
- The recurrent cost of these small programs and the administrative inefficiency associated with them have never been analysed. 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 administrative cost of governing has grown considerably in the last decade. General public services at the Commonwealth Government level, which excludes service delivery and transfers have grown at around 7.2 per cent per annum over the last decade.[26]
- The government spent $5.1 billion on industry assistance in 2011–12 across 97 measures, with 70 of these measures accounting for just $600 million, an average of just under $9 million per measure.[27]
- Based on the latest available information, the Commonwealth Government consists of 932 bodies including a range of agencies, authorities and other organisations.[28] 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.
  - This includes over 136 “advisory” bodies, outside of core agencies.
  - Over a third of all bodies come from just three portfolios: Environment; Families, Housing, and Community Services; and Innovation, Industry, Science and Research.

25. BCA calculation based on ABS, *Retirement and Retirement Intentions*, cat. no. 6238.0, July 2010 to June 2011.
26. ABS, *Government Finance Statistics, Australia, 2011–12*, cat. no. 5512.0.
27. Macroeconomics estimates.
28. Department of Finance and Deregulation, List of Australian Government Bodies and Governance Relationships as at 1 October 2009.

Possible implications

It would appear that reasonable short-term savings may be achievable through the rationalisation of government programs and bodies – either through their abolition or absorption into other agencies. In the case of small government programs, this may involve placing a sunset date on programs under a certain level of expenditure, with these programs subject to the requirement to submit a compelling business case if they are to continue. In the case of government bodies, it would appear that a focus on advisory bodies with the largest expenditure requirements and the bodies from the portfolios outlined above may yield some savings. While the savings in this area may be seen as less substantial than other areas, efficient expenditure in government machinery and administration should be a hallmark of good governance and budgetary housekeeping.

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Business Council of Australia Submission
to the
National Commission of Audit

Attachment 1: Report by Macroeconomics

‘A Primer on Public Expenditure Trends in Australia’

December 2013

A primer on public expenditure trends in Australia

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MACROECONOMICS

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Contents

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Glossary of fiscal terminology and concepts

Discretionary fiscal policy – refers to explicit decisions by governments to change policy settings, thereby affecting budget aggregates. A discretionary tightening of fiscal policy either increases tax rates (and revenue) and/or reduces spending. Conversely, a discretionary loosening of fiscal policy either reduces tax rates (and revenue) and/or rises spending.

General government sector – that part of the public sector whose agencies mainly provide non-market goods and services to the public, paid for indirectly by taxpayers.

Underlying cash balance – a measure of the overall budget position that comprises all the cash received from operating activities and from sales and purchases of non-financial assets, less finance leases and similar arrangements. Conceptually similar to the fiscal balance (an accrual measure), it will differ in any given period as it makes no allowance for non-cash (such as depreciation).

Introduction

The Australian Government's fiscal strategy is in need of comprehensive reform, the primary aim of which should be to return the Federal Budget to a sustainable footing and to keep it there. Controlling the quantum and quality of government expenditure will help to underpin growth and stability in the macroeconomy and increase efficiency in micro markets.

This paper provides a broad overview of spending trends for both Commonwealth and State General Governments.

First, we analyse the spending pressures faced by the Commonwealth, including outlays by program categories.

Second, we analyse the spending pressures faced by the States and how those trends have been impacted by the Commonwealth.

Commonwealth Spending Trends

This section examines Commonwealth general government spending tends in both historical and forward-looking terms. In the process, it probes more deeply into some of the longer term drivers of spending growth.

Table 1: Assessing the sustainability of Australian general government spending

	1962-63 to 1971-72 %	1972-73 to 1981-82 %	1982-83 to 1991-92 %	1992-93 to 2001-02 %	2002-03 to 2011-12 %
Economic growth					
Nominal	9.6	14.8	9.3	6.0	6.9
Real	5.5	2.9	2.8	3.9	3.1
Spending growth					
Nominal	10.4	17.8	10.2	6.4	7.0
Real	7.0	6.8	3.2	4.0	4.2
Share of GDP					
Total spending	17.5	22.4	25.2	24.9	25.6
Total revenue	19.2	21.9	23.7	23.9	24.7

Source: Australian Bureau of Statistics and Macroeconomics estimates. Subject to rounding.

When public spending grows below the rate growth in the economy over time, the size of government will fall, and there is scope to lower the burden of taxation over time. Governments should not need to run deficits or accrue public debt (which is a form of deferred taxation).[1] However, Table 1 illustrates the reality. For most of the past 50 years, both nominal and real public spending growth has outstripped growth in the economy. Consequently, spending as a share of GDP has risen from 17.5 per cent in the 1960s to 25.6 per cent in the 2000s. At the same time, the total revenue burden has risen from 19.2 per cent of GDP to 24.7 per cent of GDP.

