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Balancing budgets

Tough choices we need

John Daley



Balancing budgets: tough choices we need

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Balancing budgets: tough choices we need

Overview

Australian governments must make tough choices to balance their budgets. They face a decade of deficits, the result of big ticket spending initiatives, rising health costs, pressure on welfare budgets and an inevitable fall in the terms of trade. Collectively these could lead to deficits of 4 per cent of GDP, or \$60 billion in today's terms, within a decade.

Tough choices cannot be put off indefinitely. Deficits impose heavy costs on the next generation in terms of debt and high interest payments. Government budgets cannot simply grow out of trouble, and the next decade may well be economically more difficult than the last.

History shows that governments that successfully repair their budgets make the public case for reform, and start early on the hard work of cutting expenditure and raising taxes. They design a package of measures that share the burden of reform fairly across the community.

This report surveys all realistic proposals that could contribute \$2 billion a year or more to government budgets. It puts a priority on reforms that are big enough to make a difference but do not have unacceptable economic and social effects.

One reform package could add \$37 billion a year to budgets. It would broaden the GST to include fresh food and private spending on health and education; raise the age of access to superannuation and the Age Pension; remove the exemption for owner-occupied housing from the assets test for the Age Pension; and limit tax concessions on superannuation contributions. The

burden of these changes would be spread across rich and poor, workers and retirees. While all these reforms are unlikely to occur at once, it will be hard to close the looming budget gap without tackling any of them.

Structural reform of benefits and tax exemptions for older Australians offer many of the best opportunities for budget reform. They are the least-well targeted parts of our tax and welfare system, with some benefits going to people that don't need them.

Substantial budget repair almost always involves tax reform. Increasing fuel excise in line with inflation would raise significant revenue, although it hits those with low incomes particularly hard. Higher rates of existing taxes could raise large revenues. Raising the GST and municipal rates would slow economic growth less than other tax increases.

Plausible reductions in spending on transport infrastructure, industry support, school class sizes, higher education subsidies, pharmaceuticals, health services, and defence could collectively improve budget positions by \$23 billion per year. But the execution risks are high – there would be unacceptable economic and social effects unless the cuts were executed unusually well. By contrast, the oft-cited cuts to the public service and 'middle class welfare' can do relatively little to improve budget balances.

Sustainable budgets depend on governments making tough choices. None will be politically easy, but making some of them is vital to Australia's prosperity.

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1. Introduction

This report examines how Australian governments should respond to the budget pressures they face.

It follows *Budget pressures on Australian governments*, published by Grattan Institute in April 2013, which showed the **scale of the budget problem** Australian governments face. Chapter 2 outlines and updates this analysis, which shows that Australian governments face deficits of 4 per cent of GDP, or \$60 billion in today's terms, within a decade.

Chapter 3 considers the best approach to balancing budgets. It shows how repair can only succeed if politicians and the populace have the right **mindsets and approach**.

Governments then need to make **tough choices** to either increase taxes or reduce spending. Chapter 4 outlines a **framework for evaluating** these choices on the basis of their budgetary impact, and social and economic side-effects.

Chapter 5 indicates how the key reforms might be **packaged** together so that the burden of reform is spread fairly across the community.

The bulk of this report examines 20 **budget repair choices**, and a number of possible tax increases, that might help balance budgets. These choices, their budgetary impact, and their side-effects are summarised in Table 1. They are discussed in more detail in Chapters 6 to 9, drawing on the evaluation of each of them in the *Balancing Budgets: Supporting analysis* that accompanies this report. Chapter 6 covers changes to the pension and superannuation system. Chapter 7 discusses capital gains tax and housing. Chapter 8 looks at other tax exemptions, introductions and increases that may help to repair budgets. Chapter 9 covers spending cuts.

Chapter 10 looks at the role of **asset sales** in budget repair.

Finally, Chapter 11 discusses **institutions** that promote budgetary discipline in the longer term.

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Table 1: Summary of impact of proposals over \$2 billion considered in this report

Theme	Proposal	Value to budget (annual, \$2013)	Summary of social, economic and distributional impacts	Pg	Theme	Proposal	Value to budget (annual, \$2013)	Summary of social, economic and distributional impacts	Pg
Super and pensions	Age Pension and superannuation access age	\$12b	Neutral	29	Tax rate increases	Corporate tax rate	\$10b	Very negative	62
	Super contribution tax concessions	\$6b	Moderately negative	32		Income tax rates	\$10b	Very negative	62
	Superannuation earnings tax concessions	\$3b	Moderately negative	36		GST rate	\$10b	Negative	62
	Age Pension assets test	\$7b	Positive	36		Property tax rate	\$10b	Negative	62
Housing and capital gains	CGT discounts	\$5b	Neutral	40		Payroll tax rate	\$10b	Very negative	62
	Owner-occupied housing and CGT	\$15b	Very negative	43		Stamp duty rate	\$10b	Very negative	62
	Negative gearing	\$2b	Positive	45		Bracket creep	\$16b	Very negative	63
Other tax exemptions	GST base	\$13b	Negative	49	Spending cuts	Transport infrastructure costs	\$6b	Moderately negative	65
	Payroll tax threshold	\$6b	Very negative	55		Industry support	\$5b	Moderately negative	69
	Fuel tax credit	\$3b	Negative	57		Private health insurance rebate	\$3b	Negative	70
New taxes	Fuel excise indexation	\$3b	Moderately negative	58		Pharmaceuticals spending	\$2b	Positive	70
	Federal royalties export tax	\$3b	Negative	59		Cost effectiveness of treatments	\$2b	Neutral	70
						Defence spending	\$2b	Neutral	71
						School class sizes	\$3b	Moderately negative	71
						Student subsidies for higher education	\$3b	Neutral	71

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2. We have a budget problem

The Commonwealth Government has had an underlying budget problem for several years, as Grattan Institute's 2013 report, *Mining boom: impacts and prospects*, reveals.¹ Australian government budgets face a decade of deficits, as we showed in our previous publication, *Budget pressures*.² Signature initiatives, rising health expenditure, pressure on welfare budgets, and an inevitable fall in the terms of trade could lead to deficits of 4 per cent of GDP, or \$60 billion in today's terms, within a decade.

2.1 We have a structural deficit

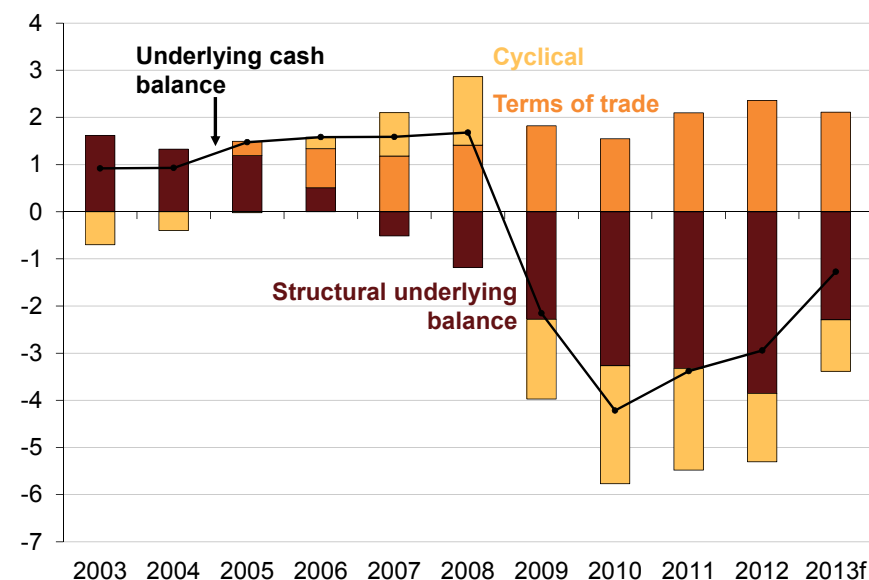
The Commonwealth Government – responsible for 60 per cent of Australian government expenditure and 75 per cent of the taxation³ – has had a structural budget deficit of more than 2 per cent of GDP for the past five years. As Figure 2.1 shows, the Commonwealth spent more than its income after allowing for fluctuations in prices (particularly the mining boom and the terms of trade), and the business cycle (particularly the Global Financial Crisis).

Calculations of the structural deficit by the International Monetary Fund, the OECD, Australian Treasury, the Parliamentary Budget Office, Deloitte Access Economics and Grattan Institute all use slightly different methods and assumptions. But they all come to a

similar conclusion: the Commonwealth Government has run a substantial structural deficit for half a decade.⁴

Figure 2.1 Commonwealth budget balance

Per cent of nominal GDP



Source: Minifie et al. (2013)

¹ Minifie, et al. (2013)

² Daley, et al. (2013)

³ Ibid., pp. 11, 58

⁴ Ibid., p. 28; PBO (2013a) ; IMF (2013a)

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The mining boom and the Global Financial Crisis (GFC) masked the problem. Australia failed to realise that the income from the mining boom would not last, but that spending increases started during the GFC *would*.

2.2 Spending has gone up

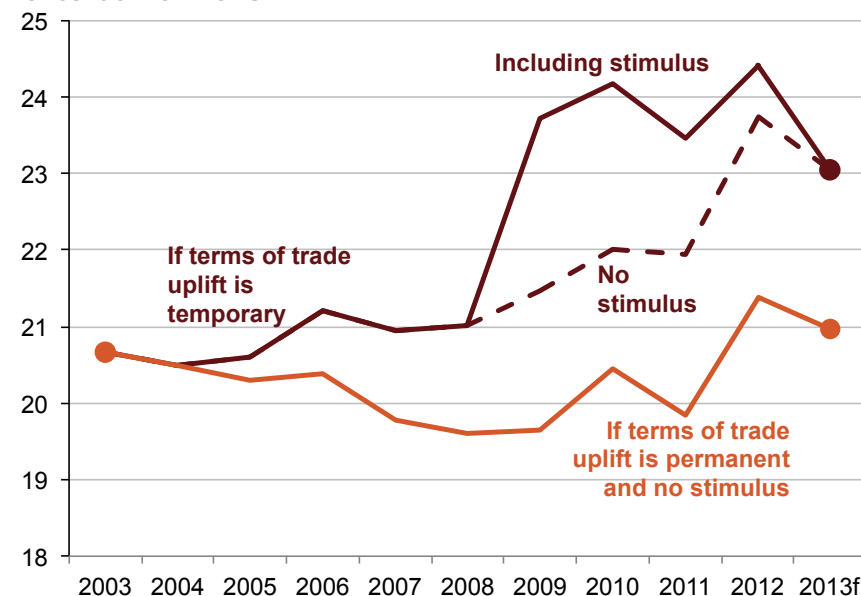
One of the problems is that we often think about government expenditure as a percentage of GDP. In normal times, this is a good rule of thumb. If the massive run-up in the price of iron ore and coal were permanent, then Commonwealth Government expenditure today is only a tick higher than in 2003. But if iron ore and coal prices return to historic levels, then it would be apparent that Commonwealth government spending rose two percentage points in eight years.⁵ That is a structural shift, as Figure 2.2 shows.

This structural shift also escaped attention because of the stimulus package. It looked as though spending was falling in 2012-13. But that fall was the consequence of the stimulus package rolling off, and payments being timed to fall in different years. *Underlying* spending has risen rapidly.

⁵ If minerals prices fall, then (if CPI remains unchanged) so will nominal GDP, which takes into account the price of Australian exports. If nominal GDP falls, but government spend is constant, the ratio of government spend to GDP would rise.

Figure 2.2 Commonwealth structural expenditure

Per cent of nominal GDP



Source: Minifie et al. (2013)

2.3 Revenue is going down

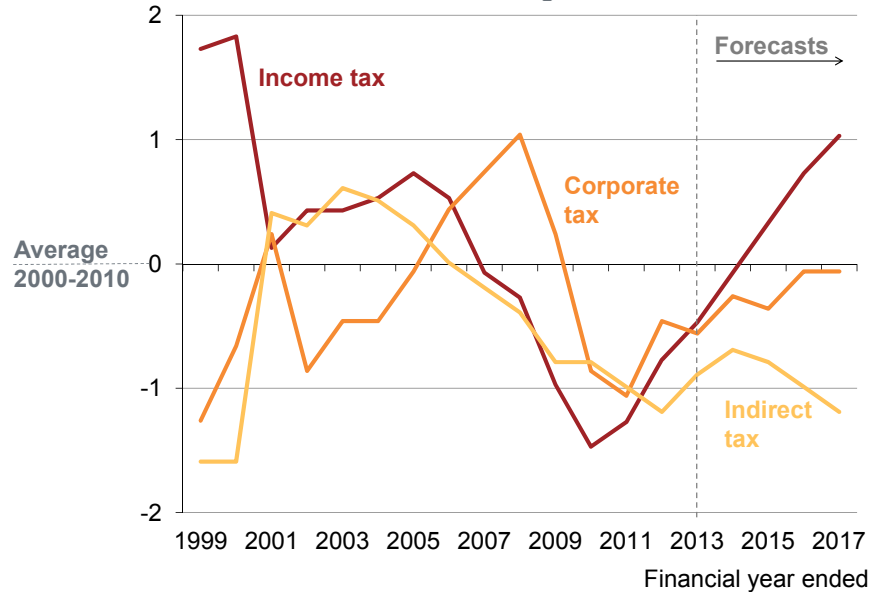
Revenues have also fallen with the Global Financial Crisis reducing income and corporate tax levels. Although revenues are expected to return to long-run averages by 2014-15 – depending on minerals prices – indirect taxes have fallen steadily and remain 1 per cent of GDP below their long-term trend (Figure 2.3).⁶

⁶ Daley, et al. (2013), p. 22

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Figure 2.3 Variation in Commonwealth major tax revenues

Per cent of nominal GDP above/below average 2000-01 to 2009-10



Source: Daley et al. (2013)

2.4 Future pressures

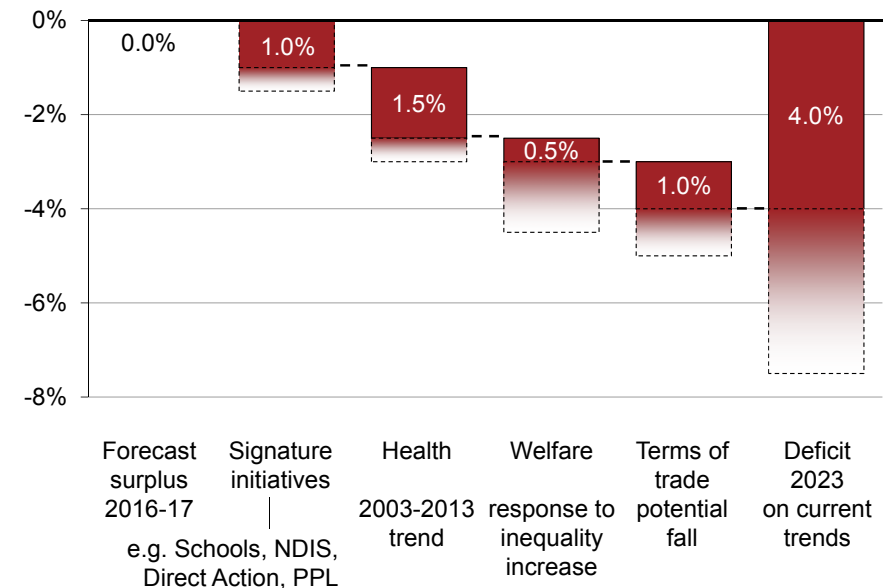
Future pressures on Australian government budgets could reduce budget balances by 4 per cent of GDP within a decade as Figure 2.4 shows.

Updating the analysis of our *Budget pressures* report for subsequent developments alters some components but comes to the same conclusion. Governments have reduced their forecast surpluses for 2015-16 to zero, which incorporates our

expectations that revenue from company tax, mining resource rent tax and the emissions trading scheme would be less than previous forecasts. Additional signature initiatives have increased in cost to 1 per cent of GDP. The expected increase in health spending to 2023 is now only 1.5 per cent of GDP (previously it was 2 per cent) as some of the increase was incorporated in 2013-14 budgets. The expectation of future hits to the budget due to increased welfare costs and a fall in the terms of trade remains unchanged.

Figure 2.4 Potential annual deficit of Australian governments by 2023

Per cent of GDP



Source: Daley et al. (2013); subsequent Grattan analysis

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The new Coalition government has promised a number of signature initiatives that will ultimately have a net cost to the budget of about \$15 billion in today's dollars by 2023 as shown in Figure 2.5.

There are the costs of abolishing the carbon and mining taxes. The government's company tax cut, increase in defence spending, and paid parental leave will also drag on the bottom line. In addition, most of the planned costs for the National Disability Insurance Scheme and school funding reforms start to bite after 2017, only reaching 'steady state' by about 2022. Initiatives of a similar magnitude were likely irrespective of who won the 2013 federal election.⁷ For these purposes, we have assumed that costs of the National Disability Insurance Scheme will be as planned: in practice, costs may be higher as political pressure and legal decisions tend to stretch definitions in favour of increased spending.⁸

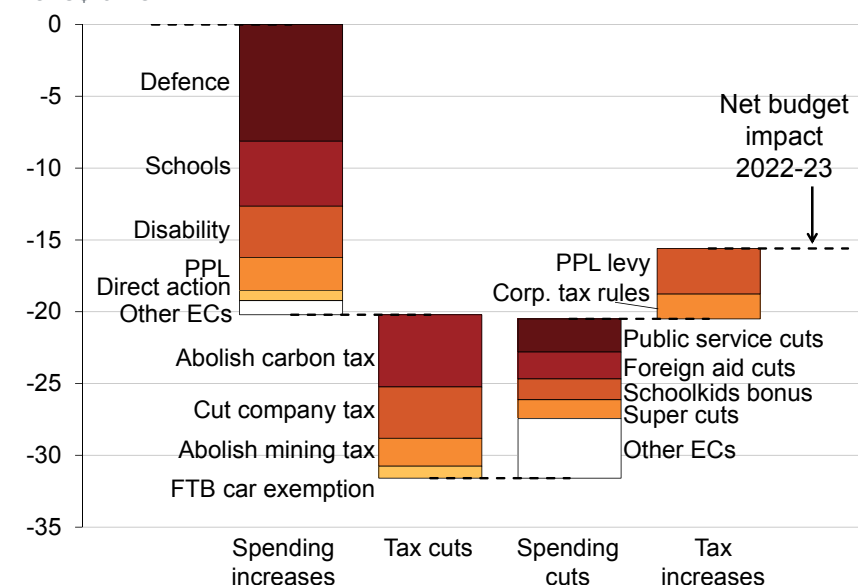
The largest threat to future budgets is the sustained pressure on health expenditure. Over the last decade, health has been responsible for most of the spending increases above GDP, for both Commonwealth and state governments (Figure 2.6).⁹ The primary drivers were not ageing, but the provision of more and better health services per person. A 60-year old today visits the doctor more often, has more tests, has more operations, and takes more drugs, than a 60-year old 10 years ago.

⁷ Ibid., p. 33-35

⁸ Burkhauser, *et al.* (2013), p.357. There are already indications that the National Disability Insurance Scheme will exceed cost estimates. See Fifield (2013); Mather (2013)

⁹ Daley, *et al.* (2013), p. 15

Figure 2.5 Potential impact of signature initiatives to 2023
2013\$ billion

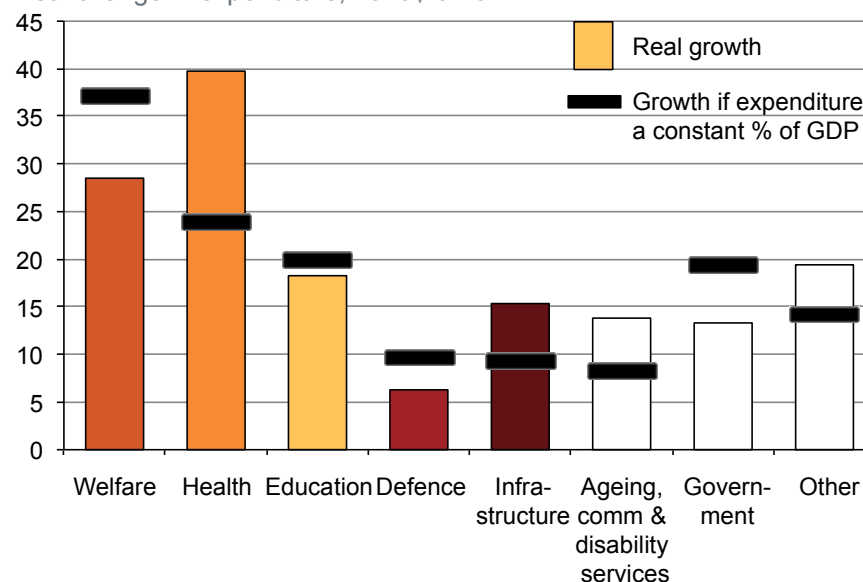


Note: 'Other ECs' is other election commitments. Impact is on all Australian budgets (Commonwealth, states and territories). Analysis includes all federal Coalition election commitments identified by the Parliamentary Budget Office except infrastructure, which has not been included as it is not possible to determine how new commitments for a given year related to the available funding envelope. Analysis also includes the government's commitment to increase defence spending to 2% of GDP in 10 years, its commitment to implement the National Disability Insurance Scheme, and a likely increase in school funding based on existing agreements with some states and likely pressure from others. Source: Grattan analysis of Treasury (2012a); Daley *et al.* (2013); Loughnane (2013c); b); PBO (2013b); Treasury (2013c); a)

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Figure 2.6 Change in Australian governments' expenditure 2002-03 to 2012-13

Real change in expenditure, 2013\$ billion



Source: Daley *et al.* (2013)

Governments are under enormous public pressure to spend more on health to improve lifespans and quality of life. If spending continues to grow at the same rate as over the past decade, health will consume an additional 1.5 per cent of government budgets by 2023.

Welfare costs are also likely to increase. Those on workforce payments such as Newstart face high levels of hardship.¹⁰ The

¹⁰ *Ibid.*, p. 18-19

Business Council of Australia has acknowledged that Newstart payments are too low.¹¹ As a result, there may be more pressure to increase welfare payments for those who are least well off, especially if the economy turns down.