Despite periods of restraint, the long-run track record of Federal Government expenditure control is not strong. Since 1991-92 trend real spending growth has averaged around 4.1 per cent per year, exceeding growth in the real economy which has averaged around 3.5 per cent annually.[2]

Whether the increasing size of government has weakened growth prospects is a matter of debate. Among advanced economies internationally, Australia has a relatively smaller size of Government. The Federal Treasury has argued that the optimal size of government is not a question that can be answered by technical economic analysis.[3] Yet there is strong international evidence that an overly large and growing size of government is not conducive to growth or rising living standards.[4] The main reason is that the welfare loss from growth in the public sector rises exponentially with increases in the tax burden. Hence, it is reasonable to conclude that living standards in Australia will be impacted adversely if the size of government is not stabilised over time. The key to maintaining stability in the size of government is to cut inappropriate, inefficient or ineffective spending wherever it exists.

Historical drivers of spending growth by function

Since the 1960s, expenditures on social security, health and education have been key drivers of growth in the Commonwealth Government spending share of the economy. Between the 1960s and

2000s, the share of total budget spending on social security and welfare payments has risen from 21 per cent to around 35 per cent (Table 2).

Table 2: Growth in the social security budget

	1962-63 to 1971-72 %	1972-73 to 1981-82 %	1982-83 to 1991-92 %	1992-93 to 2001-02 %	2002-03 to 2011-12 %
Social security and welfare (total)	**21.2**	**26.4**	**29.1**	**35.7**	**34.5**
Average real growth	4.5	11.9	5.3	4.6	3.9
Income support in total	**21.0**	**26.1**	**28.6**	**34.2**	**31.7**
Average real growth	4.4	11.9	5.1	4.1	3.5
Welfare services for the aged	**0.2**	**0.4**	**0.5**	**1.5**	**2.8**
Average real growth	10.0	12.2	18.1	23.5	8.6

Source: Australian Bureau of Statistics and Macroeconomics' estimates. Subject to rounding.

A more detailed picture of the growth of Federal social security payments category areas over the last decade is provided in Table 3. The key drivers of growth in the social security function have been payments to people with disabilities, the aged and families with children.

Table 3: Social security expenditure by category

	Real growth 2002-03 to 2011-12 %	Total budget share 2011-12 %
Assistance to the aged	4.8	12.8
Assistance to veterans and dependants	-0.1	1.9
Assistance to people with disabilities	7.3	6.1
Assistance to families with children	4.0	9.2
Assistance to unemployed and sick	0.3	2.0
Other welfare programs	48.8	0.3
Aboriginal advancement nec	-3.0	0.3
General administration	4.5	1.0
Total social security	**3.9**	**33.6**

Source: Australian Government Final Budget Outcomes.

Another major source of expenditure growth has been health spending which has risen from 7.3 per cent to 15.1 per cent of total spending since the early 1960s, and grown by 5.7 per cent in real terms over the last decade alone (Table 4). Key drivers of recent growth in the health budget are community health service programs (including Medicare and Private Health Insurance), public health service programs (population health, hearing services, blood products, e-Health etc.), the Pharmaceuticals Benefits Scheme and medical research funding.

Table 4: Growth in the health budget

	1962-63 to 1971-72 %	1972-73 to 1981-82 %	1982-83 to 1991-92 %	1992-93 to 2001-02 %	2002-03 to 2011-12 %
Health spending share (% of budget)	**7.3**	**9.5**	**11.8**	**14.3**	**15.1**
Average real growth	9.1	16.7	6.7	4.9	5.7
Other community health services	**1.4**	**2.3**	**3.8**	**5.1**	**5.8**
Average real growth	15.5	14.6	13.2	5.6	6.0
Admitted patient services in acute care institutions	**2.5**	**4.2**	**4.7**	**4.4**	**4.0**
Average real growth	6.2	41.2	3.4	2.5	3.4
Pharmaceuticals, medical aids and appliances	**2.4**	**1.5**	**1.2**	**2.2**	**2.8**
Average real growth	6.0	-0.6	5.1	11.3	4.6
Public health services	**0.2**	**0.4**	**0.1**	**0.4**	**1.4**
Average real growth	6.4	31.0	-4.7	39.1	13.9
Health research (total)	**0.0**	**0.1**	**0.1**	**0.3**	**0.7**
Average real growth	11.6	19.8	13.4	22.3	11.4

Source: Australian Bureau of Statistics and Macroeconomics estimates. Subject to rounding.

Other key drivers of the rising Commonwealth general government spending share over recent years are summarised in Table 5. Total spending on education has been rising over the last decade, including spending on primary and secondary education is growing by around 6.3 per cent in real terms. High growth rates have been seen in the "Other economic affairs" programs of the budget which relate primarily to labour market assistance and asylum seekers. Fuel and energy programs have also had strong growth in the last decade due to the mining boom.[5] This trend will likely reverse over the next decade as growth in the mining sector diminishes from historically high levels. Very high growth rates have also occurred in Housing and community amenities at 15.9 per cent (related to public housing and driven by indigenous policy and the GFC) and in Transport and communications at 14.1 per cent, driven largely by spending on roads.

Table 5: Other growth areas in the budget

	1962-63 to 1971-72 %	1972-73 to 1981-82 %	1982-83 to 1991-92 %	1992-93 to 2001-02 %	2002-03 to 2011-12 %
Education (total)	**3.3**	**7.8**	**7.3**	**7.2**	**7.1**
Average real growth	17.8	68.9	2.1	2.2	7.7
Primary and secondary education n.e.c	**0.7**	**2.6**	**2.5**	**2.7**	**3.2**
Average real growth	57.8	22.4	2.2	5.6	6.3
University education	**2.2**	**4.8**	**3.6**	**3.2**	**2.3**
Average real growth	13.7	16.0	0.9	-0.2	4.7
General public services (total)	**8.0**	**6.7**	**5.4**	**4.5**	**5.3**
Average real growth	10.0	3.2	1.9	3.6	7.2
Public order and safety (total)	**0.3**	**0.6**	**0.8**	**0.9**	**1.1**
Average real growth	13.8	13.1	8.8	5.8	6.0
Housing and community amenities (total)	**0.8**	**1.1**	**1.5**	**1.1**	**1.5**
Average real growth	16.9	14.4	12.8	2.6	15.9
Transport and communications (total)	**5.5**	**4.0**	**3.0**	**1.5**	**1.6**
Average real growth	6.7	2.0	2.3	22.1	14.1
Other economic affairs (total)	**1.1**	**1.5**	**2.1**	**2.5**	**2.3**
Average real growth	9.3	11.9	7.4	4.1	7.6
Fuel and energy (total)	**0.3**	**0.3**	**0.7**	**1.0**	**1.8**
Average real growth	3.3	-29.7	13.0	15.5	6.7

Source: Australian Bureau of Statistics special request and Macroeconomics estimates. Subject to rounding.

Historical drivers of spending growth by program

A less well known way of thinking about government spending trends is to analyse spending by actual program. These are not well reported in budget papers so it takes significant effort to generate a database to examine these trends.[6] Over time the largest government spending programs have been accounting for more of the total spending (Table 6). The Top 20 programs now account for 10 percentage points more of total spending then they did some twenty years ago. We estimate that the largest 67 programs account for about 84 per cent of Government spending. Given that the Australian Government has around 550 spending programs, this implies that some 480 programs now account for only 5 to 6 per cent of total spending in a typical year.

Table 6: Composition of Australian General Government Spending by Program Size

(% of budget)	1962-63 to 1971-72 %	1972-73 to 1981-82 %	1982-83 to 1991-92 %	1992-93 to 2001-02 %	2002-03 to 2011-12 %
Top 20 programs	57.12	59.17	57.66	62.47	67.04
Top 30 programs	65.57	65.16	66.01	69.54	75.05
Top 50 programs	n/a	n/a	n/a	72.56	81.15
Top 67 programs	n/a	n/a	n/a	74.10	83.95
Others	n/a	n/a	n/a	18.19	6.27
Departmental Expenses[1]	5.69	5.69	5.69	5.67	5.52
Accounting Variance[2]	2.17	0.86	1.39	2.19	4.34
Total Payments	**100**	**100**	**100**	**100**	**100**

Source: Macroeconomics estimates. Subject to rounding.

Note: 1 Departmental expenses relate to agency running cost such as employee expenses and accommodation costs.

2 Accounting variance relates to differences in the published cash payments series of the Australian Government and the Australian Bureau of Statistics (ABS). In this table we are trying to explain the total ABS cash payments series by employing actual Australian Government payment and expenses data over the fifty year period.

Real growth in the programs continues to outstrip real GDP growth since the early 2000s (Table 7).