We are also likely to see political pressure to keep increasing age pension benefits.¹² These grew faster than GDP over the last decade, not because of the ageing of the population, but because of deliberate policy choices to broaden eligibility and lift pensions faster than average weekly earnings.¹³ The political pressure that led to these changes will grow as the population ages.

2.5 Why does all this matter?

Of course, Australian governments owe much less than many governments elsewhere. We are not in the emergency ward, crawling from one debt reconstruction to the next, with the economy shrinking and government slashing the social safety net. But surely we do not want to go there.

The most important argument for budget reform is that government deficits effectively require future generations to pay for the spending of the current generation. In recent times, the run up in Queensland government deficit spending led to annual interest payments of more than \$1.5 billion a year, substantially constraining the state budget.

¹¹ BCA (2013)

¹² Daley, *et al.* (2013), p. 44

¹³ *Ibid.*, p. 20

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Relatively little of the most rapid increases in annual spending can be justified on the basis that they will benefit future generations by increasing future economic growth. While education, research and infrastructure will benefit future generations, spending on increased health and age pensions increased the most. While health spending increases workforce participation a little, its major effect is to help today's generation live longer and enjoy happier retirements. While this is a good thing, it is unfair to fund this through deficits that must be paid for by future generations.

Recurring structural deficits inevitably lead to higher levels of debt. At high levels, these limit the ability of governments to respond to future economic downturns.¹⁴

Given the size of current underlying and projected budget deficits, repairing the budgets of Australian governments will be hard. The rest of this report explains how it might be done.

¹⁴ Ibid.

3. Mindsets and approaches for budget repair

If Australian governments are serious about fixing their budgets, they need to make some tough choices. The ones we present are not particularly appealing. Nobody likes paying higher taxes or receiving fewer services. But we need governments to make these difficult choices rather than putting them off for future governments. We cannot simply 'grow out of trouble'; we need structural reform.¹⁵

Valuable lessons can be learnt from previous Australian and international experiences of budget repair. These experiences, summarised in *Balancing budgets: Supporting analysis*, show that to balance budgets, governments need to explain the problem, prioritise the large reforms, tackle both spending and taxation, and resist the temptation to delay.

3.1 Preparing people for pain

There is little chance of successful budget repair unless the government builds public understanding of the size of the problem, and the need for action.¹⁶

Budget reform is most likely when all those affected by it – from politicians, to senior public servants, frontline public sector staff and the general public – agree that it is necessary. That means creating a shared understanding of the scale of the problem, and why major change is needed. These attitudes do not spring into life on their own. Governments that have successfully repaired

budgets put considerable time and deliberate effort into explaining the need for change to all involved.¹⁷ Unless the ground is prepared, it is easy for the community to run out of patience with reform.

To build this public case, it helps to start from a position of political strength. For example, the Borbidge Government in Queensland was a minority government, and a mere 18 months in power gave it insufficient time and political capital to implement reforms. The final report of the 2011 Victorian Review of State Finances has not even been released, which some attribute to a combination of the government's narrow majority, and the report's recommendations, reputed to be radical.¹⁸ In contrast, the huge majorities won by Barry O'Farrell in New South Wales in 2011 and Campbell Newman in Queensland in 2012 reduced pressure from the electorate, giving those governments greater licence for bigger reform.

Reform is also easier if the economic and budgetary challenges are obvious from the outset. In the 1990s, the major economic problems facing Victoria, South Australia and Western Australia helped to create a 'burning platform' for reform, and made it easier for governments to adopt tough recommendations. Queensland, in better shape, showed far less enthusiasm for

¹⁵ IMF (2013b), p. 10

¹⁶ Mauro (2011), p. 258

¹⁷ See, for example, Kamener and Tan (2012) on the Kennett government budget reforms and Sancak, *et al.* (2011) on Canadian reform, discussed further in *Balancing budgets: Supporting analysis*.

¹⁸ Jones and Prasser (forthcoming); Uren (2012)

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reform.¹⁹ Similarly, in 2011, the Victorian government faced less severe fiscal and economic problems than those of New South Wales and Queensland, which probably contributed to the lack of enthusiasm for its audit commission's recommendations.

Nor can a government rely on a commission of audit to build this public case for budget repair. Governments should treat any commission of audit as a buttress rather than the lead element. The Kennett Government did not wait for its commission of audit to report before it cut expenditure (see Box 3.1). It had come into office with a detailed reform plan already prepared, and it brought down a mini-budget within a month of being elected.²⁰

Commissions can be useful in exploring tough choices, while being distant enough to give the government plausible deniability while it considers options. But the risk of the commission's independence is that no-one with real power 'owns' the recommendations, and they sink without trace. Successful budget reform efforts, including those in Canada, Victoria and the UK, had strong buy-in from politicians and senior public servants, and strong budget processes to accompany the repair effort. The Commonwealth Government should already be considering how it will 'sell' change and the necessary tough reforms.

The current Commonwealth Government's rhetoric provides some cause for concern. Although both the Prime Minister and Treasurer talked in May 2013 of a 'budget emergency', their language has shifted since election.²¹ There has not been a mini-

¹⁹ Jones and Prasser (forthcoming)

²⁰ Ibid.

²¹ For example, contrast statements in Griffiths (2013) with those in AAP (2013)

Box 3.1: Case study – Budget repair in Kennett's Victoria

In 1992, Victoria had a deficit of \$2.2 billion, total government debt of \$31 billion, and an A1 credit rating.

The Kennett Government was elected in 1992 with a massive majority and a mandate for budget repair. It cut spending by more than 10 per cent in real terms in four years. It increased revenues and sold about \$45 billion worth of assets. Between 1993 and 1997, expenditure as a percentage of revenues fell from 110 to 89 per cent. Government debt was reduced to \$4 billion by 2000.

Several factors contributed to this successful budget reform:

- A Budget and Expenditure Review Committee set firm expenditure reduction targets from the centre of government, but gave agencies autonomy in determining how to meet them.
- There was a concerted effort to get alignment between politicians, senior public servants, front-line public sector staff and the public on the scale of the problem and the need for major change.
- Reforms were structured so that the pain would be shared across the state. A \$100 per household debt-reduction levy raised a relatively modest amount but sent a clear message that no-one was exempt from sacrifice.

The reforms faced opposition. The government won the 1996 election, retaining a significant majority, but commentators have attributed its subsequent loss in 1999 at least partly to the harshness of its fiscal reforms.

Source: Kamener and Tan (2012); Jones and Prasser (forthcoming)

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Budget, and there is little sign that there will be policy changes announced in the Mid-Year Economic and Fiscal Outlook. A concerted and consistent effort is required to explain the extent of the budget issues.

Reform is also easier if there is a perception that the burden is being shared across society. Obviously those with more capacity to pay should bear *more* of the burden. But if everyone – the wealthy and poor, young and old, businesses and households, city and country – is seen to be making sacrifices, it blunts the power of any one group to complain about cuts. It also helps to contribute to a shared understanding of the magnitude of change required.

3.2 Prioritisation and delegation

Governments should pick a few significant reforms that will make a large difference to the structural deficit. Prioritising budget choices is important because major reform is hard; it takes political will, time and strong leadership to design and implement good policy. As Paul Keating once said, the trick to government is to pick three big things and do them well.²² Choosing a limited number of substantial reforms is important because a government can only alienate major interest groups so often before it is branded in public debate as out of touch.²³ Senior government ministers have limited time and energy both to persuade

²² Button *ibid.*. Nicola Roxon recently reflected on her time in government, noting that the Labor Party needs to “choose a few big areas and focus on them, taking people with them.” Roxon (2013)

²³ Daley, *et al.* (2012a), p. 6

stakeholders and to reallocate resources. Leadership cannot be spread too thinly, lest it lose its political influence. For their part, senior public sector managers can only properly supervise the design and implementation of a limited number of policies at the same time.

Without prioritisation, there is a risk that governments will use up their political capital on urgent, but relatively unimportant, issues.²⁴ If a government is to undergo the political pain of difficult reform, it may as well make sure that the money the proposals will save (or raise) is large enough to be worthwhile.

The media also has an important role to play in this debate. Media outlets frequently run stories about government spending or taxes that make little effort to put numbers into context. For those who do not follow budget debates closely, \$100 million seems like a huge number, but it is about one five-thousandth of the total expenditure of Australian governments. This makes it hard for voters to understand the scale of the issues discussed. *The New York Times* is working to better explain budget-related numbers,²⁵ the Australian media should follow suit.

Budget reform today also needs to be delegated. Budget repair efforts need to involve those who will have to implement them, not just public servants in Treasury and Finance. Because line agencies often know aspects of the policy area that central agency staff do not they are well positioned to identify feasible reform. Line agency staff are also more likely to ‘own’ rather than resist reforms that they have had a hand in designing. Both

²⁴ *Ibid.*, p. 6

²⁵ Sullivan (2013)

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Victoria and Canada gave agencies autonomy to determine how they would meet savings targets. Coupled with strong central oversight, it led to successful fiscal reform.

3.3 Tackling the tough choices

If big change is required, all options for reform need to be on the table, including both spending cuts and revenue increases. Reform can succeed even if it involves difficult and ambitious decisions. Overseas experience shows that ambitious plans are just as likely to achieve their targets as modest ones,²⁶ and Australian governments have successfully repaired big budget holes in the past.

However, governments cannot rely on economic growth alone to balance their budgets. Successful budget repair has historically emerged from a combination of tight fiscal policy and increased economic growth.²⁷ Fiscal repair is much easier when economic conditions are favourable, but few, if any, governments have managed to simply grow their way out of trouble without undertaking budget reform.²⁸ Although economic growth will increase tax revenues, spending tends to grow at a similar rate. Many government costs (such as welfare payments and service delivery salary costs) are linked to wage levels that tend to grow in line with the economy.

Previous experience does not dictate a particular balance between revenue and expenditure measures for budget repair.²⁹

Tax increases have been important drivers of some, though not all, budget repair.³⁰ Without major tax increases, budget repair will be hard for Australia given that its government is relatively small, major revenue sources like the GST are in structural decline (see Chapter 1), and we could not identify expenditure cuts large enough to fix Australia's long run budget challenges. The promised tax review will need to be wide-ranging and taken seriously by government.

Almost all successful repair efforts have involved broad expenditure cuts. Yet today's Commonwealth Government may have tied its own hands, ruling out cuts to health, education and defence; major changes to superannuation; and changes to its election commitments.³¹ The broad terms of reference given to the National Commission of Audit may give it scope to tackle these areas and at least build momentum for change after the next election.

Repair plans are also more likely to succeed if they include structural reforms such as changes to the welfare system and a repositioning of the role of the state.³² The proposals in this report for reforms to the age pension and superannuation, and taxes on assets and consumption, are examples of such structural change.

Repairing the Commonwealth's budget will probably require even tougher decisions than in the past. Tougher decisions are required if a previous budgetary reform has already picked the 'low-hanging fruit'.

²⁶ Mauro (2011), p. 252

²⁷ Ibid.; Abbas, *et al.* (2013)

²⁸ Abbas, *et al.* (2013), p. 17

²⁹ IMF (2013b), p. 35; Mauro (2011), p. 257

³⁰ Mauro (2011), p. 253

³¹ Crowe (2013)

³² Mauro (2011), p. 254

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The Howard Government picked much of the 'low-hanging fruit' of budgetary reform, particularly in public sector management reform and asset sales, after the last National Commission of Audit (see *Balancing budgets: Supporting analysis*). Recommendations that weren't adopted – including restructuring federal financial arrangements, and changing pension indexation – are no easier now than they were then.

At the state level, many of the recommendations of the 2012 Queensland Commission of Audit have already been enacted in other jurisdictions (examples include contestability in providing public transport, and divestment of energy assets).³³ In contrast, the sweeping reforms adopted by the Kennett Government in the 1990's may have left relatively few 'easy wins' for Victoria's 2011 Review of State Finances.

There is certainly scope for new reforms today. Some program creep can usefully be pulled back. A new wave of service delivery reform might focus on demand management given that uncapped programs like health and welfare are driving many of the budget challenges. But the Commonwealth Government shouldn't imagine that the National Commission of Audit will provide a set of easy reforms that are big enough to fix the problem. Tough choices will need to be made.

3.4 Don't wait for tomorrow

An incoming government needs to move quickly, as the Victorian experience of the 1990s and others show.³⁴ Governments must implement tough reforms early in the electoral cycle, while the failings of the previous government are fresh in voters' minds.³⁵ It is far easier for a government to build the case for and implement policy change early in its term.³⁶ A government needs to develop support for its policies, while holding off the opposition.³⁷ A government that leaves difficult decisions to the latter half of its term faces the additional stress of re-election and more pressure from lobby groups.

Once this early action has established credibility, fiscal repair is best undertaken gradually, within a credible medium-term strategy, supported by strong institutions,³⁸ and with credible contingency plans to deal with unforeseen economic shocks.³⁹

Driven by the need for speed, governments often require a commission of audit to report quickly. This creates the risk that it will lack the time for thorough analysis and will fall back on pre-conceived ideas not based on good evidence.⁴⁰ Many of the commissions of audit in the 2000s had significantly longer

³³ Costello, *et al.* (2013)

³⁴ IMF (2013b), p. 30

³⁵ Jones and Prasser (forthcoming)

³⁶ Daley, *et al.* (2012a), p. 9

³⁷ Haggard and Webb (1993), p. 143

³⁸ IMF (2013b), p. 29-30; Mauro (2011). See further discussion of budget institutions in Chapter 11.

³⁹ Mauro (2011)

⁴⁰ Martin (2013)

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timeframes, allowing more thorough work but also leading to more complexity and more politically unpalatable recommendations.⁴¹

It is concerning that in recent months both sides of politics have downplayed the urgency of Australia's budget problems. Perhaps chastened by the experience of its predecessor, the new Commonwealth government has not set a date for the budget to return to surplus. It has committed only to reaching a surplus of 1 per cent of GDP in 2023-24 – a decade and three elections away.⁴²

In the meantime, the prospects of slower economic growth and rising unemployment have led some to urge a return to Keynesian stimulus. The clouds on the economic horizon might tempt some to argue for a delay to reform. GDP growth has slowed to 2.5 per cent.⁴³ Unemployment has increased from 5.1 to 5.8 per cent between April 2012 and October this year.⁴⁴ More people have less work than they would like.⁴⁵ The OECD has cautioned against dramatic fiscal contraction in the short term, but welcomed tightening in the medium term.⁴⁶

We should worry about a tendency to look for any excuse to put off reform until *next* year. There will always be reasons to put off the hard political work of actual budget repair. Governments everywhere are keen to promise budgetary virtue, but less keen to deliver it. Budget choices are hard, and no-one likes any short-run

reduction in economic growth. The benefits of lower interest payments from reduced public debt are inevitably promises about the future that people tend to value less.⁴⁷ Governments have many incentives to run deficits, including the desire to give the public the spending increases and tax cuts they say they want, and to avoid leaving surpluses for their political opponents to spend.⁴⁸

That is why Australia's historic aversion to government debt may not always be the perfect answer from the perspective of economic theory.⁴⁹ However, it may be a very good answer given the political temptations to run deficits when it is not in the country's long-term interests. Unless governments are under constant electoral pressure to avoid debt, they will tend to find reasons to spend tomorrow's tax dollars today, until they hit the hard limit of financial market tolerance, and borrowing becomes either high cost or impossible. While that limit is a long way off today, reaching it would clearly be the worst of all outcomes.

In any case, the current economic situation may be as good as it gets for some time. Current GDP growth of 2.5 per cent may well be the long-term growth rate for many years. Economists such as Robert Gordon, Tyler Cowen, Stephen King, and some at the IMF suggest that economic growth will be slower in developed countries for the next few decades, since there is no obvious wave of productivity enhancing platforms, and ageing is starting to

⁴¹ Jones and Prasser (forthcoming)

⁴² Greber and Heath (2013)

⁴³ ABS (2013a), as at June 2013 (trend)

⁴⁴ ABS (2013l) Table 1, as at Oct 2013 (trend)

⁴⁵ ABS (2013m)

⁴⁶ OECD (2013b), p. 127

⁴⁷ See Buchanan and Wagner (1997); Kahneman (2012)

⁴⁸ Eslava (2011)

⁴⁹ Macfarlane (2006)

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reduce participation rates.⁵⁰ As a result, future governments may have even less ability to repay than current governments.

Similarly, while an unemployment rate of 5.8 per cent is high relative to the last decade of the mining boom, it is much less than the 7.7 per cent average of the previous decade.⁵¹ This rate of unemployment was achieved after a year in which the Commonwealth government reduced its spending by \$3.8 billion in *nominal* terms⁵² – even if that statistic is much helped by timing payments to fall in the earlier rather than the later financial year.

Furthermore, we have something of an insurance policy. If budget repair leads to a significant rise in unemployment, then Australia's central bank still has some room to cut interest rates further to stimulate the economy. Most central banks in the developed world do not have that luxury.

⁵⁰ Gordon (2012); Cowen (2011); King (2013); Abbas, *et al.* (2013), p. 6

⁵¹ ABS (2013I) Table 1; Grattan analysis

⁵² Treasury (2013b), p. 2

4. Framing budget choices

4.1 Criteria for choices

This report presents some potential choices to fix structural budget deficits. We do not suggest that any Australian government will – or should – implement all of them. However, we have tried to identify as many choices as possible that would both make a material difference to budget outcomes, and do not have unacceptable social or economic side-effects. Australian governments may find many of the choices unpalatable, but given the size of their long-term budget challenges, it will be hard for them to repair budgets without facing at least some of these choices. If they are all ruled ‘off the table’ then Australians are entitled to ask whether their governments are serious about restoring budget balances.

All of the budget choices presented are politically difficult. If they were easy, they would have been made already. Australia’s governments are small by OECD standards, and our public sector operates more efficiently than most.⁵³ This makes it harder to find savings by cutting waste and shrinking non-essential services.

In this report, we provide an approach to assessing budget choices that other policy actors can use as a model for prioritising potential reforms. Even if many do not agree with our assessment of individual reforms, we hope that the model will be useful in providing a disciplined approach that tackles the highest priority reforms first.

Our approach uses three criteria that we believe are the critical factors in prioritising budget reforms:

1. Will the proposal have a significant impact on the budget deficit? In other words, is the financial impact of the proposal big enough to make a difference? We classify proposals as having significant impact if they save at least \$2 billion a year. We estimate the impact of all proposals once they are fully implemented, using 2012-13 dollars.
2. If the proposal saves more than \$2 billion, what are its social, distributional and economic impacts?
 - Social impacts: how will the proposal affect people and their behaviour?
 - Distributional impacts: how will it affect people in the bottom 20 per cent of the income distribution?
 - Economic impacts: will it have positive or negative impact on economic activity?
3. How confident are we in the size of the savings? Confidence will be high if there is concrete evidence about the size of the potential benefits. That confidence is affected by factors such as the complexity of the drivers, the uncertainties inherent in those drivers, the potential behaviour change as a result of the proposal and the availability and quality of underlying data.

⁵³ OECD (2012a); OECD (2012b)

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We detail our findings on each of these criteria for each proposal in *Balancing Budgets: Supporting Analysis*. This also includes further details on methodology, including how social, distributional and economic impacts were combined.

Our focus on the size of reforms reflects the context of the Commonwealth Government's structural deficit of over 2 per cent of GDP for the last six years (\$30 billion in today's terms),⁵⁴ and the long-term projected structural deficit of 4 per cent of GDP across all Australian government budgets over the next decade (\$60 billion in today's terms).⁵⁵ Of course, smaller measures also matter. Between 2009 and 2013 the Commonwealth government made discretionary budget choices that improved its budget bottom line by \$72 billion in 2013-2014. Of these, \$13 billion were the result of small measures worth less than \$50 million a year.⁵⁶ However, inevitably a large portion of such substantial budget deficits will need to be corrected through major policy choices.

In assessing distributional impacts, we focus deliberately on the impact on the bottom 20 per cent of the income distribution – generally those who are worst off. This reflects a consensus in Australian political culture that policy should assist those who are less well-off to have opportunities to pursue lives that they have reason to value.⁵⁷ Many argue that policy should also aim to distribute resources more equally.⁵⁸ However, this latter approach

⁵⁴ See above, Section 2.4

⁵⁵ See Chapter 1.

⁵⁶ Daley, *et al.* (2013), p. 51, which also shows how these budget improvements were accompanied by discretionary measures that cost the budget bottom line \$59 billion in 2013-14.

⁵⁷ See the discussion in *ibid.*, p. 37

⁵⁸ See Leigh (2013)

is more contentious, and so we do not use it as a criterion for evaluating budget choices.⁵⁹

Our assessment of the size of each reform is generally an estimate. Setting priorities usually depends on relative size rather than precision. A \$5 billion proposal will contribute more to balancing budgets than a \$2 billion proposal, even if considerable uncertainties exist in both estimates. The main task in setting priorities is usually not in distinguishing between closely matched proposals. Rather, it is mostly to sort out the subset of proposals that are materially better than others. A more complex model of the economy that captures flow-on effects may be more precise in estimating the potential size of reforms, but we do not believe that this would assist prioritisation much. The impact of most of the proposals we examine will depend on how people respond – which is inherently impossible to predict precisely. If a reform is a priority, then often it is better to spend available resources on implementation, and discover the precise impacts in practice.

As with our estimates of budgetary impacts, our estimates of social and distributional impacts should not be treated with spurious precision. For many of these effects there is no common metric, and their relative importance depends on the weighting of different political values. For some the ultimate impact depends on second-round effects that are difficult to predict. Consequently our assessments are generally directional. They aim to produce an informed discussion.

Our analysis in this report assesses choices that are likely to have a substantial budgetary impact. There may be other reasons to

⁵⁹ Daley, *et al.* (2013), p. 36-37

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undertake policy reform, such as improving social outcomes, protecting the environment or improving fairness of distribution within the community.⁶⁰ However, these other policy ends are beyond the scope of this report unless they are contained within proposals that have a substantial budgetary impact.

We do not assess the political feasibility of implementing these choices. Any significant reforms are likely to encounter substantial opposition. We aim to identify where political capital might be expended so that it would make the most difference to improving outcomes in the interests of all Australians.

4.2 Scope of choices

The 20 proposals we examine in detail aim to cover all of the spending reductions, tax exemptions, and new taxes that are commonly raised in discussions about budget repair. They include all those we have identified in publications such as the Henry Tax Review and tax expenditure statements. They also include a broad range of ideas raised with us in many external discussions about the material in this report. As well as proposals with a budgetary impact of more than \$2 billion a year, we also examine a number of reforms that are popularly believed to have a large budgetary impact, although our analysis suggests the impact would probably be much smaller in practice. These include abolishing negative gearing, public service cuts and reductions in 'middle-class welfare'.

As well as these specific proposals, we also briefly examine possible increases to existing taxes. In our summary of proposals,

we have arbitrarily assumed each would raise \$10 billion a year; the tax rates required to do so are discussed in Section 8.7.

We also examine asset sales (Chapter 10 below). These are not included in our summary of proposals because the contribution of an asset sale to the annual budget balance depends on the sale price, government interest rate, and future dividends if the asset remains in government hands - an analysis beyond our scope.

We have only considered changes to budgetary policy as per the Pre-election Economic and Fiscal Outlook, published in August 2013.⁶¹ Some of the signature initiatives promised by the incoming government are costly, and not enacting these may be a better way to improve the budget balance (see Box 4.1). Nevertheless, these proposals are hypothetical until legislated, and so have not been included.

Doubtless there are sensible proposals that we have failed to identify. We hope, however, that the approach and analysis we present provides a starting point for others to build a more comprehensive picture of the choices available to Australian governments in the difficult task of budget repair.

⁶⁰ Daley, *et al.* (2012a), p. 7

⁶¹ See Treasury (2013c)

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Box 4.1: Commitments of the new government

The new Commonwealth Government made a number of election commitments that would have a significant effect on the long-term budget balance (see Figure 2.5). Further budget improvement might be achieved by not enacting some of these proposals:

- Expanded paid parental leave – an extra \$2 billion a year going mostly to middle- and upper-income families (Section 9.5).⁶²
- Cutting company tax – results in foregone revenue of over \$3 billion per year.⁶³
- Changes to climate policy – the net effect of abolishing the carbon price and associated industry compensation, and introducing Direct Action, costs about \$4.5 billion a year.⁶⁴
- Increasing defence spending – the commitment to increase defence spending to 2 per cent of GDP in 10 years, from current levels of 1.6 per cent, will cost around \$8 billion at full implementation.⁶⁵

Although these commitments were offset by budget improvements elsewhere in the Coalition's election platform (such as a levy on large companies, the abolition of the schoolkids bonus, and cuts to the public service and foreign aid)⁶⁶ it would be possible to enact those improvements without the accompanying spending, improving the budget balance.

Note: All costings are at full implementation, in \$2013

⁶² Grattan analysis of Loughnane (2013a); PBO (2013b)

⁶³ Grattan analysis of PBO (2013b)

⁶⁴ Grattan analysis of *ibid.*

⁶⁵ Grattan analysis of Loughnane (2013b); Thomson (2013)

⁶⁶ See PBO (2013b); Hockey and Robb (2013)

4.3 Summary of key choices

The impacts of the 20 choices we analyse are summarised in Figure 4.1.

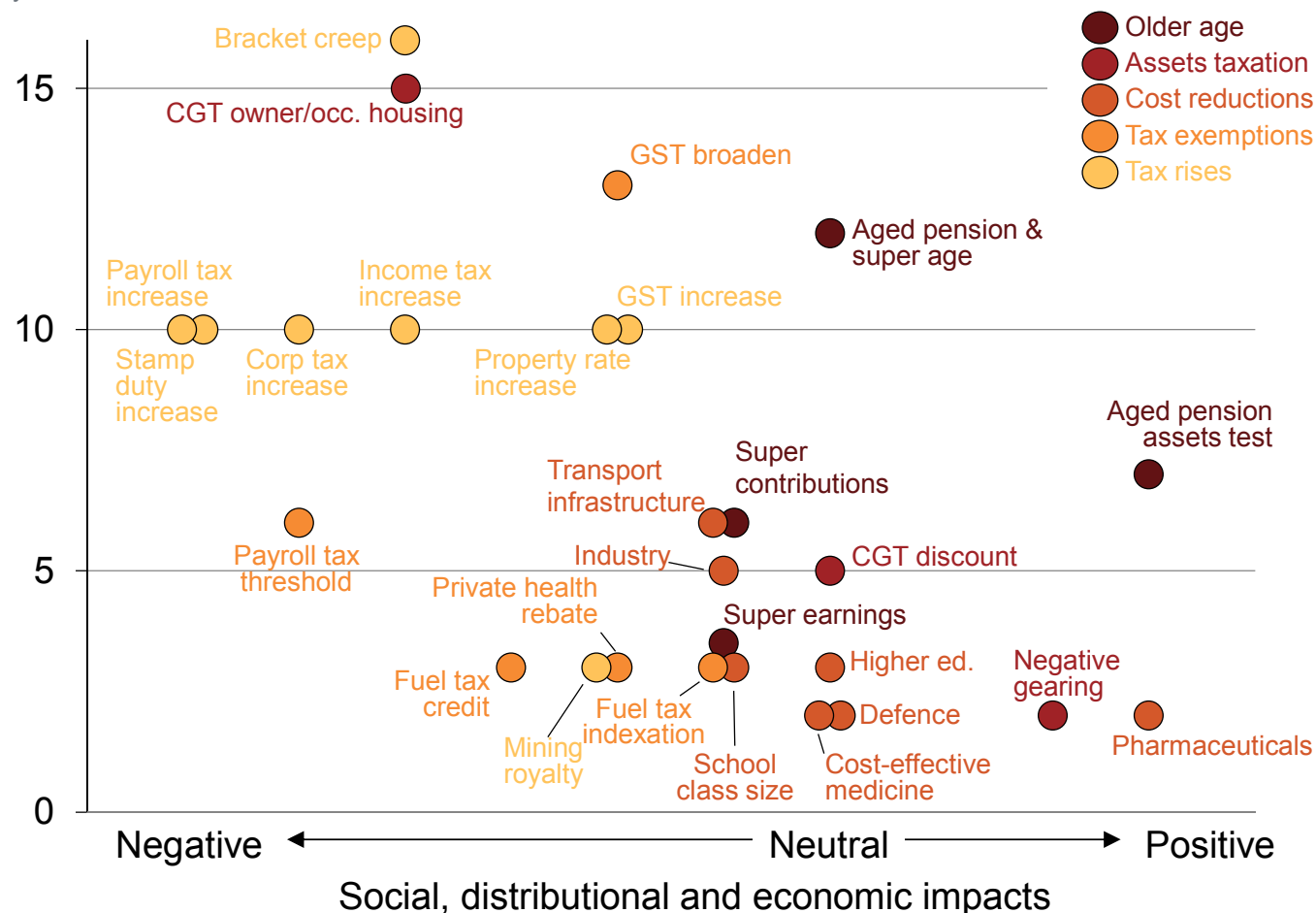
Some clear themes emerge from the figure. Proposals for better targeting of support for older people (shown in brown) are generally larger and more attractive than other alternatives. Just four choices could improve the budget balance by \$27 billion a year.⁶⁷ The different components of reform of assets taxation (shown in red) have very varied assessments. Broadening the GST is an attractive reform, but other tax exemptions (shown in light orange) are generally less attractive – by and large these tax exemptions have survived for good reasons. Tax increases (shown in yellow) could do more to improve budget balances, but they usually have more negative side effects. A number of cost reductions (shown in dark orange) have smaller side effects, but their budgetary impact is also often smaller.

⁶⁷ There is some interaction between the Age Pension asset test proposal and the retirement age proposal. If the retirement age is lifted, the *additional* savings from reforming the Age Pension asset test are reduced as fewer people are old enough to qualify for the Age Pension.

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Figure 4.1 Budgetary, social and economic impacts of budget choices

Budget impact per year, 2103\$ billion



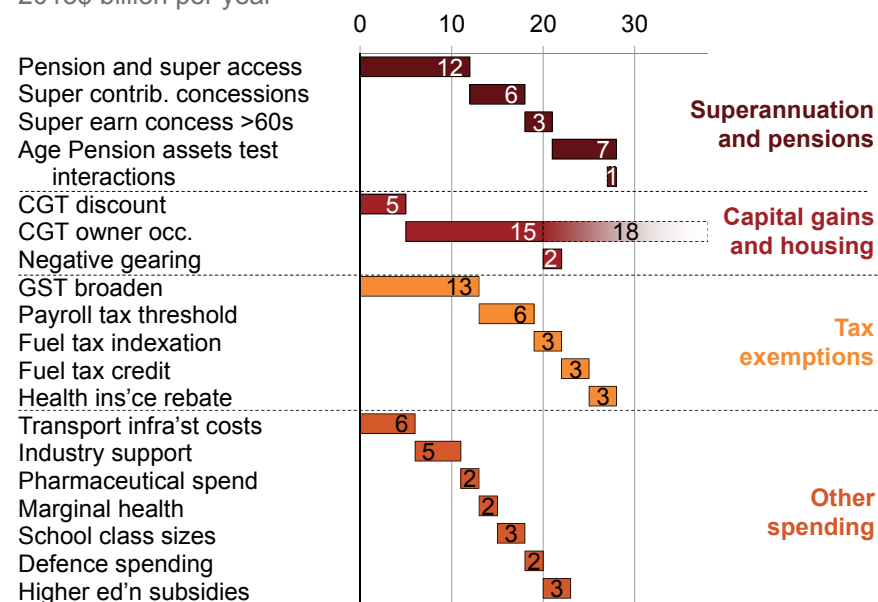
Note: Proposals considered that would generate less than \$2 billion are not shown. These include congestion charges, grants to first home-buyers, middle-class welfare, public sector efficiency, avoidable hospital costs and end-of-life care. See *Balancing budgets: Supporting analysis* p. 48-9.

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Spending reductions, including reform to the age pension assets test and increases to the pension age (which reduce pensions), and the variety of other spending proposals identified, add to around \$33 billion a year. Tax increases as a result of removing exemptions add to around \$50 billion a year. Higher tax receipts as a result of increasing the age of access to pensions and superannuation would raise about \$9 billion (Figure 4.2).

Most of the remainder of this report explores these choices in detail. Each choice is explored in *Balancing budgets: Supporting analysis*, published in association with this report.

Figure 4.2 Cumulative budgetary impacts of choice themes
2013\$ billion per year



Note: interaction effects between CGT proposals are captured within the proposal for CGT on owner-occupied housing, as shown in a lighter colour.

5. Packaging reform

All the proposals in this report would leave some people worse off, at least in the short run. In the last decade, governments have been averse to making decisions that create identifiable losers.⁶⁸ Chapter 3 shows how important it is for pain to be shared: people may be more willing to accept the burden if they understand that everyone is experiencing some pain. It is also harder for special-interest groups to claim that their interests should not be adversely affected when everyone in the community is sharing the burden.

For these reasons, big and difficult reforms may be best introduced in a package. A package can indicate the magnitude of the overall problem and show that the burden is widely shared. It can also include some (smaller) spending increases that mitigate the impacts on those worst off and least able to absorb adverse change

In developing a potential reform package, we considered the following criteria:

- Prioritisation – which proposals are big enough to care about? Will they materially improve the budget deficit?
- Distributional impact – how might proposals be combined so that a range of identifiable groups share the burden fairly?

5.1 One potential package

A package that would distribute the burden across the community, affecting both rich and poor, and focus on the most attractive opportunities identified in our prioritisation, would:

- broaden the GST
- raise the pension and super age
- include the primary residence in the Age Pension asset test
- limit superannuation tax concessions.

The proposals in this package would contribute about \$37 billion a year towards balancing budgets. The package picks up many of the proposals that would do most to improve budget balances, with relatively limited side effects

It would affect both rich and poor. Broadening the GST would affect all income groups, but would hit low-income earners hardest, although compensation could reduce most of the impact. Raising the pension and superannuation age would affect all income groups. Including the primary residence in the Age Pension asset test would primarily affect middle-income earners – people doing well enough to own their own house, but not so well

⁶⁸ Daley, *et al.* (2013), p. 9. For example, see Megalogenis (2012); Tingle (2012)

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that they do not qualify for the Age Pension.⁶⁹ Limiting superannuation tax concessions would mainly affect high-income earners, who reap most of the benefits of tax concessions for contributing more than \$10,000 a year to superannuation.

The package would probably slightly reduce inequality overall, consistent with some – but by no means all – efforts to improve budget balances around the world.⁷⁰

The major sensitivity with this package is that all of the reforms appear to affect older Australians more. This may be more perception than reality, but it would be an important issue to manage.

Increasing the pension and superannuation preservation age mainly affects those aged about 50 to 55 in the short term. Assuming that the eligibility ages are lifted gradually, those already retired would be unaffected. All Australians who are under 50 today will share the burden in the future as they age. Many under the age of 45 may believe that increase is inevitable – and in any case the effect is at least 20 years away.

Including owner-occupied dwellings in the assets test primarily affects those over 65 – although obviously these rules will apply to everyone when they are older.

⁶⁹ People in this cohort are likely to be middle-income earners over their lifetimes, and although their income in retirement is likely to be less than when working, their disposable incomes can often be relatively high: see Phillips and Nepal (2012)

⁷⁰ Rawdanowicz, *et al.* (2013), p. 27-28

Limiting superannuation contribution tax concessions would affect high wage earners in all age groups, but particularly those over the age of 60 who currently pay much lower rates of income tax than younger people on similar incomes. Again, those who are younger now pay their share in that they will also miss out on current, generous arrangements as they age.

Broadening the GST affects the spending of all Australians. Older Australians who are not working are likely to prefer other tax changes such as income tax increases that inherently affect them less.

The skew of Australia's current tax and welfare systems explains why the proposed package would have a greater impact on older Australians in the short term. Our tax and welfare system is generally tightly targeted to those most in need. The biggest exception is pension and superannuation systems, which are substantially 'age-based' rather than 'needs based'. Inevitably, reforming these arrangements emerges as a high priority that would substantially improve budget balances with relatively limited side effects.

Other packages might be designed around a different combination of proposals. The key task is to group together major reforms in ways that demonstrate that everyone in the community is sharing the burden of budget repair.

5.2 A package for federalism

Packaging reforms together can also help to overcome the politics of federalism, and ensure that both Commonwealth and state

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governments pull their weight in improving budget balances.

Broadening the GST would transfer substantial additional revenue to states if current arrangements were maintained. The Commonwealth would incur much of the political pain in broadening the GST. To improve its budget, the Commonwealth might reduce some of the tied grants paid to the states that provide about 25 per cent of their revenue – although inevitably these are in program areas where the Commonwealth (at least in the past) saw substantial political benefits from involvement.

Such a substantial contribution to state government budgets and autonomy provides an opportunity to lock in other reform. One option would be to make the increased GST revenue conditional on states also reforming payroll tax thresholds. But while this might contribute up to \$6 billion a year to State government budgets, it is unclear that this reform would substantially improve long-run economic growth given its potential impact on unemployment. Alternatively, the Commonwealth might make the increased GST conditional on states reducing their payroll rate, but also abolishing the payroll tax threshold, which would provide some efficiency gains (see Section 8.2).

A better alternative might be to make the increased GST revenue conditional on states reducing stamp duties and increasing property rates over time. This reform, while politically difficult, would make it easier to sell property to whoever values it most highly. It also reduces the vulnerability of state budgets to falling revenues when there are fewer property transactions (typically

when property prices are falling).⁷¹ This reform would not improve State budgets much, but it would substantially improve the efficiency of the tax system, and lift economic growth.

Any such package would reduce vertical fiscal imbalance (see glossary) between the Commonwealth and states. Many say that because states don't raise half the revenue they spend, they tend towards less responsible budgets.⁷²

⁷¹ For discussion of the merits of this reform, see Daley, *et al.* (2012a), p. 33-34; Kelly, *et al.* (2013), p. 32-33

⁷² See Eyraud and Lusinyan (2011)

6. Superannuation and pensions

Improving the targeting of pension and superannuation policy is the largest single theme among the budget choices we have identified.

Obviously these choices primarily affect older Australians in the short term. They emerge as high priorities because tax and welfare policies for older Australians are less well-targeted to those most in need than are other policies, and consequently there are more opportunities for change that deliver substantial improvements to the budget with relatively few side-effects. These choices will affect all Australians as they age, not just the current older generation.

Budget measures that affect older Australians may also be appropriate because older Australians are putting most pressure on government budgets. As we showed in *Budget pressures on Australian governments*, the largest spending increases over the last decade have been increased spending on health (where more is spent per capita on older people than on younger people) and on the Age Pension. Both of these spending categories grew substantially faster than GDP, not because of the ageing population, but because of explicit and implicit choices to spend more per person of a given age.⁷³

The key choices we identify are increasing the age of access for the Age Pension and superannuation, limiting tax concessions for superannuation, and including owner-occupied housing in the Age

Pension assets test. Although a government is unlikely to make all these choices simultaneously, collectively they could improve budget balances by \$27 billion a year.⁷⁴

6.1 Pension and superannuation preservation age

Increasing to 70 the age of access to the Age Pension and superannuation (the 'retirement age') is one of the most economically attractive choices to improve budgets in the medium term. It could ultimately improve the budget bottom line by \$12 billion a year in today's terms, while producing a lift in economic activity of up to 2 per cent of GDP.⁷⁵ The principal adverse social consequence is that some who would prefer to stop working earlier will not be able to afford to do so. Given increasing life expectancy, this is a reasonable burden.⁷⁶

Increasing the retirement age would almost certainly lead to many people choosing to work for longer. There is a noticeable increase in the number of people who retire once they can withdraw super tax free, and another jump once they become eligible for the Age Pension (Figure 6.1).

⁷³ Daley, *et al.* (2013)

⁷⁴ This costing is based on all measures being introduced, and includes likely interaction effects between the proposals.

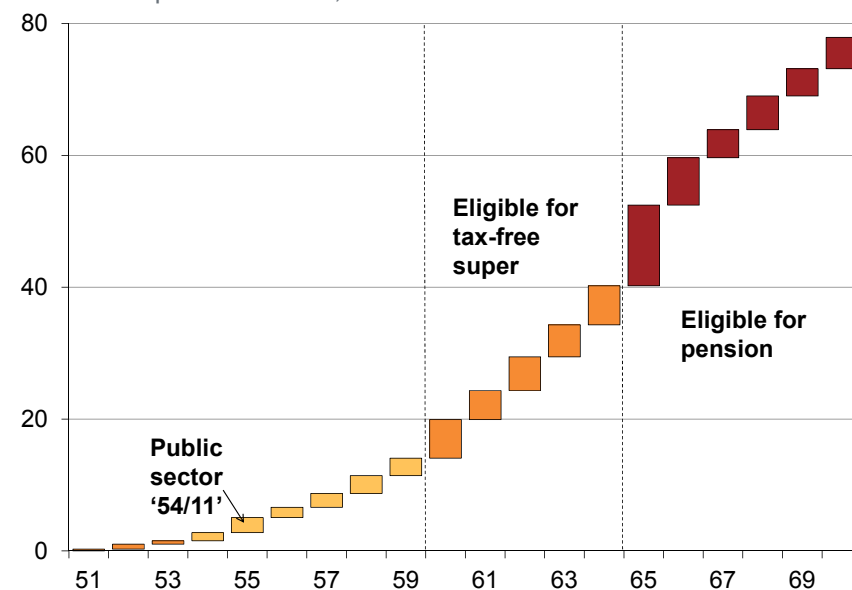
⁷⁵ Daley, *et al.* (2012a)

⁷⁶ A recent analysis of ageing policy can be found in PC (2013)

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Figure 6.1 Age of eligibility for superannuation and Age Pension affects retirement decisions

Cumulative per cent retired, males



Source: Grattan analysis of ABS (2011a)

Note: Assumes that differences in labour-force participation rates between cohorts 1 year apart in age reflect retirement rates.

It is probably only feasible to increase pension and superannuation ages gradually over several years. Current legislation will increase the pension age from 65 to 65½ in 2017, and then by 6 months every 2 years until it reaches 67 in 2023.⁷⁷ This timetable could be accelerated to start raising the pension

age by 6 months every year starting in 2015, and it would then reach 70 by 2025.

The age of access to superannuation is legislated to rise from 55 to 60 by 2024, although there are already substantial restrictions and tax penalties on superannuation withdrawals between 55 and 60. The age of unfettered access to superannuation could be increased from 60 by 6 months every year starting in 2015, and it would then reach 70 in 2035. Once the substantial increases in life expectancy of the last 30 years have been incorporated into the access ages as proposed, then it may be appropriate to index the access age for age pension and superannuation to life expectancy.

This phasing would still have a substantial effect within a decade. The benefit to the budget bottom line would be approximately \$12 billion by 2023, and about \$15 billion by 2035 in today's dollars.

People working for longer would improve medium-term budget balances in a number of ways. First, they would pay income taxes for longer – increasing income taxes by about \$9 billion a year in today's terms by 2035, on our calculations. Second, they would continue to contribute to their superannuation accounts for longer, and so would self-fund their retirement for longer. Third, Age Pension payments would reduce by at least \$3 billion a year in today's terms, on our estimate. This third saving is primarily from those who retire onto part pensions. Those who qualify for the full Age Pension in the early years of retirement were usually receiving other welfare benefits such as the disability pension immediately beforehand. For this group, changing the age of eligibility for the Age Pension will not reduce welfare payments;

⁷⁷ DHS (2013a)

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instead it will merely change the category of payment received.⁷⁸

Unlike almost all the other budget choices examined, this proposal would *increase* economic activity. A higher retirement age that encourages more mature-aged people to work for longer would produce a sizeable increase in economic activity. Our previous work identified this as one of the few policy game-changers for economic growth, with analysis estimating that increasing the retirement age to 70 would increase economic activity by about 2 per cent once fully implemented.⁷⁹

There would be some social costs to people working for longer. Contrary to popular belief, there would be little impact on volunteering, and life satisfaction would not be materially lower.⁸⁰ However, some people prefer to retire early, and some of them would no longer be able to afford to do so.