Table 7: Real Growth in Australian General Government Spending by Program Size

	1962-63 to 1971-72 %	1972-73 to 1981-82 %	1982-83 to 1991-92 %	1992-93 to 2001-02 %	2002-03 to 2011-12 %
Top 20 programs	5.38	7.30	3.88	5.16	3.07
Top 30 programs	5.19	7.09	3.95	5.00	3.49
Top 50 programs	n/a	n/a	n/a	5.38	3.74
Top 67 programs	n/a	n/a	n/a	5.75	3.72
Others	n/a	n/a	n/a	-2.37	20.65
Departmental Expenses	6.70	6.16	3.51	3.70	2.44
Accounting Variance	2.07	49.34	20.96	22.38	7.63
Total Payments	**6.70**	**6.16**	**3.51**	**3.80**	**4.16**
Real GDP Growth	5.52	2.89	2.79	3.92	3.07

Source: Macroeconomics estimates. Subject to rounding.

The growth path of each of the Top 20 programs is presented in Table 8 below. The highest growth programs over the last decade include Income Support for Carers (11.0 per cent), Private Health Insurance (8.8 per cent), National Partnership Payment to the States (6.3 per cent), Medicare Services (6.1 per cent), Disability Support to Pensioners (6.0 per cent) and support for Non-Government Schools (6.0 per cent).

Table 8: Recent Growth in the Top 20 Spending Programs

	Avg. real growth 2002-03 to 2011-12 %	Real growth 2011-12 %	Share of total 2011-12 %
Revenue assistance to States	1.47	-2.26	12.16
Income support for seniors	4.85	5.20	8.99
Family tax benefit	3.72	6.38	5.08
National Partnership payments to the States	6.28	-13.20	4.79
Medicare services	6.11	6.84	4.62
Disability support pension	5.95	6.27	3.76
Assistance to the States for healthcare services	3.26	1.93	3.23
Pharmaceuticals	4.66	0.36	2.39
Non-government schools	5.95	3.93	2.00
Residential care	5.05	7.24	1.94
Job seeker income support	-1.35	4.42	1.89
Public sector superannuation	1.47	-1.09	1.67
Private health insurance	8.81	13.21	1.51
Parents' income support	1.55	2.29	1.51
Income support for carers	10.99	9.25	1.48
Fuel tax credits scheme	4.72	8.78	1.47
Higher education support	2.41	-10.82	1.47
Army capabilities	-1.23	-2.99	1.36
Air force capabilities	-2.00	5.37	1.09
Child care fee assistance	26.54	9.09	1.09

Source: Macroeconomics estimates. Subject to rounding.

Controlling discretionary spending: the recent track record

Up to now in this paper we have analysed spending trends in the aggregate, by looking both at elements of spending that are demand driven (by entitlement criteria such as social security payments) and those elements which are more discretionary or directly controllable by government.

Non-discretionary elements of the budget are demand driven programs which have eligibility criteria written into legislation that entitle recipients to receive those benefits provided they meet certain eligibility criteria. Growth in these programs is driven by a number of demand specific parameters, along with the broader macroeconomic environment. Once these criteria are mandated by the Parliament, growth in these programs is determined by the program parameters, unless government chooses to modify the program in some way to broaden or narrow the scope of the program.

Discretionary elements of budget are those elements which are directly the purview of the Treasurer to change. These include various grants to the States, local councils and private agencies, agency budgets and especially new spending commitments.

Have recent Federal Government been successful in controlling discretionary spending? Analysis by Macroeconomics, based on the expenditure reconciliation tables in Budget Paper No.1, suggests that in five budget rounds up to 2013 the Rudd Gillard Governments generated new net discretionary spending (including fixed assets purchases) totalling $153 billion. This includes temporary GFC Mark I stimulus spending worth around $70 billion.

Hence, we find a net increase in policy spending of around $83 billion over five years. Higher spending was funded partly by higher discretionary revenues (taxation and charges) of around $72 billion over five years, with the remainder "funded" by higher public net debt.

A comparable analysis of the last five Budget rounds of the Howard Government reveals net discretionary spending of around $133 billion over five years. Note that this period also witnessed net discretionary tax cuts of around $117 billion. Part of the problem here was that the Howard Government had to manage the difficult political issue of what to do with windfall surpluses from the China boom. We also acknowledge that the last five years of the Howard Government were not representative of its overall fiscal record which included paying down significant Commonwealth net debt and the creation of the Future Fund in 2005.

The ten year period also coincides with the China Boom from 2004 onwards where Australian governments were presented with windfall tax revenue receipts. For example, Macroeconomics estimates the windfall commodity income receipts added $160 billion to the Commonwealth budget bottom-line up to 2011-12. Essentially successive Australian Governments spent the proceeds of the China Boom and more.