Yet this is a reasonable burden to impose. Life expectancy has increased substantially, while the eligibility age for the Age Pension did not move for men between 1908 and today. Increasing life expectancy is largely due to health care improvements that are themselves putting the greatest pressure on budgets.⁸¹

When the Age Pension was introduced in 1908, the age of eligibility was set to 65 for men and 60 for women. At that time, a

⁷⁸ Horin (2010) Most of this group receive Disability or Carer's Pension rather than Newstart, and so there is little difference in benefits when moving to the Age Pension: Gregory (2012)

⁷⁹ Daley, *et al.* (2012a)

⁸⁰ Ibid.

⁸¹ Daley, *et al.* (2013)

15-year old boy could expect to live to 64; a 15-year old girl to 67. Those who survived to receive the pension did not spend much time drawing it: on average male recipients would spend a little over 11 years on the pension, while women would draw it for 17.⁸²

Today, the Age Pension age of eligibility is 65 for men and women, though this will increase slowly to 67 by 2023. Life expectancy for 15-year old boys is 80 today, and almost 85 for girls. Half the men going onto the Age Pension at 65 today will receive it for more than 19 years; half the women for more than 22.⁸³

The value of this increased life expectancy, and its link to active lives, is perhaps best illustrated by the boom in travel over the last few decades. As the CEO of a leading tour operator remarked recently:

"Modern medical science is [a] gift that keeps on giving! New knees and hips, as well as heart stents – especially heart stents – are giving my customers another 10 to 20 years of travelling".⁸⁴

Increasing the age of access to superannuation would not be a regressive policy change, because any reduction in choice would primarily affect those with higher incomes. Those who withdraw their super early are almost always those on higher incomes (Figure 6.2).

⁸² ABS (2008)

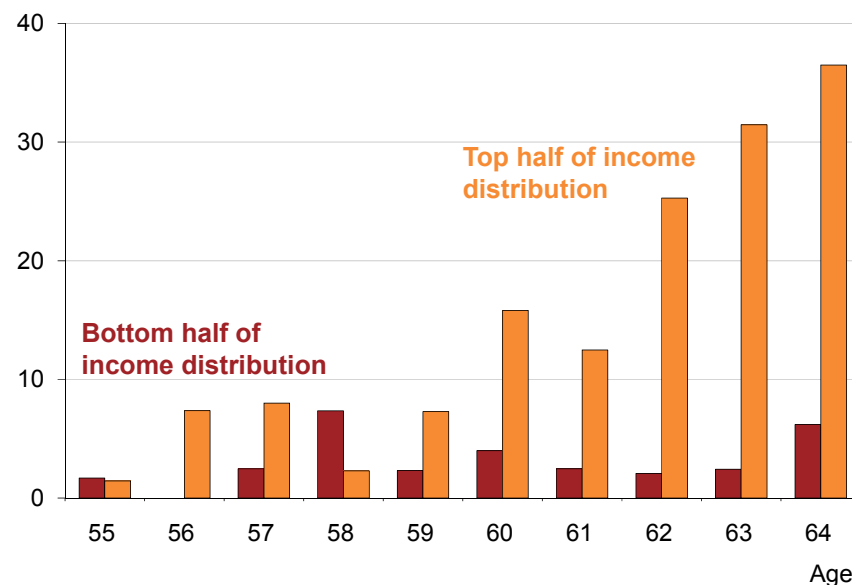
⁸³ Daley, *et al.* (2012a)

⁸⁴ Kohler (2013)

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Figure 6.2 Proportion of age cohort withdrawing payment from their superannuation account

Per cent



Source: Grattan analysis of ABS (2011c)

The primary concern with increasing the retirement age is the increased burden on those who are not fit to work at age 65. Yet this is a declining proportion of the population.⁸⁵ The needs of this group would be best addressed by allowing earlier access to superannuation for those who have a disability. Assessments of

⁸⁵ The proportion of the workforce in the most physically demanding sectors (agriculture, construction and manufacturing) has dropped from about 28 per cent to 20 per cent in the last two decades, and these trends are likely to continue. See Lowe (2012)

eligibility for the disability pension might also use less stringent tests of whether a person aged over 65 has such a severe impairment that they are unable to work.⁸⁶ This is preferable to setting a lower than ideal retirement age for all people because of concern for this particular group.

Of course, policies that encourage employment of older workers would also help. However, as we showed in *Game-Changers*, pension eligibility ages are the biggest driver of retirement decisions around the world. In Australia most people retire because they choose to do so rather than because they are unable to find employment.⁸⁷

6.2 Superannuation contribution tax concessions

At present, employees are only taxed at 15 per cent for the first \$25,000 – or \$35,000 for those aged 59 and over – that they put into their superannuation account each year. Reducing these thresholds to \$10,000 could raise up to \$6 billion a year. The change would have little impact on low-income earners, as the vast majority of contribution tax concessions benefit older workers on high incomes. There would be some negative economic impact as older workers would pay more income tax, and so have less incentive to work. It may also reduce national savings.⁸⁸

⁸⁶ Although this might create some 'leakage' into the disability pension, by definition these people would currently be on the Age Pension, so there would be no net increase in welfare payments.

⁸⁷ Daley, *et al.* (2012a), p. 52-53

⁸⁸ For a discussion of the relationship between superannuation and national savings, see Gruen and Soding (2011)

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Superannuation differs from regular savings because it attracts significant tax concessions. Contributions made from pre-tax earnings are only taxed at 15 per cent up to the \$25,000 or \$35,000 thresholds.⁸⁹ Earnings from superannuation funds are only taxed at 15 per cent during the accumulation phase (usually pre-retirement) and not taxed at all when supporting retirement income streams; earnings from other savings are taxed at the person's marginal tax rate.⁹⁰ People – especially high-income earners – who save through superannuation usually pay substantially less tax than if they save through other investments.

Superannuation savings can be taxed at three points: when they are put into a superannuation fund (known as contributions); when they earn income (known as accumulations, which include both capital gains and income); and when they are withdrawn or produce an income stream.

In Australia, superannuation contributions from pre-tax earnings are effectively untaxed for those earning less than \$37,000 a year. For those earning more, contributions up to the thresholds are taxed at 15 per cent, and over the thresholds at the person's marginal tax rate (which can be as high as 46.5 per cent). In 2014-15 these thresholds will be raised to \$30,000 of contributions in a single year for those under 50, and the \$35,000

threshold will apply to those over 50.⁹¹ By comparison, savings outside of superannuation are generally made from post-tax earnings, and so in effect contributions are taxed at the person's marginal tax rate, which is 38.5 per cent for many taxpayers.

These arrangements lead to workers over 60 paying substantially less income tax than younger workers with similar incomes. They can arrange their affairs so that the first \$35,000 of income is deposited to superannuation – from where it can immediately be withdrawn tax free (conditional on a superannuation balance of more than \$350,000), but is not included in taxable income. As a result a 61-year old working full-time on the Australian average wage of \$77,000 a year may pay at least \$5000 less a year in tax than a person under 60 who only makes compulsory superannuation contributions of 9.25 per cent.⁹²

Superannuation earnings also attract less tax. Capital gains made on assets inside a superannuation fund are taxed at 10 per cent, and other income — interest and dividends — is taxed at 15 per cent. Franking credits (tax paid on behalf of the shareholder by a company) may be used to offset a tax liability within the fund, including capital gains.⁹³ By comparison, earnings on savings outside of superannuation are again taxed at the marginal tax rate – 38.5 per cent for many taxpayers.

⁸⁹ Changes announced in the 2013 budget would tax contributions from those earning more than \$300,000 a year at 30 per cent (Swan and Shorten (2013)). The Coalition government has not announced any change to this policy (see Hockey and Robb (2013); Hockey and Sinodinis (2013)).

⁹⁰ Changes announced in the 2013 budget would tax earnings above \$100,000 a year that are supporting income streams at 15 per cent (Treasury (2013a) BP2, p. 41.) The Coalition government has announced that it will not proceed with these changes (Hockey and Sinodinis (2013)).

⁹¹ ATO (2013a) The threshold is indexed to CPI and rounded to the nearest \$5,000: it is expected to lift to \$30,000 in 2014-15.

⁹² These calculations do not include additional tax concessions from the Seniors and Pensioners Tax Offset. Depending on the spouse's income this might reduce the tax payable by a person aged 65 or over by another \$1600.

⁹³ ASIC (2013c)

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Some retirement systems in other countries balance tax concessions on contributions and accumulations by taxing withdrawals. In Australia withdrawals from superannuation accounts are generally untaxed if the person is aged over 60.⁹⁴

Our proposal would reduce the concessional contributions threshold to \$10,000.⁹⁵ Contributions above the threshold would be taxed at the marginal rate. After taking into account the interaction between deposit and accumulation tax concessions, this proposal would increase Commonwealth tax revenues by around \$6 billion when it was fully implemented. Not all the superannuation contribution concessions would become revenue if they were revoked.⁹⁶ However, we expect that income tax would be paid at marginal rates on almost all of the income that would otherwise attract a superannuation contribution tax concession. Although some investments would be switched into other asset classes, there is no alternative investment that allows taxpayers to avoid paying income tax on earnings before they are invested.

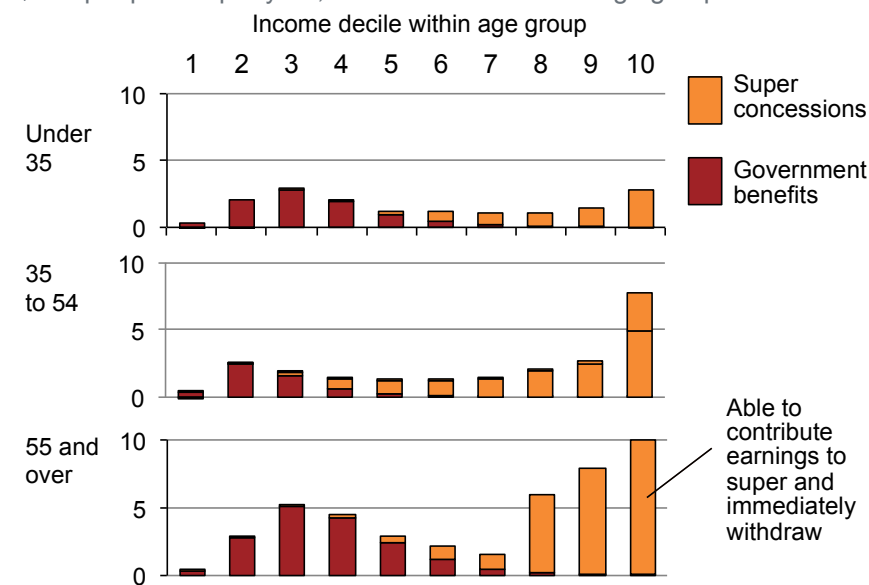
⁹⁴ ASIC (2013a). More complex rules apply to taxation of withdrawals by people aged between 55 and 60.

⁹⁵ There is considerable uncertainty about the superannuation balances of those making concessional contributions into their superannuation accounts. Some who are making contributions are 'catching up' on not having had a superannuation guarantee for much of their working career. Others are simply using the rules to minimise their tax. Given the available data, it is impossible to tell what proportion of super contributions are made by each group. However, data from the ATO (2013c) suggest that those with the capacity to make large contributions are among the richest 30 per cent of those in their 60s. The Household Expenditure Survey, which gives a survey-based estimate of superannuation balances, suggests that the top 30 per cent of those in their 60s are more likely to have large superannuation balances (ABS (2011c)).

⁹⁶ Treasury (2013d)

The proposal would have limited social impact. It would have almost no impact on the bottom 20 per cent, as superannuation contribution concessions mostly benefit older people on high incomes, as Figure 6.3 shows. Capping superannuation tax concessions would also support gender equity as the current

Figure 6.3 Superannuation concessions and government benefits
\$000 per person per year, income earners within age group



Note: Assumes those aged 60 and over with income over \$60,000 contribute the full amount allowed by the concessional cap.

Source: Grattan analysis of ATO (2013c)

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superannuation concessions primarily benefit men (and their female partners).⁹⁷

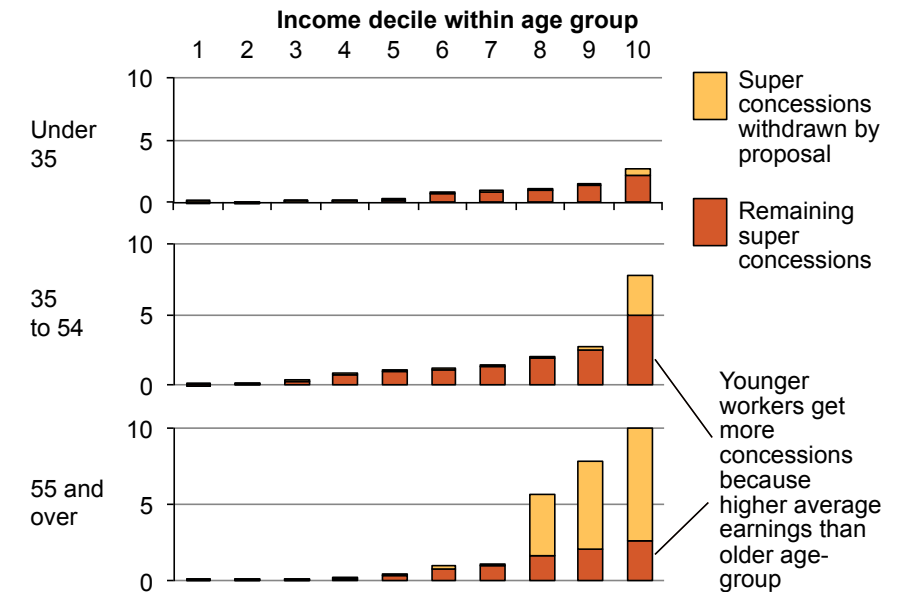
Tightening these tax concessions is unlikely to substantially reduce the draw on the Age Pension. Those in the top 10 per cent of earners aged 35 to 54 are likely to have sufficient savings that they will not qualify for an Age Pension.⁹⁸ And those in the top three earning deciles aged 55 and over would probably save anyway. The superannuation concessions probably do increase their retirement incomes, but only at the cost of younger people paying more tax.

Tightening superannuation tax concessions might reduce workforce participation because it would increase marginal rates of income tax for those over 60. Assuming a 10 per cent reduction in take home pay leads to a 2 per cent reduction in participation,⁹⁹ we estimate the proposal would reduce labour force participation for those aged 60 to 70 by about 0.5 per cent, reducing income tax by about \$0.3 billion.

Nor would the proposal undermine the superannuation system. The articulated purposes of the superannuation system are to provide an adequate level of retirement income, relieve pressure on the Age Pension, and increase national savings.¹⁰⁰ Yet these aims need to be balanced against the many other purposes of government. Merely increasing retirement incomes of older workers is not sufficient justification for providing substantial tax

concessions that in effect mean that younger workers on similar incomes must pay more tax. Most people would like to be rich – both before and in retirement. If some are to have higher retirement incomes, the question is who is going to pay for it. As Figure 6.4 shows, even after the concessions are reduced, those on higher incomes will still receive substantially greater concessions than other taxpayers.

Figure 6.4 Superannuation concessions withdrawn by proposal
\$000 per person per year, income decile within age group



Notes: Assumes those aged 60 and over with income over \$60,000 contribute the full amount allowed by the concessional cap.
Source: Grattan analysis of ATO (2013c)

⁹⁷ Jefferson (2012)

⁹⁸ See Figure 6.7 showing that few households in the top 10 percent qualify for an Age Pension.

⁹⁹ Saez, *et al.* (2012)

¹⁰⁰ Treasury (2013d), p. 21

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We recommend changes to taxation of contributions rather than withdrawals, which would be administratively complex and potentially extremely costly. Changes to withdrawal rules raise difficult questions of how to treat superannuation that has already been contributed, and now cannot be withdrawn. These contributions were made with expectations that they would be treated according to the existing rules on accumulation and withdrawal. An alternative proposal would tax *all* contributions at the taxpayer's marginal rate, but exempt all earnings from tax.¹⁰¹ Again this would be administratively complex, as all previously contributed superannuation funds would then be taxed at a different rate to all newly contributed funds.

6.3 Superannuation earnings tax concessions

Taxing superannuation earnings of those over 60 at 15 per cent (as for younger taxpayers) would yield \$3 billion in additional tax revenue. The measure would have minimal effect on the bottom 20 per cent of income earners, as they receive very little in superannuation earnings.

Superannuation accounts held by over-60s do not pay tax on earned income, such as dividends, interest and capital gains, so long as the account-holder is making some withdrawals.¹⁰² Superannuation accounts held by under-60s, by contrast, pay 15 per cent tax on all income.¹⁰³

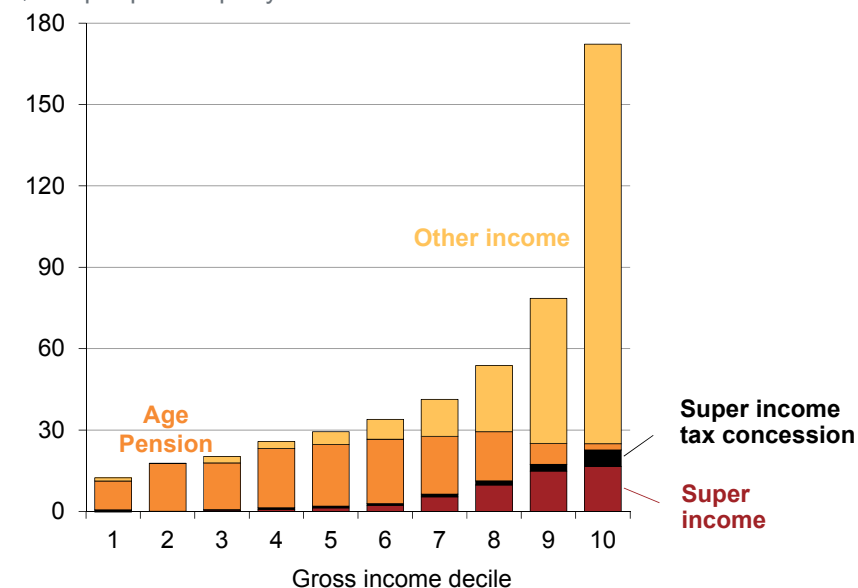
¹⁰¹ Freebairn (2013a)

¹⁰² ASIC (2013a)

¹⁰³ This anomaly was excluded from the terms of reference of the Henry Review: Treasury (2010a)

The proposal would tax all earnings on superannuation at 15 per cent, restoring the taxation arrangements that existed until late 2006. The proposal would have little effect on low income earners. As Figure 6.5 shows, the richest 10 per cent of those in their 60s receive most of the benefit of this tax exemption, worth on average around \$100 a week to them.¹⁰⁴ By contrast, those in the bottom 20 per cent, with limited superannuation balances, barely benefit from this concession.

Figure 6.5 Income by source for those in their 60s
\$000 per person per year



Source: Grattan analysis of ABS (2011c)

¹⁰⁴ Based on Grattan analysis of ABS (2011c)

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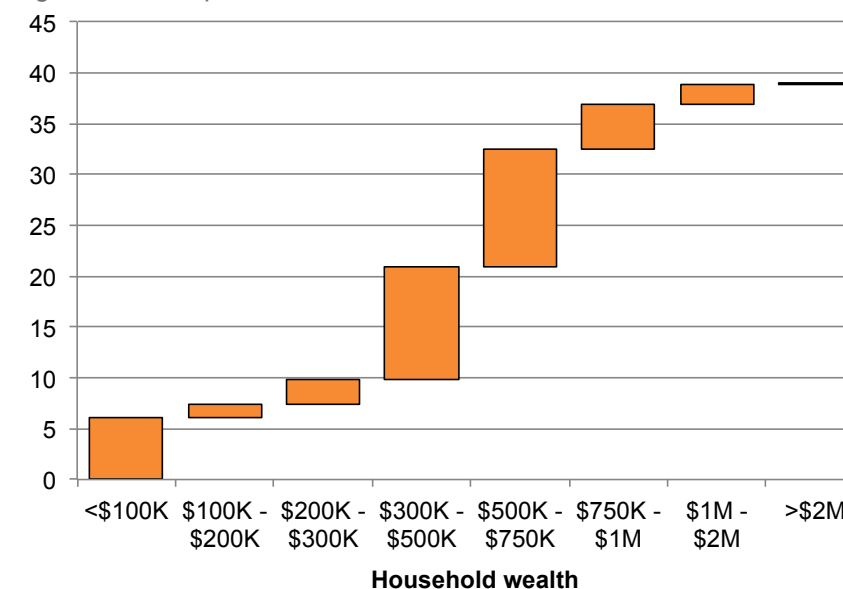
6.4 Age pension asset test

Including owner-occupied housing in the calculation of a retiree's eligibility for the Age Pension would contribute about \$7 billion a year to the budget.¹⁰⁵ The change would also encourage people to downsize to housing which may be better suited to their needs, enabling more efficient use of the existing housing stock. The change would have little impact on those in the bottom 20 per cent of incomes because they do not have enough wealth to put them over the asset test threshold. The impact on low-income retirees with high-value houses would be mitigated by allowing them to claim the pension that would be paid back when their house is eventually sold.

Currently an assets test is applied to the Age Pension. Those with net wealth above a threshold have their payments reduced progressively. The assets included in the asset test include most forms of wealth, such as cash deposits, shares, superannuation balance and investment properties – but not the primary residence. Although there is a slightly lower threshold for those who own their own home, this effectively only takes into account the value of the residence up to \$142,500. Consequently, many Age Pension payments are made to households that have substantial property assets. Almost \$20 billion of these payments – around half of the total – are made to households with more than half a million dollars in net assets (Figure 6.6).