The tendency in recent years for government to throw money at policy problems as if that was some sort of cure-all needs to be systematically reversed. As Gary Banks, then Chairman of the Productivity Commission, observed in 2009 "Australia's productivity slump was not caused by any lack of spending on education and training, R&D or even infrastructure".[7] Unfortunately, the Australian Government's existing spending review processes are piecemeal, without an overarching strategic framework. Hopefully the Commission of Audit can address this deficiency.

A central problem with recent governments has been the tendency to outspend savings efforts, while continuing to raise expectations about future government spending.

Projected spending growth over the longer term

Looking ahead towards the middle of the century, Macroeconomics' expenditure projections suggest there is no possibility that existing policy settings will allow for sustainable spending growth rates at or below 3 per cent each year. This is due mostly to the susceptibility of a limited number of large Australian Government spending programs to demand shifts, especially those related to public health and ageing.

Public subsidies in certain key programs, which drive down the market cost of service provision, result in excess demand for the same goods as consumers exploit the lack of targeting in the government subsidised services. So greater demand per person for public services then population ageing is driving up the cost of Australian Government spending. The change in the household consumption mix in favour of lifestyle and health goods is combining with the lack of conditionality in the architecture of certain public programs and population ageing (along with rising costs of health technology) to drive up the costs of public service provision. This taste shift will only be exacerbated over the next forty years as an even greater proportion of the population reaches 65+ (see Table 9).

Table 9: Projected Size of Selected Age Cohorts and Their Share of Total Population

	2010	2020	2030	2040	2050
0-64	**19,241,000**	**21,487,000**	**23,584,000**	**25,645,000**	**27,744,000**
	86.51%	83.63%	80.68%	78.72%	77.38%
65-84	**2,600,000**	**3,700,000**	**4,800,000**	**5,600,000**	**6,300,000**
	11.69%	14.40%	16.42%	17.19%	17.57%
85-100	**365,000**	**532,000**	**802,000**	**1,319,000**	**1,815,000**
	1.64%	2.07%	2.74%	4.05%	5.06%
100+	**4,000**	**7,000**	**14,000**	**24,000**	**50,000**
	0.02%	0.03%	0.05%	0.07%	0.14%

Source: Treasury 2010. Subject to rounding

Australian General Government spending is projected to average around 2.7 per cent per annum in real terms over the period 2013-14 to 2057 (Table 10). Larger programs are again expected to account for much of this real spending growth. These include Top 20 spending programs such as income support for seniors (growth of 4.8 per cent, per annum), medical services and benefits (growth of 4.7 per cent, per annum), income support for disability pensioners (growth of 3.7 per cent, per annum) and residential and flexible care (growth of 4.7 per cent, per year).

What is driving growth rates in these programs is a shift in household consumption towards health and well-being expenditures, especially those subsidised by government through Medicare and the Seniors Health Card, coupled with the demographic impacts of the ageing of the population.[8]

Underpinning Macroeconomics' Intergenerational spending projections is the assumption that future governments can keep real spending growth below 2 per cent across many programs in an era of subdued economic growth, while also keeping expenditure growth in high-growth portfolios (such as health) at manageable levels.

However, a key message from these longer term projections is that governments must actively manage those spending programs with real growth rates in excess of 3 per cent annually, while restricting new spending commitments and eliminating existing underperforming programs. This requires much greater fiscal discipline and managerial attention than has been displayed in the past.

Finally, the Australian Government Budget is also impacted strongly by tax concessions (large and small) which reduce the taxable incomes and tax payable by households or business. The 2012 Tax Expenditure Statement details 363 income tax concessions which collectively cost the budget $111 billion (or around one third of budget revenue) before account is taken of likely behavioural impacts which reduce these estimates.

Some of the larger concessions, including those related to taxes on employer superannuation contributions and on super earnings, collectively cost around $32 billion in 2011-12, before behavioural responses were allowed for. Treasury estimates they are likely to grow by more than 5 per cent per annum over the next 20 years and therefore represent a further budget risk. All of the concessions should be treated in the same way as direct budget expenditures for the purposes of program evaluation and the merits of each concession should be periodically re-established.

Table 10: Real Projected Growth of Program Elements in Base Spending

	Estimates 2013-14 to 2016-17 %	Projections 2017-18 to 2026-27 %	2027-28 to 2056-57 %
Key programs			
Revenue assistance to the States and Territories	1.79	2.03	3.00
Income support for seniors	5.71	4.58	5.08
Family tax benefit	1.41	1.38	1.68
National Partnership payments to the States	4.33	1.84	1.99
Medicare services	6.15	3.43	3.92
Disability support pension	2.37	3.89	3.68
Assistance to the States for healthcare services	6.21	4.13	4.21
Pharmaceuticals and pharmaceutical services	2.06	3.18	3.67
Disability Care	35.08	1072.00	1.94
Non-government schools national support	4.86	0.96	0.16
Residential and flexible care	4.69	4.74	4.70
Job seeker income support	0.37	-0.01	0.00
Public sector superannuation	2.06	1.92	1.94
Private health insurance	2.60	2.51	2.54
Parents' income support	0.37	-0.01	0.00
Income support for carers	2.06	1.92	1.94
Fuel tax credits scheme	3.74	2.31	2.47
Higher education support	1.46	1.42	1.29
Army capabilities	2.68	3.87	2.47
Air force capabilities	3.74	3.87	2.47
Top 20 programs	2.79	2.91	3.14
Top 50 programs	2.73	2.60	2.89
Top 67 programs	2.68	2.56	2.86
All others	-0.32	-0.01	0.00
Departmental others	-0.32	-0.01	0.00
Total real growth rate	**2.64**	**2.41**	**2.92**

Source: Macroeconomics estimates. Subject to rounding.

Note: * The high initial growth rate of the Disability Care program are due to its setting up as the program eventually reaches a mature funding level in the mid 2020s.

Assessing the Sustainability of States Spending

Section 4 examines the extent of budget pressures arising from State Governments, including how they interact with and impact on the Commonwealth Budget position.

Historical spending growth by State Governments

Recent growth in General Government outlays by State and Federal Governments have been nearly identical over the past 10 years at around 7 per cent, per annum (Table 11).

Table 11: Comparison of Government Spending by Sub-function – Nominal Growth

	Commonwealth 2002-03 to 2011-12 %	States 2002-03 to 2011-12 %
Overall	**6.93**	**7.20**
General Public Services	9.94	6.60
Public Order and Safety	8.48	7.69
Education	10.60	6.40
Health	8.81	8.52
Social Security and Welfare	6.62	9.42
Housing and Community Amenities	24.77	7.76
Recreation and Culture	6.73	4.80
Fuel and Energy	9.48	5.20
Agriculture Forestry Fishing and Hunting	6.91	1.91
Mining and Mineral Resources	2.98	6.53
Transport and Communications	3.24	7.55
Other Economic Affairs	10.33	5.23
Other Purposes	4.98	7.16

Source: Australian Bureau of Statistics and Macroeconomics estimates. Subject to rounding.

Note: Commonwealth spending is adjusted for grants payments to the States.

Once of the reasons for this commonality of outlays growth has been the similar growth in the size of public employment and the public payroll between governments (Table 12).

Table 12: Growth in State Employment and Payroll

	Commonwealth Government				State Governments			
	Employment	Growth	Earnings	Growth	Employment	Growth	Earnings	Growth
	'000	%	$b	%	'000	%	$b	%
2002-03	241.6	-8.9	13.0	2.5	1109.0	1.3	51.7	5.3
2003-04	243.7	0.9	14.2	9.8	1138.6	2.7	55.2	6.7
2004-05	246.9	1.3	14.6	2.4	1177.4	3.4	59.9	8.6
2005-06	253.3	2.6	15.8	8.4	1207.6	2.6	64.3	7.4
2006-07	253.0	-0.1	15.6	-1.3	1248.1	3.4	69.2	7.5
2007-08	237.1	-6.3	15.3	-1.8	1342.6	7.6	77.2	11.7
2008-09	242.9	2.4	16.6	8.1	1386.6	3.3	83.1	7.6
2009-10	243.7	0.3	17.0	2.6	1414.3	2.0	89.3	7.4
2010-11	251.2	3.1	18.2	7.3	1447.9	2.4	97.6	9.3
2011-12	250.0	-0.5	19.0	3.9	1449.6	0.1	99.4	1.9
Average		**-0.5**		**4.2**		**2.9**		**7.3**

Source: Australian Bureau of Statistics special requests. Subject to rounding.

Note: # The measure of employee earnings is 'cash wages and salaries', regular and irregular wages and salaries in cash..

The key sub-functional spending areas that experienced rising GDP shares (a key indicator of significant spending growth) over the last decade for either the Commonwealth or State are presented in Table 13 below.