Figure 6.6 Age pension expenditures and household wealth

Age Pension expenditures, 2012-13, \$ billion



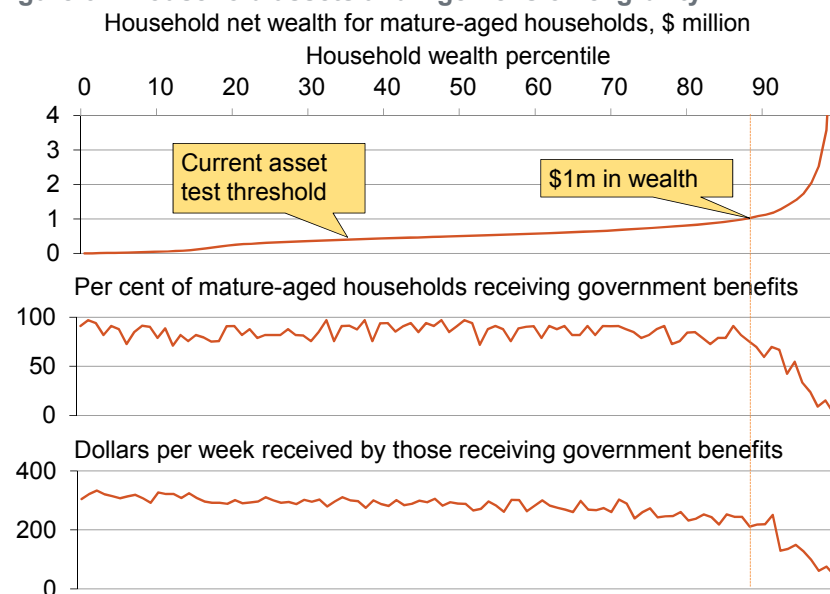
Source: Grattan analysis of ABS (2011c)

Of mature age households with a million dollars in net assets, about 80 per cent receive welfare benefits. On average they receive more than \$200 a week (Figure 6.7).

¹⁰⁵ This estimate is based on Grattan analysis of *ibid.* and HILDA (2012)

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Figure 6.7 Household assets and Age Pension eligibility



Note: 'Mature-aged households' refers to households in which the household reference person, generally the 'head' of the household, is of Age Pension age (65 and over).
Source: Grattan analysis of ABS (2011c)

Including owner-occupied housing in the Age Pension assets test raises significant concerns that the change would hurt asset-rich but income-poor households. An equitable solution would be to allow people who fail the asset test due to the value of their dwelling to receive the age pension. However, the government would accumulate a claim against their dwelling, which it would reclaim when the dwelling was transferred or sold.¹⁰⁶ The value of

the debt would be included in calculating the asset test. Over time the net asset value might reduce so that the person was eligible for the pension without accumulating further debt. By definition the person would always retain a net equity in the dwelling of at least the asset test threshold.

On our estimates, such a reform would improve the budget bottom line by about \$7 billion a year on an accounting basis, though only about \$5 billion a year on a cash measure. The difference is the value of the debt accumulated by the government that will be realised when houses are ultimately sold.

This proposal would also treat homeowners and renters more fairly. Home-owners would be able to access benefits equivalent to rent assistance, but the same assets test threshold would apply to both home-owners and renters.

In addition to their cash payment, Age Pension recipients are eligible for significant concessions on services such as car registration and third party insurance, utilities, rates and health expenses. These benefits are available to those receiving a part pension of any value, so the majority of mature-aged households are currently eligible.¹⁰⁷ Reducing the number of people eligible for the Age Pension thus has the potential to reduce concession expenditure for states, improving their budget position.

However, the proposal would leave untouched other 'age-based' welfare schemes, including the Senior Australians and Pension

¹⁰⁶ In effect the scheme would be similar to including dwellings in the asset test, and the government providing a no-interest reverse-mortgage.

¹⁰⁷ Grattan analysis of ABS (2011c), see Figure 6.7. Commonwealth-state agreements prevent states from restricting eligibility for concessions to full pensioners. See Treasury (2010b) Section D6

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Tax Offset (which reduces income tax rates for those over 65) and the Seniors Health Card (which further subsidises medical costs for those over 65 but not eligible for a pension).

The change would also have substantial positive economic and social effects. The current Age Pension asset test encourages many retirees to stay in houses which may be larger than they need. If a retiree moves into a smaller house and has a surplus, this surplus is included in the Age Pension asset test, and the pension reduced accordingly.¹⁰⁸ Despite some policy attempts to smooth the transition to more appropriate housing,¹⁰⁹ many retirees face reduced retirement incomes if they move into a smaller dwelling.

Removing barriers to downsizing would enable more efficient use of the existing housing stock – particularly important when supply of new housing stock is constrained.¹¹⁰

The current Age Pension test also encourages retirees to hold more of their wealth in a highly concentrated asset: their residence. A reformed asset test would encourage retirees to invest in a more balanced portfolio. It would also reflect that older owner-occupiers have been the primary beneficiaries of the very large real increases in house prices over the past 40 years, which are unlikely to be repeated in future now that interest rates cannot fall much further.

¹⁰⁸ ASIC (2013b)

¹⁰⁹ Net receipts up to \$200k from the sale of a dwelling held more than 25 years may be quarantined from the asset test for 10 years or until they are used. See Chancellor (2013)

¹¹⁰ See Kelly, *et al.* (2011)

7. Capital gains tax and housing

Change to the tax treatment of housing and other assets has been widely discussed as a way to improve budget balances. Options that have been canvassed include reducing the capital gains discount on assets, taxing the capital gain on the largest single asset class in Australia – owner-occupied housing – and eliminating the ability to negatively gear investments, typically investment properties. Our analysis shows that abolishing the capital gains tax discount is attractive; levying capital gains tax on owner-occupied housing could have large negative social and economic side-effects, and abolishing negative gearing would raise little budgetary revenue in the long run.

Many of these proposals also affect home ownership, the availability of housing, and the equitable treatment of renters and owner-occupiers. While these important policy objectives were discussed in the recent report published by Grattan Institute, *Renovating housing policy*,¹¹¹ this report focuses on the extent to which the proposals might improve budget balances.

Instincts that these proposals would yield substantial revenue may be based on the very large increases in property prices over the last two decades. Yet these increases were largely based on long-term reductions in inflation rates and interest rates, which are unlikely to be repeated in future.¹¹²

Pressure to reform this area also stems from inconsistencies in the taxation of different investment types. Rules for specific

investment types such as dividend imputation, capital gains, and superannuation, result in real effective marginal tax rates for a high-income earner ranging from 70 per cent (on bank deposits) to -30 per cent (on superannuation).¹¹³ This report focuses on reforms that would contribute to balancing budgets, although obviously rationalizing the taxation of investments as well is preferable.

7.1 Capital gains discount

Eliminating the capital gains tax (CGT) discount to tax capital gains at the same rate as income could raise \$5 billion a year in extra revenue.¹¹⁴ The additional revenue raised is relatively uncertain, and depends on future asset price appreciation and interest rates. There might be some reduction in the numbers of individual entrepreneurs setting up businesses. There would be little impact on people in the bottom 20 per cent of the income distribution.

Capital gains tax is levied on assets that are sold for more than their nominal cost plus the cost of improvements. The introduction of capital gains tax in 1986 ensured that all sources of income were taxed.¹¹⁵ Before this income from capital investments was

¹¹¹ Kelly, *et al.* (2013).

¹¹² Ellis (2013)

¹¹³ Treasury (2010b) Vol 1, p. 67

¹¹⁴ In 2012-13, the capital gains discount was valued at \$5.4 billion with \$4.7 billion provided to individuals and trusts. This excludes exemptions for owner-occupied housing. Treasury (2013e), p. 5, 7

¹¹⁵ The principle of comprehensive income was outlined by Haig and Simons in the early 20th century and discussed by Evans (2002), p. 119

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not taxable and people could reclassify ordinary income as capital gains to avoid paying tax.¹¹⁶

Initially, capital gains were calculated as the difference between an asset's purchase price (indexed for inflation) and selling price.¹¹⁷ Since 1999, capital gains have been calculated as the difference between an asset's purchase price (not indexed for inflation) and selling price, less a discount.¹¹⁸ Under that discount, individuals and trusts are taxed on 50 per cent of their capital gains, and superannuation funds on 67 per cent of their gains.¹¹⁹ A range of special provisions apply to small businesses.¹²⁰

The discounts were rationalised on the basis that they encourage people to become entrepreneurs and invest in riskier assets. Proponents argue that the discounts compensate for capital gains being eroded by inflation, double taxation on savings and reduce potential lock-in effects created by the tax.¹²¹ However, other forms of investment – such as bank deposits – are similarly eroded by inflation and double taxation, but receive no discount, and tax is payable each year rather than being deferred until the

¹¹⁶ Ibid., p. 118. The incentive to reclassify income as capital gains still exists as a result of the 50 per cent discount, but is weaker than when capital gains were untaxed.

¹¹⁷ As a result of 'grandfather' provisions, capital gains tax is only levied on assets acquired after 1985.

¹¹⁸ Other changes introduced at the same time included abolishing averaging provisions, rationalization and extension of a series of small business retirement and roll-over concessions and the removal of depreciable assets from the CGT regime: Evans (2002).

¹¹⁹ Ibid.

¹²⁰ Wood, *et al.* (2006), p. 23

¹²¹ Burman (2009), p. 114

investment is sold.¹²² Not surprisingly, all of the arguments for the capital gains tax discount are contested¹²³ and some commentators argue that the discounts reduce equity.¹²⁴ Freebairn describes the capital gains tax regime as "...an unsatisfactory hybrid with limited logic."¹²⁵ Nevertheless, the Rudd government explicitly rejected changes to the discounts in its response to the Henry tax review.¹²⁶

There are good arguments to abolish the capital gains discount altogether. Other forms of investments and income from working are taxed at the marginal rate of income tax. On other investments (such as bank deposits), investors are not compensated for inflation, and effectively pay tax on the nominal value of their investment. It is not obvious why returns on investment should be taxed less than returns from working.

If the discount were abolished entirely, additional tax of \$5 billion would have been collected in 2012-13.¹²⁷ It is likely that investors would attempt to change their investment strategy in response. However, it is difficult to see an alternative strategy that would become more attractive, and so reduce the amount of tax collected if investors moved to alternative investments.

The proposal may have negative social and economic effects. Removing the discount may reduce investment in new

¹²² Capital gains are taxed on sale rather than by estimating the increase in value and paying tax each year.

¹²³ For example, see Burman (2009) p. 113-114 and Evans (2002) p. 120-122

¹²⁴ For example, see Evans (2002), p. 127

¹²⁵ Freebairn (2012), p. 22

¹²⁶ Lester (2010)

¹²⁷ Treasury (2013e)

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businesses, since the returns from selling a successful business would be lower.¹²⁸ This effect may be limited: the discount is smaller for superannuation funds and does not apply to larger businesses. For individuals and small businesses there are already a range of exemptions (not affected by this proposal) that limit the effect of capital gains tax. In any case, capital gains paid on the sale of businesses are a small proportion of the total tax collected: most of the tax is paid by individuals on share-market investments and investor housing.¹²⁹

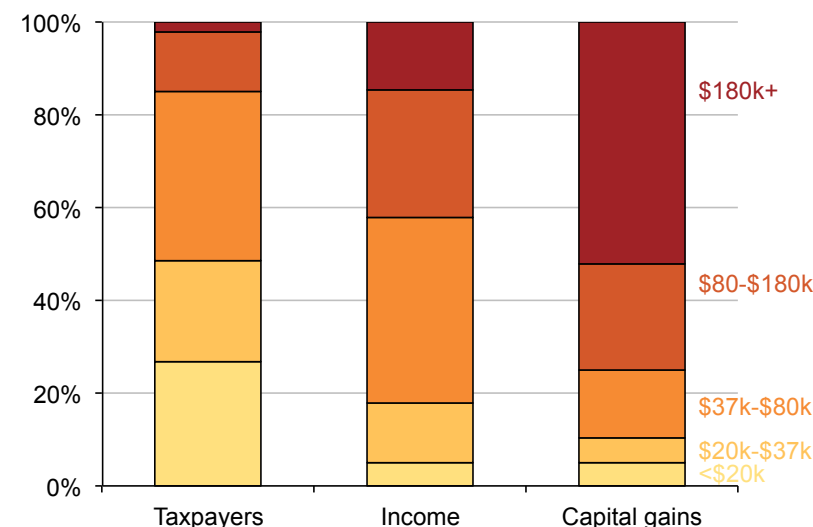
The proposal may have the disadvantage of increasing asset lock-in effects: investors might avoid selling assets that would produce capital gains.¹³⁰ As a result, it would discourage rebalancing portfolios in order to maintain diversity.¹³¹

Abolishing the discounts would have little impact on people in the bottom 20 per cent of the income distribution, and would be strongly progressive.¹³² As Figure 7.1 shows, high-income earning individuals benefit the most from capital gains tax discounts. 2 per cent of the highest income earners earn 52% of the capital gains. Compared to lower-income earners, higher income earners are more likely to have additional income that can be invested.¹³³

In order to reduce the effect on investment decisions by removing the discount, capital gains tax could be calculated as the sale price less the cost base of the asset increased at the same rate

as inflation (the original 1985 design for CGT). This would calculate real capital gains, accounting for inflation. Alternatively, the discount could be reduced to 40 per cent, but capital gains would still be calculated on the nominal cost base.¹³⁴ These arrangements would generally collect more tax than the current

Figure 7.1 Proportion of taxpayers, income and total capital gains
Percentage of total, by income tax bracket, 2010-11 tax returns



Note: Tax free thresholds changed between 2010-11 and 2012-13. 2010-11 data is presented in 2012-13 tax brackets as closely as data allows.
Source: Grattan analysis of ATO (2013c) Detailed table 2.8

¹²⁸ OECD (2006); Djankov, *et al.* (2010)

¹²⁹ See *Balancing budgets: Supporting analysis*, p. 16

¹³⁰ For example, see Dai, *et al.* (2008)

¹³¹ OECD (2006)

¹³² Treasury (2010b) Vol.1, p. 66

¹³³ Evans (2002); Burman (2009), p. 116-117

¹³⁴ Treasury (2010b), p. 80. This would work in conjunction with changes to the way savings are taxed.

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discount arrangement, depending on the rate of asset price appreciation, inflation, and how long the asset is held.¹³⁵ However, it is unclear why these intermediary proposals would be preferable to simply abolishing the capital gains tax discount altogether.

7.2 Capital gains exemption for owner-occupied housing

Making owner-occupied housing liable for capital gains tax could generate additional tax revenue of \$15 billion. However, collections could be anywhere between zero and \$36 billion, depending on whether the capital gains tax discount of 50 per cent remains in place, whether owners are allowed to claim tax deductions for the interest paid on home mortgages, and future rises in house prices. However, the proposal would have substantial negative social impacts. It would discourage moving house since home sales would crystallise liability to pay capital gains tax. Young purchasers would be tempted to choose oversized housing to reduce the number of home moves they make over a lifetime. If mortgage interest can be deducted from income tax, this would encourage home-owners to consume more and save less. The policy might well reduce home ownership rates.

If capital gains tax is charged on owner-occupied housing with the 50 per cent discount that applies to capital gains on other assets, it could generate about \$18 billion a year in gross revenue based on a 5-year average. After allowing for alterations and additions, the net capital gain would be \$15 billion. The tax payable would

increase to \$36 billion a year if the capital gains tax discount were also abolished.¹³⁶

Relatively little tax would be raised for many years if all existing holdings were exempted from the tax (similar to the exemption of all assets acquired before the capital gains tax was first introduced).

The potential tax revenue would be substantially reduced if owner-occupiers were allowed to deduct expenses incurred in owning the house, particularly mortgage interest. If this had been permitted in 2012-13, mortgage interest deductibility would have offset most of the capital gains. Based on a 10-year average, about \$63 billion in interest was paid annually on owner-occupied housing, entitling owners to deductions valued at about \$19 billion,¹³⁷ compared to potential capital gains revenue of around \$18 billion if the 50 per cent discount is retained, as shown in Figure 7.2.¹³⁸ Some tax would nevertheless be paid by individual taxpayers with low leverage or with houses that rose in value quickly.

¹³⁵ See *Balancing budgets: Supporting analysis*, p. 17

¹³⁶ Treasury (multiple years), based on five year average between 2008-09 and 2011-12.

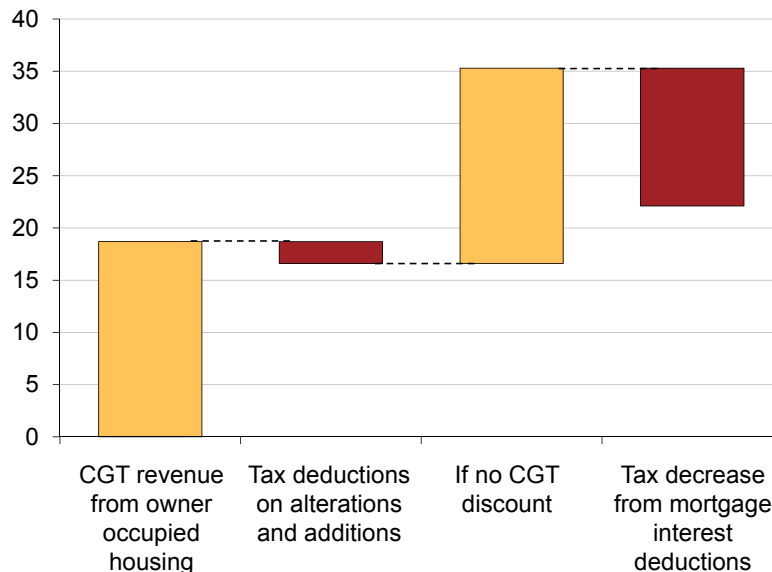
¹³⁷ RBA (2013b), Table D2, RBA (2013a), Table F5

¹³⁸ Deductions for alterations and additions were significantly less, valued at \$2 billion, assuming that all alterations and additions are undertaken by owner-occupiers and an average marginal tax rate of 30 per cent. This does not include deductions for maintenance. ABS (2013d); ABS (2011b)

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Figure 7.2 Fiscal impact of collecting CGT on owner-occupied housing

\$ billions / year



Note: Assumes no CGT discount, total value of alterations and additions are attributable to owner-occupiers and an average marginal tax rate of 30 per cent.

Source: ABS (2012, 2013); RBA (2013)

However, allowing tax deductibility of mortgage interest encourages households to maintain higher leverage, increasing their vulnerability to an economic downturn, as the US experienced over the past 5 years.¹³⁹

There would be less tendency to over-leverage, and the tax revenue would be substantially larger, if owner-occupiers were not allowed to deduct mortgage interest. This might be justified on the basis of 'imputed rent'. If owner-occupiers were treated equitably with renters and landlords, they would pay tax on the rental value of the dwelling – but claim the mortgage interest against this income.¹⁴⁰ Tax is not levied on imputed rents in Australia, and so mortgage interest is not deductible against it. Consequently, it might be considered fair to disallow owner-occupiers from deducting mortgage interest from their capital gains.

However, there would be substantial adverse social and economic effects. The policy change could exacerbate lock-in effects, with people delaying selling their houses in order to avoid capital gains tax. People would over-invest in housing relative to their immediate needs. Some would buy a first home larger than they currently need (to delay incurring a CGT liability associated with up-sizing); others would hold on to homes that no longer meet their needs.¹⁴¹ The increase in demand for larger housing would make the existing stock more expensive for those who would really value the additional space. Housing lock-in may also discourage people from moving to housing closer to their employment, limiting job mobility and increasing transport costs. It would also limit capital gains tax revenue in the short term, although in the long-run similar amounts of capital gains tax would be levied if sales are merely delayed.

¹⁴⁰ Kelly, *et al.* (2013), p. 24

¹⁴¹ Stamp duties paid when a house is sold already have these effects (see *ibid.*: CGT on owner-occupied housing would make them worse).

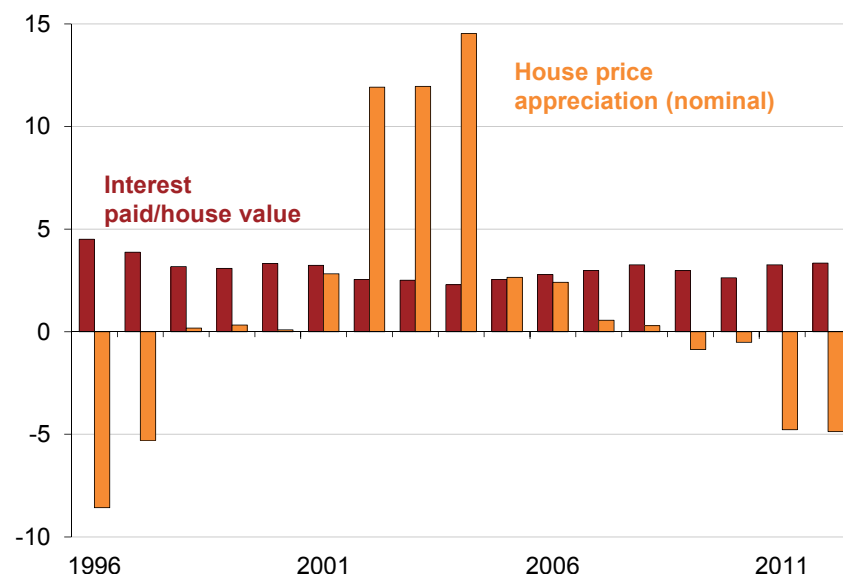
¹³⁹ Bartlett (2012), p. 108-109

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The proposal might also significantly reduce home ownership rates. It would reduce the return on housing for owners relative to landlords.

The budget impact would also depend on other factors that are inherently difficult to predict. Apart from the policy choices made, these factors include tax collected would depend on house price appreciation rates, initial leverage, interest rates, and repayment rates. Notional capital gains tax foregone over the last decade

Figure 7.3 House price appreciation and interest paid
Per cent per year



Source: Grattan analysis of ABS (2013j); RBA (2013c); RBA (2013a)

includes gains on three years of very rapid house price appreciation, largely driven by a one-off reduction in interest rates, as Figure 7.3 shows.

House price appreciation in future may be much slower. Imposing capital gains tax may itself reduce demand and therefore house prices, reducing future tax revenue. The actual tax collected could well be substantially less than the 'headline' tax expense of \$15 billion.

7.3 Negatively geared investments

Negative gearing allows taxpayers to deduct any losses they make on investments (including mortgage interest) from their overall income when they calculate their tax liability. Under the proposed reform, investors would no longer be able to deduct these losses against wage income. However, they would be able to carry forward any losses and deduct them against any capital gain they make when the investment is sold. The proposal would contribute about \$4 billion a year to the budget in the short term, falling to approximately \$2 billion a year in the long term. The change could increase rates of home ownership by reducing demand for investment properties. The change would have little impact on those in the bottom 20 per cent, who own relatively few investment properties.

Negative gearing is a popular way to reduce personal income tax.¹⁴² In the ten years to 2010-11, 1.2 million taxpayers recorded

¹⁴² While negative gearing is most commonly used for investment properties, it can also be used to fund investments in other assets such as shares. Any change in tax rules should apply to all asset classes.

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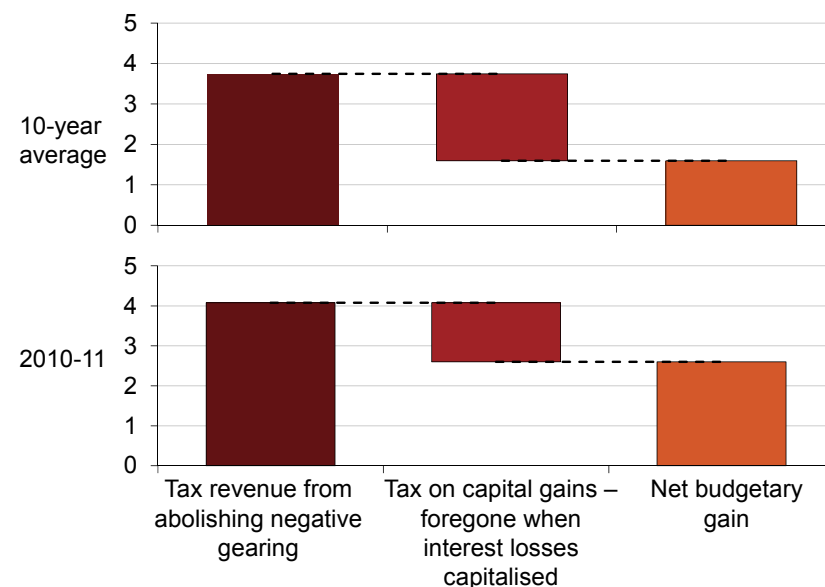
net losses of \$13b on investment properties.¹⁴³ As an investment and tax strategy it is attractive because while losses (including interest on borrowings) are fully deducted against taxable income, any capital gains are usually taxed with a 50 per cent discount, and tax is not payable until the asset is sold.¹⁴⁴ As a result negative gearing can be an attractive means to reduce and defer personal tax liabilities.

Under the proposal, investors would not be allowed to claim losses on investments against other income (particularly wages and salaries). However, to maintain parity with the remainder of the tax system, they would be able to carry forward these losses and claim them against the capital gains liability once the investment is sold.¹⁴⁵

The proposal would generate additional tax revenue in the short term, although the potential revenue is particularly sensitive to changes in the housing market. Applying the average marginal tax rate to the average annual net rental losses of \$13 billion would yield \$4 billion in additional tax revenue.¹⁴⁶ Under the proposal, however, in the medium term this \$13 billion loss would be offset against future capital gains. Between 2001-02 and 2010-11, on average investors made annual capital gains on real estate of \$14 billion, which was discounted to \$7 billion, incurring tax liabilities of \$2 billion (see Figure 7.4).¹⁴⁷

The precise reduction in future capital gains tax would depend on future house price appreciation and the level of gearing of each individual investor. However, since net rental losses are larger than the capital gains tax liability, it is likely that investors forced to defer their negative gearing benefit will end up paying no capital gains tax when they sell their properties. Assuming no change in investor behavior, the net budget benefit to government would therefore be only about \$2 billion a year. While this would be the long-run effect, in the shorter run it could improve budget

Figure 7.4 Budget impact of abolishing negative gearing with losses offset against capital gains tax liability
\$ billion, based on tax returns, 10-year average



Source: ATO (2013); Grattan analysis

¹⁴³ Inflated to 2012-13 dollars. ATO (2013c), Detailed Table 2.1

¹⁴⁴ See above Section 7.1

¹⁴⁵ Eslake (2013)

¹⁴⁶ ATO (2013c) Detailed table 2.1, Grattan analysis, 10-year average, converted to 2012-13 dollars.

¹⁴⁷ Ibid., Table 7.6, converted to 2012-13 dollars

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balances by \$4 billion a year. If the capital gains discount were reduced (see Section 7.1), then the budget benefit of abolishing negative gearing would be smaller as the carried forward losses offset a greater amount of future tax liability.

If the proposal induced property investors to invest in other assets, tax revenue would be even higher. Alternative investments will not usually produce a tax deduction against income – indeed any switch to investments that generated a positive return would increase the tax collected.

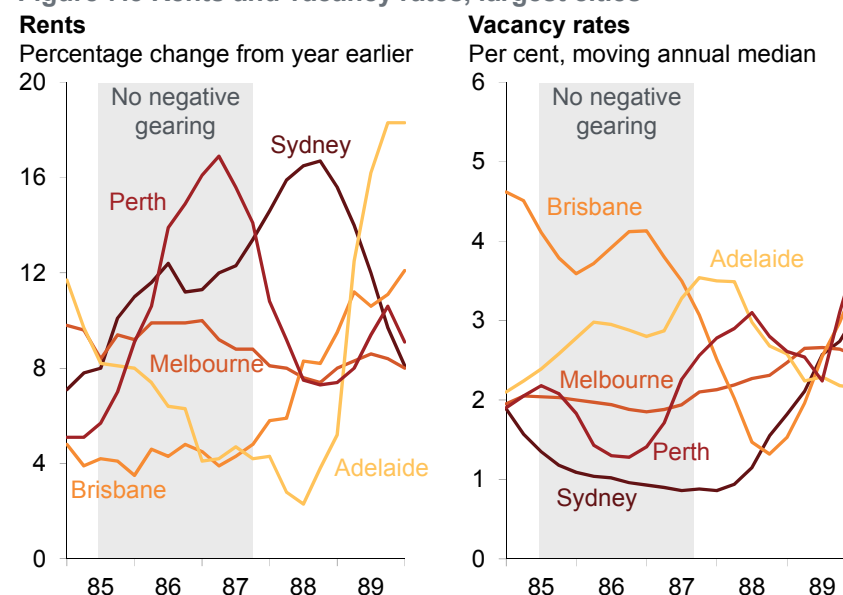
There are other ways to reform negative gearing. The Henry Tax Review proposed to both discount net rental losses by 40 per cent (this discount would also apply to other types of deductions),¹⁴⁸ and to increase taxable capital gains from 50 to 60 per cent (reducing the capital gains discount from 50 to 40 per cent).¹⁴⁹ Based on 2010-11 figures, this proposal would generate about \$1.6 billion in additional tax revenue, assuming no change in investor behaviour.

Abolishing negative gearing would have a number of positive social outcomes.¹⁵⁰ It may increase home ownership rates by reducing returns at the margin for landlords relative to first homebuyers. This could then increase investment in other more productive assets.

Although many say that abolishing negative gearing would increase rents, this is a folk memory based on increases between

1985 and 1987 in Sydney and Perth. (see Figure 7.5).¹⁵¹ During this period when negative gearing was not permitted, rents did not increase particularly rapidly in Melbourne, Brisbane or Adelaide, and it appears that the Perth and Sydney rental increases were driven by unusually low vacancy rates

Figure 7.5 Rents and vacancy rates, largest cities



Note: shaded area indicates the period from July 1985 until September 1987 in which negative gearing was not available for property investments

Source Kelly, Harrison, et al. (2013) p.26, citing ABS, REIA via Eslake (2013)

¹⁴⁸ Treasury (2010b), p. 33-34

¹⁴⁹ Ibid.

¹⁵⁰ See Kelly, et al. (2013)

¹⁵¹ Eslake (2013)

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In theory, negative gearing should have no effect on rents: for every landlord that sells, there would be a renter that buys and becomes a home-owner. The supply of rental properties would fall at the same rate as the number of renters.

Nor is the abolition of negative gearing likely to affect construction of new dwellings, as almost all of investment property loans are now for existing dwellings.¹⁵² There might be some impact on construction rates as abolition of negative gearing would depress house prices. However, the market for new housing, typically at the edge of cities, is somewhat detached from the market for established housing, typically closer to the centre of cities.¹⁵³

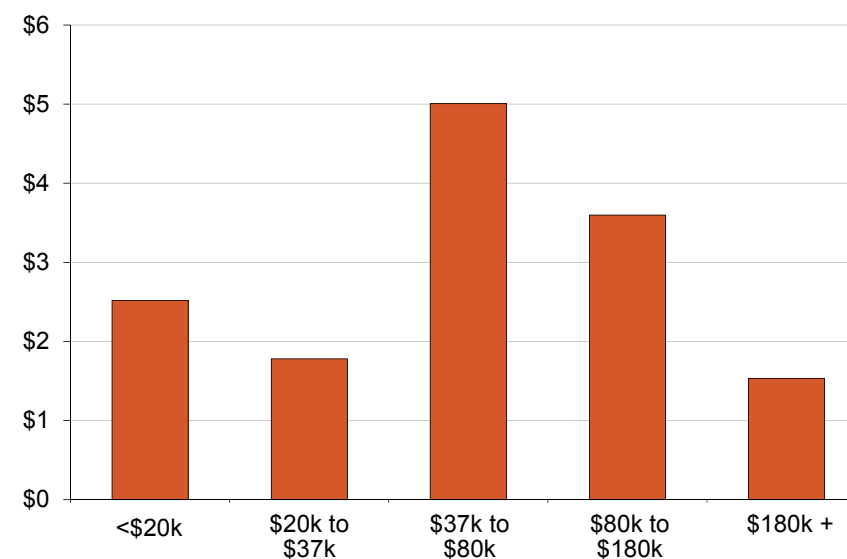
Consequently, lower prices for established housing will only have a limited effect on prices, and therefore supply, of new housing.

Abolishing negative gearing on other assets, particularly share investments, would have little impact. Investors borrow relatively little to invest in shares and managed funds outside of superannuation. Even at the height of the share market boom, only about 10% of investments outside of superannuation were funded by borrowing;¹⁵⁴ since then margin lending has reduced by 71 per cent from its peak in 2007).¹⁵⁵

Abolishing negative gearing would have limited impact on those in the bottom 20 per cent, although there are a number of low-income earners who own investor property and make substantial losses. Taxpayers with incomes between \$37,000 and \$80,000

claim the most under negative gearing, but those with incomes under \$20,000 per year made surprisingly large losses totalling over \$2 billion (Figure 7.6).

Figure 7.6 Total rental loss by taxable income bracket after deductions
\$ billion, 2010-11



Notes: The tax-free threshold was increased from \$6,000 in 2010-11 to \$18,200 in 2011-12. 2010-11 data is presented in current income tax brackets as closely as data allow.
Source: ATO (2013), Grattan analysis

¹⁵² RBA (2013c)

¹⁵³ Kelly, *et al.* (2011), p. 13

¹⁵⁴ See Daley (2007)

¹⁵⁵ RBA (2013c) Table D10

8. Other tax exemptions, introductions, and increases

Governments could choose to reduce deficits by increasing their revenue. They could do so by reducing tax exemptions, increasing taxes or introducing new ones. In general, the economic cost of tax increases is considerable.

Eliminating tax exemptions (often known as ‘tax expenditures’) generally distorts economic activity less than introducing new taxes or increasing existing taxes. Tax exemptions, by their very nature, shape decisions to earn, spend, or invest. Eliminating them can level the playing field, increasing economic efficiency and reducing unfairness. However, tax exemptions can have worthwhile policy objectives that justify any loss of efficiency

Tax exemptions already discussed include superannuation tax concessions, the exemption of owner-occupied housing from capital gains tax, and capital gains discounts. Other major tax exemptions – described below in Sections 8.1 to Section 8.3 – are the exemption of several expenditure categories from the GST, the exemption of small businesses from payroll tax, and the exemption of various businesses from normal rates of fuel tax.

Most taxes inherently grow roughly in line with GDP. The exception, which creates an ever-widening hole in the Commonwealth budget, is fuel tax. As the tax is set as a fixed amount per litre that has not been indexed to inflation since 2001, the value of the tax inherently falls behind increases in GDP and government expenditure, as Section 8.4 discusses.

New taxes might be proposed. The analysis in Section 8.5

focuses on a mining tax given the salience of this issue in the Henry Tax Review, the recent history of tax reform, and the unusual size of Australia’s mining sector, in which more was invested over the last decade than in any other country.¹⁵⁶ Other new taxes emphasised by the Henry Report are those that put a price on externalities. Congestion taxes may have useful outcomes, but experience shows they do not raise much revenue, as discussed in Section 8.6. There is much to be said for pollution taxes (including carbon taxes), but given the wider political issues involved they are beyond the scope of this report.¹⁵⁷

Finally, governments could simply increase the rates of existing taxes. Again, the range of options is very large, but by way of comparison in Section 8.7 we indicate the rate increases required to raise an additional \$10 billion a year from each tax, as well as briefly considering their collateral impacts.

8.1 Broaden the GST

About \$13 billion a year could be raised by extending the GST to cover private spending on fresh food, health, education, childcare, water and sewerage, while increasing welfare benefits to reduce the effects of the change on those worst off. The choice is attractive. It adds substantially to the collective budget bottom line

¹⁵⁶ Minifie, *et al.* (2013), p. 7

¹⁵⁷ On carbon taxes as the least bad way to reduce carbon pollution see Daley and Edis (2011) and OECD (2013a). On congestion taxes, see Treasury (2010b) Vol 2, p. 373

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of Australian governments.¹⁵⁸ It drags relatively little on the economy as it discourages working or investing less than most other taxes. Eliminating exemptions reduces time wasted in definitional issues. It has few social impacts, and the effect on people in the bottom 20 per cent of the income distribution would be largely mitigated by increases in welfare.

Almost all taxes drag on economic growth. But the GST, a form of consumption tax, is a relatively efficient tax. It does not discourage earnings or investment nearly as much as income and corporate taxes. It is hard to avoid on a large scale. It distorts behavior less than other potential state government revenue sources, such as payroll tax and stamp duties.¹⁵⁹ If governments want to increase the amount of revenue they raise, it will harm growth less to do so with GST revenue than with most other taxes.¹⁶⁰

Australia's GST covers about 60 per cent of a comprehensive consumption tax base.¹⁶¹ This gives Australia the seventh-lowest 'coverage ratio' amongst 32 OECD countries.¹⁶² Australia's

¹⁵⁸ Under existing legislation – which the Commonwealth Parliament could amend – state governments benefit from any increase in GST revenues.

¹⁵⁹ Although increasing the GST reduces the real value of working, it has less impact than a higher rate of income tax, if nothing else because it has less psychological impact because it is not visible in take-home pay.

¹⁶⁰ See PwC (2013), Mirrlees, *et al.* (2011), Daley, *et al.* (2012a) and Treasury NSW (2011) for a more comprehensive discussion of the effects of various taxes on growth.

¹⁶¹ Freebairn (2013b)

¹⁶² Treasury (2012b), p.155

consumption taxes are a lower percentage of GDP (and corporate taxes are a higher percentage) than in most of the OECD.¹⁶³

Private spending on a range of categories is currently exempt from GST, as Figure 8.1 shows. If the tax were extended to cover fresh food, health, education, child care, water and sewerage, governments could have raised an extra \$15 billion in 2012-13.¹⁶⁴ This figure takes into account the effects of consumer behaviour change due to increased costs, and leaves exemptions in place for a number of areas where applying a GST is particularly difficult.¹⁶⁵ Using 10 per cent of this revenue to compensate lower-income households for the regressive impact of the tax – more than these households in fact spend – would still improve budget balances by \$13 billion.¹⁶⁶

¹⁶³ Daley, *et al.* (2012b), p. 27

¹⁶⁴ Treasury (2013e), p. 212-213

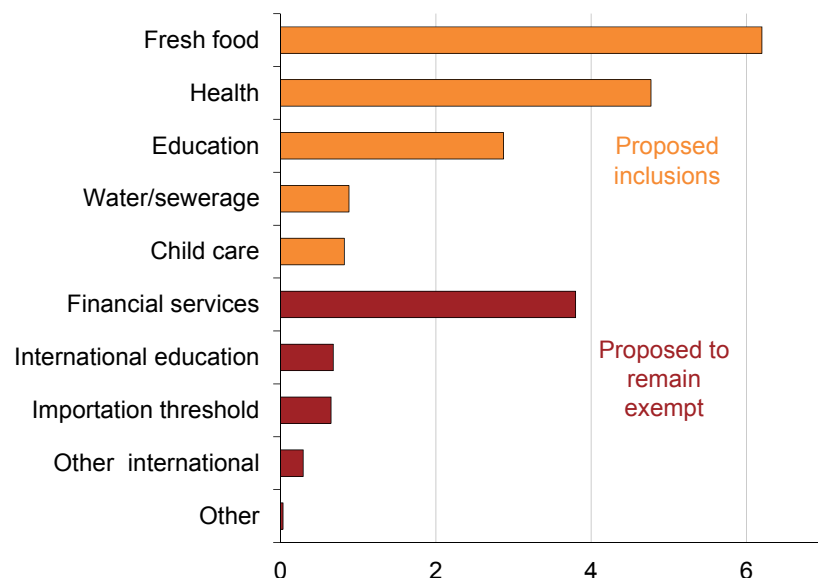
¹⁶⁵ Under this proposal, exemptions would remain for international transactions including international education, financial services, existing residential housing, supplies by charitable institutions, and administrative purposes (e.g. very small businesses). Financial services are 'input taxed': financial services providers pay GST on their inputs, but do not charge GST to consumers. Applying GST to housing would be very complex. Owner-occupied housing is effectively treated as being input-taxed, rather than applying GST to imputed rents. GST is not applied to residential rents to maintain neutrality between owner-occupiers and investors. See *ibid.*, p. 230.

¹⁶⁶ Households in the bottom quintile account for around 9 per cent of consumption, so should be compensated equivalently (Grattan analysis of ABS (2011b)). Note this more precise data on consumption by the bottom 20 per cent updates the estimates in Daley, *et al.* (2012a), p. 33.

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Figure 8.1 Foregone tax revenue from expenditure excluded from GST

Foregone revenue by exemption category, 2012-13, \$b



Note: Excludes foregone revenue from housing, as comparable estimates are not available.

Source: Grattan analysis of Treasury (2013e) and ABS (2013k) Table 11.1

Instead of broadening the GST base, the government could raise similar revenue by increasing the rate from 10 to 13 per cent, while maintaining existing exemptions (see Section 8.7 below) and providing similar compensation.

There are a number of reasons to favour broadening the base over increasing the rate. A broader GST is simpler and more efficient than a limited one. A broader based tax may have lower

administrative costs as businesses which deal in both exempt and non-exempt goods simplify their accounting. Having fewer 'grey lines' between exempt and non-exempt categories reduces opportunities for tax avoidance and lobbying by rent-seekers for exclusion of particular goods.¹⁶⁷

Increasing GST revenue would discourage states from raising other more inefficient taxes because they are raising less through the GST than originally expected.¹⁶⁸ The introduction of the GST in 2000 was intended to create a sustainable revenue base for state governments, who faced rising expenditure pressures. It worked for the first few years – GST grew at average of 8.3 per cent a year up to 2007-08. But between 2008-09 and 2011-12, the average increase was only 2.2 per cent and has been very volatile.¹⁶⁹ In this time, household savings rates have gone up,¹⁷⁰ reducing GST by about \$10 billion. Households have spent relatively more on GST-exempt categories, particularly rent and mortgage interest, and to a lesser extent health and education (Figure 8.2), reducing GST by about \$2 billion.¹⁷¹ Tax exempt international internet transactions have grown (Box 8.1), reducing GST by about \$0.7 billion. As a result, GST takings have declined relative to both GDP and total consumption over the past decade (see Figure 2.3 above).¹⁷²

¹⁶⁷ Eslake (2011); Freebairn (2013b); PwC (2013)

¹⁶⁸ Eslake (2011)

¹⁶⁹ Treasury (2012b), p. 153

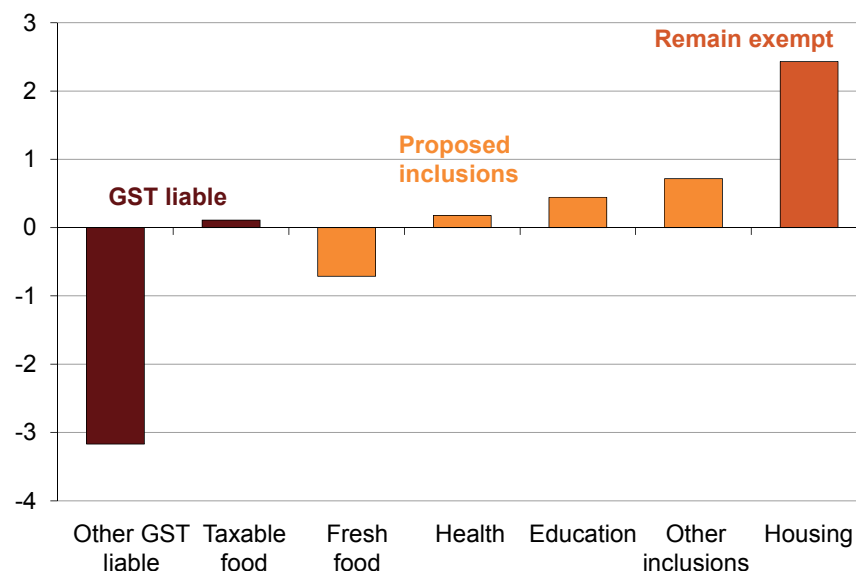
¹⁷⁰ ABS (2013o)

¹⁷¹ The shift in spending towards untaxed categories is about 3% of total household expenditure of \$708 billion. ABS (2013b) Table 42

¹⁷² Treasury (2012b)

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Figure 8.2 Changes in consumer expenditure by GST liability
Change in share of household expenditure, 2004 – 2010, per cent



Source: ABS (2012a)

There is no obvious reason for these trends to reverse in the foreseeable future. Savings rates are now close to long-run averages, with the low savings rates in the late 1990s and early 2000s looking like a historical anomaly. Nor is the rise in health spending likely to slow significantly as the population ages: older people spend a much higher proportion of their income on health.¹⁷³

¹⁷³ Productivity Commission (2005), p. 264

Box 8.1: GST on overseas internet purchases

The GST importation threshold, through which imports of goods from overseas worth less than \$1000 are exempt from GST, has attracted considerable commentary, including from state premiers.¹⁷⁴ But this exemption only cost \$0.65 billion in foregone revenue in 2012-13.¹⁷⁵ It was established because the cost of collecting the tax on small transactions (estimated at \$2 billion a year in 2011) was greater than the revenue that would be collected.¹⁷⁶ Once administration costs are factored in, halving the threshold to \$500 might raise \$0.02 billion a year from items entering Australia via international mail.¹⁷⁷ As online retailing becomes a greater share of purchases, and new transaction technology reduces collection costs, change might be worthwhile. In particular, a substantial portion of the revenue could be collected from a small number of online retailers greater than a threshold size, responsible for most of the transactions.¹⁷⁸

The competitive disadvantages of the Australian retail sector run deeper than paying GST. As the Productivity Commission showed, industry productivity and regulatory barriers are bigger problems.¹⁷⁹ However, pressures on Australian retailers to improve their productivity would be weakened if GST were charged on all international internet purchases, deterring retailers with small volumes from entering the Australian market.