Table 13: Commonwealth and State Government Spending by Sub-function

	Commonwealth		States	
	2002-03	2011-12	2002-03	2011-12
Spending Share of GDP	% GDP	% of GDP	% GDP	% of GDP
General Public Services	**1.37**	**1.57**	**0.43**	**0.46**
Government Superannuation Benefits	0.26	0.28	0.03	0.00
Others	1.11	1.29	0.40	0.46
Public Order and Safety	**0.24**	**0.26**	**1.36**	**1.43**
Police and Fire Protection Services	0.00	0.00	0.79	0.83
Others	0.24	0.26	0.56	0.60
Education	**1.36**	**1.20**	**3.65**	**3.45**
Primary and Secondary Education	0.74	0.61	2.80	2.61
Tertiary Education	0.53	0.56	0.53	0.46
Pre-school Education and Education Not Definable by Level	0.00	0.00	0.20	0.29
Others	0.08	0.29	0.11	0.10
Health	**2.66**	**3.18**	**3.31**	**3.73**
Acute Care Institutions	0.21	0.08	2.36	2.65
Community Health Services	1.46	1.70	0.60	0.62
Public Health Services	0.07	0.44	0.12	0.13
Others	0.92	0.95	0.22	0.32
Social Security and Welfare	**8.71**	**8.63**	**0.86**	**1.09**
Welfare Services	0.03	0.07	0.78	1.02
Social Security	8.40	8.30	0.05	0.05
Others	0.28	0.26	0.03	0.02
Transport and Communications	**0.14**	**0.30**	**1.33**	**1.47**
Road Transport	0.03	0.12	0.77	0.72
Rail Transport	0.00	0.07	0.37	0.44
Others	0.11	0.12	0.77	0.72
Other Economic Affairs	**0.47**	**0.66**	**0.32**	**0.28**
Labour and Employment Affairs	0.38	0.51	0.15	0.13
Others	0.10	0.15	0.18	0.16
Others	**3.72**	**4.03**	**2.43**	**2.26**
Overall	**18.67**	**19.82**	**13.68**	**14.18**

Source: Macroeconomics estimates. Subject to rounding.

Note: Commonwealth spending is adjusted for grants payments to the States.

Key drivers of the 1.2 per cent increase in GDP spending share for the Commonwealth over the 2000s include:

- public health services (accounts for 0.4 percentage points of the rising GDP share);
- community health services (accounts for 0.2 percentage points of the rising GDP share); and
- general public services including foreign affairs and economic aid (accounts for 0.2 percentage points of the rising GDP share);
- labour and employment affairs including spending on immigration and asylum seekers (accounts for 0.2 percentage points of the rising GDP share); and
- road transport (accounts for 0.1 percentage points of the rising GDP share).

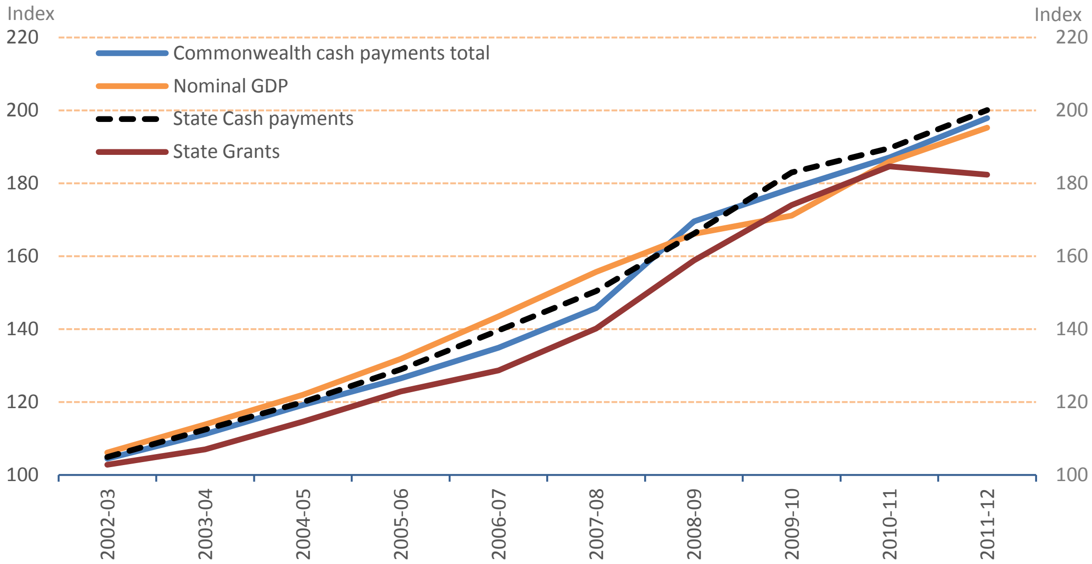
Key drivers of the 0.5 per cent increase in GDP spending share for the States over the 2000s include:

- public hospitals (accounts for 0.3 percentage points of the rising GDP share);
- welfare services (accounts for 0.2 percentage points of the rising GDP share); and

- pre school education (accounts for 0.1 percentage points of the rising GDP share).