¹⁷⁴ Koziol (2013); Treasury (2012b), p. 159

¹⁷⁵ Treasury (2013e), p. 195; EY (2012), p. 1

¹⁷⁶ Productivity Commission (2011), p. 169

¹⁷⁷ Grattan analysis of Treasury (2012c), p. 193-4

¹⁷⁸ Treasury (2012b), p. 160; EY (2012)

¹⁷⁹ Productivity Commission (2011)

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A GST is regressive. People with lower incomes tend to save less. As a result, GST paid is a greater proportion of their *income*. However, those on higher incomes pay much more GST per person. The wealthiest 20 per cent of households spend almost six times as much on fresh food as the poorest 20 per cent; the exemption of fresh food from the GST benefits those wealthy households to the tune of \$2 billion a year.¹⁸⁰

Figure 8.3 shows that low-income households do not spend a significantly greater proportion of their consumption on the goods proposed for inclusion in the new GST base. This indicates that a broader GST would not be significantly more regressive than current arrangements.

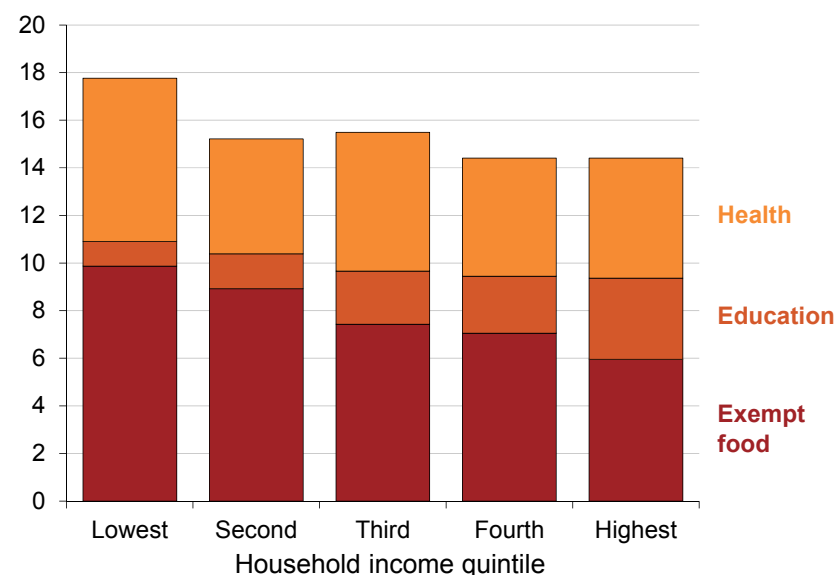
However, any regressive effects from a broader GST should be dealt with through welfare transfers and income tax cuts at the lower end.¹⁸¹ It is better to pursue equity through the tax and welfare system as a whole, rather than making the GST more complex in an attempt to protect those on lower incomes. As the Henry Review noted:

“A narrower GST does not mean it is fairer, but adds complexity. Income redistribution to make Australia fairer is primarily the job of the personal income tax and transfer system. This means that other taxes and charges can be used in the most efficient way, reducing the overall complexity of the

system. It is very difficult to target GST exemptions on some products to certain groups.”¹⁸²

Some of the increased revenue raised from a broader GST should be used for income redistribution. There is a risk that any compensation will be eroded through bracket creep and low indexation of benefits, as happened in New Zealand, so continued

Figure 8.3 Proportion of household consumption spent on goods proposed for inclusion in the GST base
% of household consumption



Source: Grattan analysis of ABS (2013i)

¹⁸⁰ Treasury (2010b) Vol 1, p. 286

¹⁸¹ Henry (2011); Freebairn (2013b)

¹⁸² Treasury (2010b) Vol 1, p. 286

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attention needs to be paid to the impact of the tax-transfer system on those worst off.¹⁸³ Unfortunately, the opposite may be a bigger risk: governments under budget pressure may squeeze welfare benefits and community services even harder.

What are the risks of broadening the GST? Taxing private expenditure on fresh food could lead to people spending more on processed foods, leading to poorer, long-term health outcomes.¹⁸⁴ Yet Treasury estimates suggest that spending on these categories is relatively inelastic, so there may not be much change in consumption.¹⁸⁵ Similarly, higher prices for education could lead to parents moving children into government schools, and students choosing not to enroll in higher education. But demand for education also seems to be relatively insensitive to price: changes in private school fees and higher education contribution amounts have not significantly affected choices in the past.¹⁸⁶ There are other potential side-effects, including whether increases in child-care costs might reduce workforce participation rates. This would require further attention.

GST on international student fees may reduce the competitiveness of Australian higher education. By analogy with other exports, it may be appropriate to rebate or waive

international student fees. Doing so would reduce the additional tax raised by \$0.7 billion a year.¹⁸⁷

GST on education would result in government taxing a service that it also subsidises. There would be less churn of tax if government simply reduced the subsidy.¹⁸⁸ This may well be a first-best option. However, given the difficulties of reducing government subsidies for education (at least in nominal terms), broadening the GST to include education may be a more palatable option since it would be seen as imposing a universal rule across the economy.

Expanding coverage of the GST to include health would increase the price paid by consumers for a number of subsidised health services and products, including private health insurance, pharmaceuticals and medical services. The GST exemption currently acts as a hidden and indirect subsidy for these services and products. If government, on policy or equity grounds, wishes to ensure no net change in the price to consumers of a subset of previously GST-exempt products and services, a better public policy is to increase subsidies to these so the total subsidy is direct and overt rather than a hidden subsidy through GST exemption. The Commonwealth is responsible for the key health care services and products that would be affected by these changes. The current GST exemption for these services and products thus effectively represents a subsidy from the states – the beneficiaries of GST revenue – to the Commonwealth.

¹⁸³ Davidson (2000). See ACOSS (2012) for analysis showing that the purchasing power of NewStart allowance has fallen far below its pre-GST level, eliminating the value of the compensation introduced at the time, and Daley, *et al.* (2013), p. 19 illustrating the severe pressures on NewStart households.

¹⁸⁴ Veerman and Cobiac (2013)

¹⁸⁵ Treasury (2013e), p. 212

¹⁸⁶ Norton (2012); Jensen, *et al.* (2013), p. 57; Treasury (2013e), p. 213

¹⁸⁷ Grattan analysis of ABS (2013k) Table 11.1, which indicates that international students at all levels of education spent \$6.8 billion on fees in 2012.

¹⁸⁸ See Norton (2012) for discussion of whether these subsidies should be reduced anyway.

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Increasing the subsidy to private health insurance, benefit-paid pharmaceuticals and medical services to offset the GST increase is estimated to cost \$2 billion.¹⁸⁹ This cost has not been included in the budget impact above.

There might be concerns that a GST on private health and education spending would create market distortions between private and public service providers. However, competitive neutrality is not an object of current education and health policy, as government already provides higher subsidies per student or patient for government-supplied services.

8.2 Payroll tax threshold

Removing the threshold below which payroll tax is not payable would contribute a net \$6 billion a year to Australian government budgets. However, this choice may be relatively unattractive depending on the impact on unemployment. Any substantial increase in unemployment reduces economic activity, and has serious social impacts on the bottom 20 per cent. On the other hand, broadening payroll tax to include all employees may increase economic efficiency by encouraging activity to move from less efficient small firms to more efficient large firms.

Payroll tax is the largest single state tax, contributing \$21 billion to state budgets in 2012-13.¹⁹⁰ Businesses with payrolls below the threshold do not pay the tax. Those with larger payrolls pay tax at a single marginal rate on payroll amounts above the threshold

(Queensland and the Northern Territory use a deduction system but a similar structure applies). The threshold varies by state, from as low as \$550,000 in Victoria to \$1.75 million in the ACT.¹⁹¹

The net effect of eliminating the thresholds would increase the tax revenues of Australian governments by \$6 billion a year. It would increase State payroll tax revenues by \$8 billion a year. Businesses deducting this tax as an expense would reduce Commonwealth company income tax revenues by approximately \$1.5 billion,¹⁹² and the Commonwealth would also be liable for increases in unemployment benefits (discussed below), which could amount to \$0.5 billion.

Views differ on whether eliminating the payroll tax threshold would increase unemployment. Some believe there would be little impact because most workers would ultimately accept a drop in wages rather than become unemployed. Others believe some wages paid would increase due to the interaction of awards, minimum wage laws and payroll tax. By increasing the floor on these wages, payroll tax would increase unemployment.

Cross-country evidence does not strongly support the claim: many European countries have much higher payroll taxes levied as 'social security charges' and historically, some have lower unemployment rates than Australia.¹⁹³

Estimates of the sensitivity of employment decisions to payroll tax rates vary widely: a 1 per cent increase in labour costs is

¹⁸⁹ Grattan analysis of ABS (2011b) and ABS (2013a)

¹⁹⁰ DTF NT (2012); DTF SA (2012); DTF Tasmania (2012); DTF Victoria (2012); Treasury ACT (2012); Treasury and Trade Qld (2012); Treasury NSW (2012); Treasury WA (2012)

¹⁹¹ Treasury NSW (2013)

¹⁹² Grattan analysis of ATO (2013c) and ABS (2013f)

¹⁹³ Nickell (1997)

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estimated to increase the unemployment rate by anywhere between 0.04 and 1.01 percentage points.¹⁹⁴ The median estimate of the studies reviewed is an increase of 0.35 percentage points. In Australia, and given existing payroll tax rates, this would imply that eliminating the payroll tax threshold in all states would increase unemployment by approximately 40,000 people. The direct fiscal cost to the Commonwealth budget of such an unemployment increase would be around \$51 million per year.¹⁹⁵ The flow-on costs of higher unemployment, slower economic growth and poorer social outcomes are difficult to quantify but they would be significant.

Timing would be very important. Analysis conducted for the Australian Fair Pay Commission found that increases in minimum wages affect unemployment rates more during a recession than when employment is growing.¹⁹⁶

Beyond these costs to government and society, individuals face specific costs from unemployment. The direct financial cost to households of this increase in unemployment, in the form of the difference between their previous earnings and the amount they receive in unemployment benefits, would be about \$0.9 billion a year.¹⁹⁷

There would be some additional compliance costs for firms that are brought inside the tax net. Some surveys of small business owners estimate the compliance cost for business could be as high as \$0.6 billion a year.¹⁹⁸ However, the cost of change is likely to be substantially lower given the growing popularity of standard package payroll systems amongst small businesses, and the options of administering the tax through workers compensation systems or the Commonwealth PAYG tax base.

On the other hand, abolishing the threshold would reduce economic distortions that encourage smaller, less productive firms. The same employee costs about 5 per cent more to a firm with a payroll above the threshold. Small businesses generally have lower productivity per employee than larger firms.¹⁹⁹ On this basis, the NSW Treasury estimates that abolishing the payroll tax threshold would produce an *extra* 8 cents of economic activity for every dollar of revenue raised – implying an increase economic activity in Australia by around \$0.6 billion a year.²⁰⁰ Presumably the basis of this calculation is that abolishing the threshold would encourage economic activity to move towards larger more efficient firms.²⁰¹

Despite the significant revenue available from reducing the threshold, some states and territories have historically competed to increase their payroll tax thresholds with the aim of attracting mobile businesses to their jurisdiction (Figure 8.4).²⁰² However,

¹⁹⁴ Karanassou and Sala (2008); Hutchings and Kouparitsas (2012); Dixon, *et al.* (2004); Debelle and Vickery (1998); Dungey and Pitchford (1998); Lewis and MacDonald (2002); Carne (2007); Treasury (1996); Stacey and Downes (1995); Bernie and Downes (1999); Treasury NSW (1999); ABS (2012b); ABS (2013c); ABS (2013l). See *Balancing budgets*: Supporting analysis, p. 25

¹⁹⁵ Grattan analysis based on Treasury (2013c)

¹⁹⁶ Australian Fair Pay Commission (2009)

¹⁹⁷ Grattan analysis of ABS (2013c) Table 14a-14h

¹⁹⁸ Lignier and Evans (2012)

¹⁹⁹ OECD (2013c)

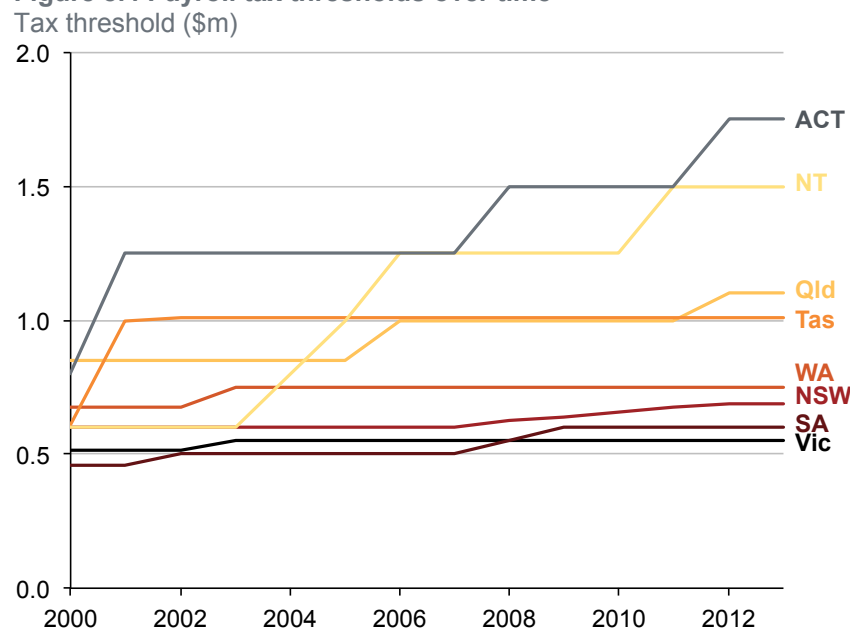
²⁰⁰ Treasury NSW (2011), p. 11. See also Dixon, *et al.* (2004)

²⁰¹ Treasury (2010b) Vol 1, p. 298;

²⁰² Gabbittas and Eldridge (1998); Treasury (2012b), p. 169

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Figure 8.4 Payroll tax thresholds over time



Source: NSW Treasury (2000-2013)

over the past decade, only the two territories have increased the threshold materially faster than inflation.

8.3 Fuel tax exemptions

Halving the exemptions that reduce the fuel tax paid by a variety of commercial users would contribute around \$3 billion a year to the Commonwealth government budget. However, a higher effective tax rate would reduce economic activity, particularly in coal mining and agriculture, also reducing corporate and income taxes.

Ordinary users of petroleum fuel pay an excise of 38.1 cents per litre of fuel.²⁰³ Commercial users of fuel such as freight trucks can usually claim a tax credit so that they pay 12 cents less than this. Those using fuel in mining (generally off public roads) effectively only pay excises of about 6 cents a litre, and forestry and agriculture users (also generally off public roads) pay close to no fuel tax.

The current exemptions are worth about \$5.8 billion.²⁰⁴ Halving this would add about \$3 billion to the Commonwealth budget.

Fuel taxes paid by commercial users drag substantially on economic activity because inherently they are a tax on business inputs. Fuel excise can nevertheless be justified as economically efficient if it is considered as a form of user pricing for road building and maintenance, the costs of congestion, and vehicle pollution.²⁰⁵ It is imprecise, but relatively easy to collect. However,

²⁰³ ATO (2013b)

²⁰⁴ Treasury (2013a), BP 1 p. 6-41

²⁰⁵ Treasury (2010b), E 3-2 p 375. Fuel excise collects \$15 billion a year, from which about \$6 billion are returned in FTC Treasury (2013a) BP 1 p. 6-41. Motor vehicle registration revenues are around \$8 billion. Annual road building costs

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this justification for fuel excise on business inputs implies that off-road use should be exempt.

Reducing fuel excise exemptions would have several unattractive collateral impacts. It might substantially reduce economic activity, particularly in thermal coal mining and agriculture. As their products are internationally traded, they would have little ability to pass on the increased costs. Any reduction in the activity of these industries would hurt regional communities largely dependent on them. Many of these areas are already struggling economically. The impact on economic activity is likely to be substantial relative to the additional tax collected. Grattan analysis suggests the effect could be around \$0.5 billion.

8.4 Fuel excise indexation

Reintroducing fuel excise indexation would contribute around \$3 billion, after compensatory welfare increases, at minimal social and economic costs.

Most fuels in Australia attract several taxes, including an excise, and the GST. The GST component automatically increases as the price of fuel increases. Between 1983 and 2001, the excise component was increased each year by the rate of consumer price inflation. Although the excise was cut by 6.7 cents per litre as part of the GST package, petrol prices continued to rise.²⁰⁶ As

were around \$16 billion in 2009 (DIT (2009)), and in 2010, accidents were reported to cost \$15 billion; see Treasury (2010b) p 390.

²⁰⁶ The combination of the cut in excise, together with other savings from the tax package was intended to amount to 1.5 cents per litre, cancelling out the impact

a result, the Howard Government abolished indexation.²⁰⁷ This exacerbated the structural decline in the fuel tax base, growing more slowly than GDP given declining per capita car use, and increased fuel efficiency.

At current volumes, the decision to abolish indexation has reduced government revenues by a little over \$4 billion in 2013-14. However, higher priced fuel would probably lead to reduced fuel consumption. Judging the impact is difficult: actual oil price increases swamp the impact of fuel tax indexation (Figure 8.5). If excise had been indexed since 2001, fuel prices would be about 10 per cent higher; if this reduced use by 5 per cent, Commonwealth tax revenue would be \$1 billion a year lower. On this basis the net increase in Commonwealth tax revenue would be \$3 billion a year.

Reintroducing fuel excise indexation would hit the bottom 20 per cent of households hardest. These households spend about 6 per cent of their income on fuel. The richest 20 per cent of households only spend about 2 per cent.²⁰⁸ This could be remedied through the tax-transfer system. Returning the increase to the bottom 20 per cent would consume 8 per cent, or approximately \$320 million of the additional \$3 billion raised.²⁰⁹

of the GST and keeping petrol prices constant. Costello and Coleman (2008), p. 154

²⁰⁷ Treasury (2002); Costello and Coleman (2008), p. 154. This was in addition to a further cut to the excise of 1.5 cents per litre.

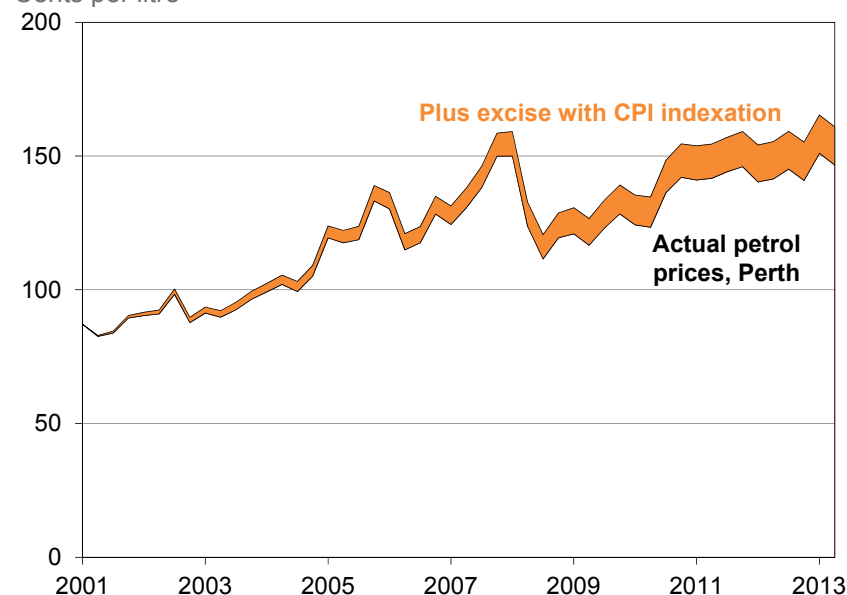
²⁰⁸ Grattan analysis of ABS (2011b)

²⁰⁹ Grattan analysis of ibid.

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Figure 8.5 Fuel prices with and without excise indexation

Cents per litre



Source: Grattan analysis of ABS (2013e) and Fuel Watch WA (2013)

Most of the economic costs of reintroducing fuel excise indexation can be reduced using the existing fuel tax credit scheme. This scheme rebates much of the tax on fuels paid by producers, minimising its impact on economic activity.