Indeed these sub-functional drivers of Commonwealth spending tend to reveal a problem of vertical fiscal imbalance between the Commonwealth and the States. On the one hand the Commonwealth from the middle of the 2000s benefitted immediately from China Boom as commodity price rises flowed through to higher Commonwealth income tax receipts and not initially to the States via higher production levels and so higher royalty receipts. On the other hand, however, much of the demand for public services was experienced through the states particularly in front-line health, education services and welfare services.

Chart 1 Growth in Government Spending Compared to Economic Capacity



Source: Australian Bureau of Statistics special request, national accounts and Budget Papers.

What did the Commonwealth do? Did it raise the overall level of grants funding to the States? No, grant funding increased at less than the pace as overall spending and economic activity (Chart 1). Instead, the Commonwealth moved decisively into the delivery of new services such as public health service programs (including preventative health, population health, hearing services, blood products, e-Health etc., immunology and medical research), whilst failing to contain costs in more traditional areas such as the Pharmaceuticals Scheme and Medical Benefits Scheme which are the Commonwealth's primary responsibility.

What did the States do? They continued to spend more, especially in core service delivery areas areas such as public hospitals, education and welfare that have historically been state responsibilities.

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Endnotes

[1] Public debt has a role in helping government to smooth out variations in revenue and expenditure caused by the business cycle and to fund the acquisition of necessary "lumpy" public infrastructure purchases which generate sufficient economic and social returns, but which are underprovided by the private sector.
[2] Kirsty Laurie and Jason McDonald, 2008, provide a very detailed overview of Commonwealth spending trends with a focus on the Howard Government era.
[3] Ken Henry, 2009, p12.
[4] Tanzi and Schuknecht, 2000 and Dar and Khalkhali, 2002, pp. 679-692.
[5] The fuel tax credit scheme designed to reduce or remove a tax on business inputs – in this case, fuel used by businesses off road – is the principal source of this growth. Fuel tax is paid by business and later credited which accounts for its appearance on both sides of the Budget. As Treasury has noted repeatedly, fuel tax credits are not a subsidy and those who support the abolition of the scheme are arguing for industry to pay higher taxes.
[6] Any careful review of Commonwealth or state budget papers reveals there is very little information provided about the things that taxpayers actually care about when it comes to spending (see Anthony 2013). For example, you will find almost no meaningful discussion of the following questions:

- What are the names of all government spending programs and what is each supposed to achieve (on current reckoning there are more than 550 Commonwealth programs)?
- How much has government spent on each program since its inception and what has that delivered in terms of policy outcomes?
- How much does government plan to spend on each program in the future and what should that spending deliver in terms of policy outcomes?
- What resources are required to deliver each program in terms of staffing levels and departmental outlays?
- Are there alternative programs (either in Australia or overseas) which may be more efficient and/or effective in achieving particular objectives?
- How does each program rate in comparison with other programs in terms of overall effectiveness and value for money?
- How would an independent expert rate the program's overall performance and productivity?

Program-based performance reporting would be a fundamental transparency check on governments. Yet it has been a very long time (since the mid to late 1980s) since this information was included in budget documentation. Unfortunately, program-specific budget estimates were basically abolished and removed from budget papers in 1998-99 with the start of accrual accounting. As a result, the public can find lots of accounting data in budget papers, but very little information that is actually useful in assessing the policy performance of government programs.

Taxpayers should possess tools that allow them to assess for themselves the adequacy and efficiency of government spending programs. In other words, they need a budget document that provides a "clear read" between program budget estimates and outcomes, including policy performance information and appropriate historical information. This would be a genuine transparency reform, one that would help to make the operation of government more accessible, assessable and accountable to the public.

Without this level of analysis, budget papers tend to create the illusion of transparency, rather than the reality. Ministers and/or senior public servants for the most part are not held accountable for the adequacy and efficiency of public resource use. And most parliamentary processes (such as Senate Estimates hearings) become exercises in futility.
[7] Gary Banks, 2009, p.3.
[8] This longer term modelling is predicated on three key assumptions over the projection period:

- real GDP growth averaging 2.5 per cent;
- a productivity growth rate of 1.6 per cent; and
- an inflation rate of 2.5 per cent.