8.5 Mining taxes

A mining tax could be designed as a federal export tax on minerals, set at 50 per cent of the portion of the price above nominated thresholds. A well-designed tax might capture a lot of revenue in the short term. But once prices drop in line with most analyst forecasts, a new mining tax would probably collect little more than \$3 billion a year after 2017. The tax would discourage some investment and economic activity. Its effects would be far more acute when prices fall

The combination of Australia's mineral resources and its strong institutions have attracted world-leading levels of investment.²¹⁰ Inherently these resources cannot be moved, and when prices remain as high as they have been over the last decade, profits can be substantially higher than the cost of investment. Mining taxes seek to capture some of these profits (or 'excess rents') to benefit the community.

Mining taxes can be designed in a number of ways. The most efficient design in theory is a profits tax (such as the original design of the Resource Super Profits Tax) whereby government takes a share of both the profits and losses. Its effect is the same as government buying shares in mines whenever miners invest in mining projects. In theory the tax is more efficient because it does not affect returns to private shareholders, and so does not affect their investment decisions.

However, there are substantial problems in practice. The design requires that the government pays out (either in tax credits or

²¹⁰ Minifie, *et al.* (2013), p. 7

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cash) when a mine loses money. Investors will be adversely affected if they – or their financiers – do not trust governments to make good on this promise. As one commentator put it:

“There will be times when the government is writing cheques to miners. Imagine that the economy is tanking and mining profits are way down. How politically feasible is it to believe that the government will write cheques to miners – apparently they’re all foreigners anyway – and not send that same money to Australians?”²¹¹

Mining taxes can also be designed as royalties. These are used extensively by Australian states, which essentially sell minerals to mining companies. The royalty may be determined by the market price of the underlying mineral, the energy content, or a price per tonne.²¹² As royalties increase the costs of inputs, they reduce investment and operation of more costly mines. However, royalties have a number of advantages: they are easy to explain, difficult to game, and relatively efficient if the level of royalty is linked to the price.²¹³

There are some constitutional difficulties with the Commonwealth Government levying simple mining royalties.²¹⁴ However, the Commonwealth could levy an analogous tax as an export tax. It could be set as a percentage of the price above a threshold set

²¹¹ Davidson (2010)

²¹² DoI (2013)

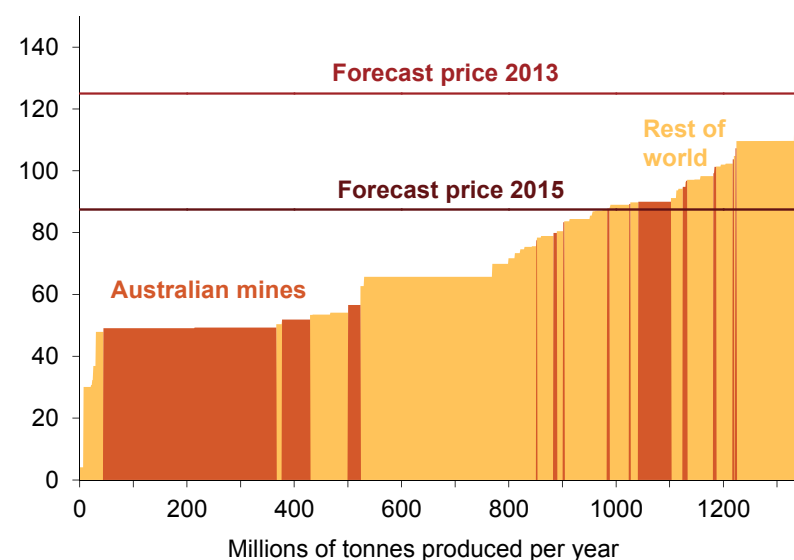
²¹³ Although KPMG Econtech (2010) estimated that royalties substantially reduce economic activity, others argue that these estimates are implausibly high. See Pincus (2012)

²¹⁴ s.114 of the Commonwealth Constitution prohibits the Commonwealth from imposing a “... tax on property ... belonging to a State”.

high enough for each mineral that most investments would proceed anyway.

Mines vary widely in how cheaply minerals can be extracted from them. More costly mines are more acutely affected by cost increases, including taxes such as royalties payments. For some minerals (especially iron ore), most Australian production comes from inexpensive mines, which would be relatively unaffected by increases in tax (Figure 8.6).

Figure 8.6 Cost curve for global iron ore mines
Cost per tonne, \$US/t iron ore 62% equivalent, CFR



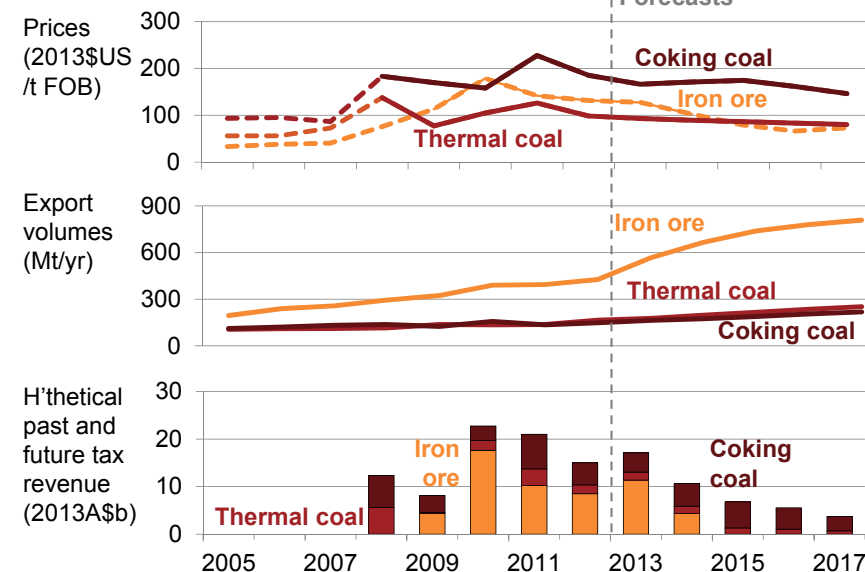
Source: Credit Suisse (2013), Goldman Sachs (2013), Deutsche Bank (2013)

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Other minerals, like thermal coal, are extracted at a cost closer to the sale price. Increased taxes would more severely affect investment and output of these mines. Avoiding substantial negative effects would depend on the Commonwealth accurately selecting the price thresholds for the tax so that they did not substantially deter investment. However, the Commonwealth government is unlikely to be able to levy substantial revenue through such an export tax in the near-term. Our analysis of price and volume forecasts by Goldman Sachs, Deutsche Bank and the Bureau of Rural and Energy Economics suggests that even a fairly heavy tax on the exports of minerals would only raise about \$3 billion a year by 2017, beyond which analysts are wary of forecasting prices.²¹⁵ Most prices are forecast to fall below thresholds at which substantial investment and operation would become marginal, and volume increases are unlikely to fill the gap (Figure 8.7).

Mining taxes designed in this way also provide very volatile revenues. The danger is that the revenue is committed to long-term recurrent spending, rather than saved to a fund that can provide more sustainable revenues over a longer period.²¹⁶ A government today might want to help future generations by imposing an export tax today. But such an approach will provide little revenue for medium-term budget pressures.

Figure 8.7 Mining prices, export volumes, and potential tax revenue forecasts



Assumes threshold prices of \$90/tonne for 62% iron ore FOB; \$75/tonne for thermal coal and \$120 for metallurgical coal in constant \$2008 terms.
Source: Grattan analysis of Credit Suisse (2013), Goldman Sachs (2013), Deutsche Bank (2013), BREE (2013).

²¹⁵ Goldman Sachs (2013)

²¹⁶ Minifie, *et al.* (2013)

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8.6 Congestion charges

If implemented well, congestion charging can be effective in reducing traffic congestion and making more efficient use of existing road infrastructure.²¹⁷ In theory, it could also raise revenue. For example, some estimate that a charge of 10 cents per kilometer travelled in the Sydney metropolitan area could raise up to \$3 billion in revenue.²¹⁸ The exact amount of revenue raised is highly dependent on the design of the scheme.

However, international experience shows that it is very politically difficult to implement congestion charging unless the majority of the revenue is directed towards improving public transport infrastructure.²¹⁹ There is no reason to think that Australia is different in this regard; surveys here suggest that road pricing proposals have much more public support if funds are used to lower car registration charges, eliminate existing tolls, and improve public transport.²²⁰ A congestion charge regime would have to be close to budget-neutral to be feasible.

8.7 Tax increases

Budget outcomes can always be improved by raising the rates of existing taxes.

A comprehensive assessment of alternatives for tax reform is beyond the scope of this report. Relevant considerations include

their impact on equity, and the extent to which they reduce economic efficiency by distorting decisions to work, spend, or invest.²²¹ These considerations are similar to those in our general framework for assessing budget proposals: budgetary impact, social, distributional and economic impacts, and confidence that a policy change will have the budgetary result intended.

To put other specific proposals into context, we can briefly compare the major taxes that already raise more than \$10 billion a year in revenue, as shown in Table 2.

There is no obvious limit to the size of tax rises, which depends on the rate chosen. To compare proposals, we can ask how much would tax rates change to raise \$10 billion?

In general, corporate and income taxes distort economic activity more than consumption and land taxes.²²² Increasing taxes generally tends to distort economic activity more than removing tax exemptions that are by definition aimed at encouraging specific activities. Tax expenditures also tend to benefit the rich more than the poor.²²³ Many of these tax exemptions (often described as ‘tax expenditures’) are discussed above.

The social and distributional impacts of major taxes vary. Any assessment needs to distinguish between who *pays* the tax and who *bears the burden* (because the tax reduces their resources in the long run). For example, corporate and payroll taxes are levied on corporations, but individuals ultimately bear the burden.

²¹⁷ Treasury (2010b) Vol 2, p. 379

²¹⁸ Unpublished analysis cited in University of Sydney (2012); see Hensher and Mulley (2013)

²¹⁹ Albalade and Bel (2009)

²²⁰ See, for example, Hensher, *et al.* (2013) and Palmer (2010)

²²¹ PwC (2013)

²²² See *ibid.*, Mirrlees, *et al.* (2011); Daley, *et al.* (2012a); Treasury NSW (2011).

²²³ Rawdanowicz, *et al.* (2013)

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Table 2: Impact of increasing large taxes to raise an additional \$10b

Tax	Revenue raised (yr)	Rate change to raise \$10b/yr	Econo. Impact (\$GDP/yr)	Impact on bottom 20%
Personal income	\$161b (2012-13)	Raise marginal rates by 2 percentage points	-\$2.4b	Neutral – bottom 20% pay little/no income tax
Company income	\$68b (2012-13)	Increase rate from 30% to 34%	-\$4.0b	Mod. negative – lowers employment and real wages
GST	\$50b (2012-13)	Increase rate from 10% to 12%	-\$0.8b	Mod. negative – regressive impact mitigated by welfare
Payroll	\$20b (2011-12)	Increase average rate from 5.5% to 9.1%	-\$4.1b	Negative – discourages employment
Property rates	\$13b (2011-12)	Increase revenue by 75%	-\$0.2b	Mod. negative – few in this group own property
Stamp duty	\$12b (2011-12)	Increase average rate on median home from 4.8% to 8.9%	-\$3.4b	Mod. negative – few in this group own property

Note: Economic impact based on estimates of marginal excess burden by KPMG Econtech for the Australia's Future Tax System Review (Treasury (2010b). Estimates of excess burden vary substantially: see for example Treasury NSW (2011). See Balancing budgets: Supporting analysis p. 27 for further detail.

Sources: Grattan analysis of KPMG Econtech (2010); Daley et al. (2012a); b); PwC (2013); Rawdanowicz et al. (2013); ABS (2013o) Tables 10 and 18; Treasury (2013a); Treasury NSW (2013); ABS (2013h) Table 7

The key question is how the burden is distributed: between Australian and foreign individuals, and between rich and poor. Such a complex assessment is beyond the scope of this report.

Increasing the rate of GST raises many of the same issues as broadening its base. In practice it would need to be accompanied by increased welfare payments to mitigate the effects on those worst off, which would consume about 10 per cent of the revenue raised (see Section 8.1 above).

Our analysis has focused on increasing property rates rather than land taxes. The existing state land tax base has very substantial exemptions – not least owner-occupied property – and so is a very inefficient tax base. By contrast, property rates (currently levied by local councils) have very few exemptions. It is constitutionally possible for state governments to levy a property rate in addition to local council rates (such as the Victorian government's Fire Services Levy). However, it would be politically very difficult to increase property rates without simultaneously reducing stamp duties.²²⁴ While this would boost economic productivity, it would do little to improve budget balances.

8.8 Bracket creep

As an alternative to raising the rate of income tax, bracket creep can help repair the budget, albeit not equitably. Not increasing tax thresholds substantially increases income tax receipts as a percentage of GDP. When tax thresholds are not increased, wage inflation pushes incomes into higher tax brackets. Individuals then

²²⁴ As recently implemented by the ACT, and proposed by many, including Daley, et al. (2012a) and Kelly, et al. (2013).

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pay more of their income in tax, even if the purchasing power of their income has not increased.

Bracket creep can be valuable to the Commonwealth Government. Assuming 2.5 per cent wage inflation for the next decade, maintaining current personal income tax thresholds would increase Commonwealth taxes by about \$16 billion in today's dollars.²²⁵

Bracket creep falls squarely on middle-income earners. A person at the 50th percentile of the income distribution would pay an additional 4 per cent of their income in tax, while someone in the top 10 per cent would pay only an additional 2 per cent. The bottom 20 per cent would pay only 1 per cent of their incomes.²²⁶

²²⁵ Grattan analysis of ATO (2013c)

²²⁶ Grattan analysis of *ibid.*

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9. Spending cuts

Governments can improve their budget position by reducing spending. Reducing Age Pension spending by including owner occupied housing in the assets test is discussed above. This chapter discusses a large number of other choices. They include reducing spending on transport infrastructure, industry support, defence spending, school class sizes, higher education subsidies and pharmaceuticals. In the unlikely event that governments chose to implement all of these changes, they could improve budget balances by \$23 billion. For most of these spending reductions, execution would need to be unusually good to avoid very undesirable social and economic side-effects

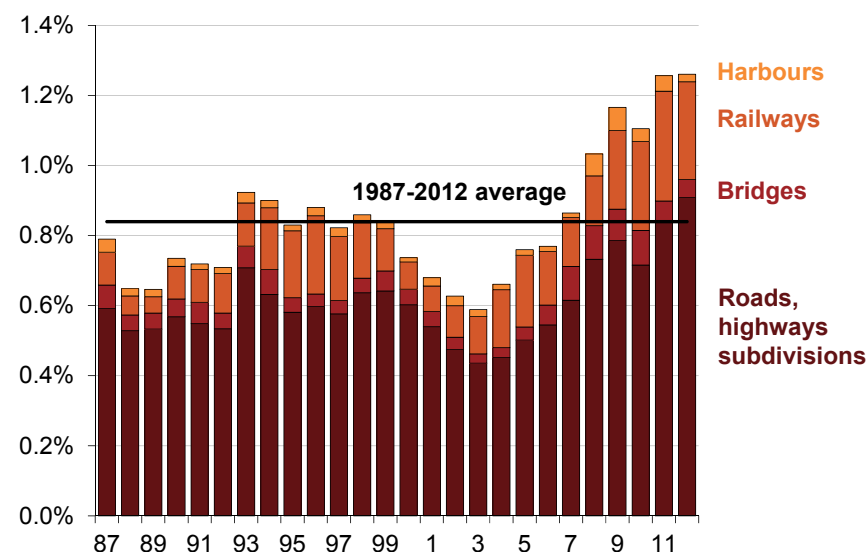
This chapter also discusses a number of other proposals that are often raised but where the potential savings appear to be limited. These include 'middle-class welfare' and public service spending,

9.1 Infrastructure spending

Reducing high levels of Australian government spending on transport infrastructure could save up to \$6 billion a year. The economic and social impacts would depend on how well the remaining expenditure was prioritised, and how well costs were controlled. The substantial lift in expenditure over the last five years includes a number of projects where the projected benefit: cost ratio was low, and then actual costs were higher and benefits lower than expected. If fewer low value projects were selected, a return to historic spending levels might well have little economic impact.

Australian government spending on infrastructure is currently at record levels. ABS data indicates that \$18.8 billion was spent on 'transport infrastructure engineering construction for the public sector' in 2011-12. As Figure 9.1 shows, this is the highest annual spend as a percentage of GDP since records began in 1987.²²⁷

Figure 9.1 Engineering construction work done for the public sector
% of GDP



Source: ABS (2013g) Table 11

²²⁷ ABS (2013g) Table 11

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If spending returned to the long-run average of 0.84 per cent of GDP from its current high of 1.26 per cent, it would add \$6.3 billion a year to the budget bottom line.²²⁸

Governments are spending more than ever, but it's questionable whether they are getting good value from that spending. Making better choices about what to build, and building it more efficiently, would produce the same outcomes at lower cost.

There have been persistent calls in Australian public debate in recent years to increase government spending on infrastructure. It is said that Australia has an infrastructure deficit of more than \$700 billion,²²⁹ a claim that seems to be based more on a wish list devised by engineering and construction firms than on any rigorous economic analysis. Recently, the new Commonwealth Government and some commentators have suggested that going further into debt to fund infrastructure would be their preferred approach to boosting economic growth.²³⁰

Improving the capacity of transport system in Australia is critical for supporting growth and maintaining quality of life, particularly in

cities.²³¹ But there are other ways to do this aside from building big infrastructure. Previous work by Grattan Institute has demonstrated that infrastructure doesn't *necessarily* increase economic growth.²³² It can do so, but only if it is the right infrastructure in the right place, at the right time, for the right price.²³³

There are two ways to reduce transport infrastructure spending without materially reducing outcomes. The first lies in making better choices about what infrastructure gets built. While some progress has been made with the establishment of Infrastructure Australia and its processes to recommend infrastructure priorities to the Commonwealth Government, there is a long way to go. Governments continue to promise investment in projects that don't have rigorous benefit cost analyses ahead of those that do.²³⁴

Even when these analyses are followed, they do not guarantee value for money. Analyses for transport infrastructure systemically overestimate the benefit cost ratios of projects. As Figure 9.2 shows, an international survey of large infrastructure projects found that project costs are typically at least 20 per cent higher than forecast.²³⁵ A litany of local examples – from the cost

²²⁸ Analysis of infrastructure investment is severely restricted by data availability. Determining exactly how much government spends on infrastructure, and on what types of infrastructure, is difficult because not all infrastructure expenditure appears directly in the headline budget balance; some is treated as capital expenditure and so is captured in the budget via interest and depreciation costs, and some is spent outside the general government budget by government-owned corporations. Rigorous post-hoc evaluation of projects is rare, making it difficult to assess value for money: see *Balancing budgets: Supporting analysis*, p. 33

²²⁹ Engineers Australia (2010)

²³⁰ See, for example, Bassanese (2013)

²³¹ Kelly, *et al.* (2013)

²³² See Daley, *et al.* (2012a) and Daley (2013) for a further discussion of the relationship between infrastructure and economic growth.

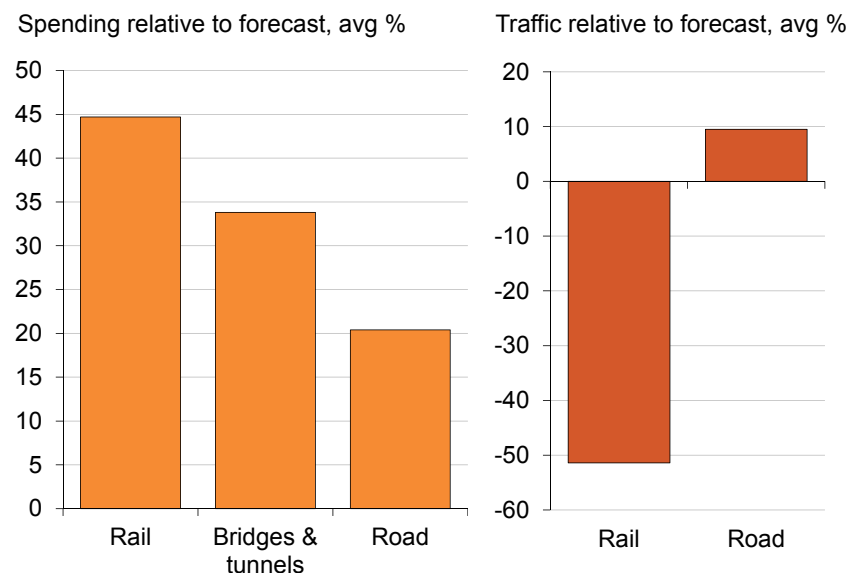
²³³ Eslake (2010)

²³⁴ See, for example, Wiggins (2013); Infrastructure Australia (2013); Flyvbjerg (2009); Davies (2013); Dobes (2008); Ergas and Robson (2010)

²³⁵ Flyvbjerg (2009)

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Figure 9.2 Actual spend and traffic relative to forecasts for large transport projects



Note: Cost overrun data based on analysis of 258 projects in 20 countries; traffic forecast data based on analysis of 208 projects in 14 countries.

Source: Flyvbjerg (2009)

overruns for the Myki ticketing system in Melbourne to the highly optimistic initial traffic forecasts for the Clem7 Tunnel in Brisbane, the Cross City Tunnel in Sydney, Eastlink in Melbourne, and the Sydney and Brisbane airport trains – demonstrates that Australia is not immune from this dynamic.²³⁶ Unfortunately, rigorous evaluation is hampered by lack of availability of data.

Governments seem reluctant to invest financial or political capital in alternatives to major transport projects.²³⁷ Evidence suggests that pricing for demand management, such as road user charges, is a highly effective way to make use of existing transport system capacity and reduce the need for costly new investment.²³⁸ But while state governments have used road pricing to fund new projects, they have been reluctant to impose it on existing road infrastructure. Another option is to consider the value of small, local infrastructure upgrades to remove bottlenecks. These local solutions often have much better benefit cost ratios.²³⁹

A second broad avenue for cutting expenditure is to reduce the costs of projects once they are chosen. In Australia, construction costs have risen faster than prices in other industries, and are higher than those in many comparable countries. The causes of these high costs are complex and intertwined, and some are probably unavoidable. The mining boom has created skills shortages in construction industries. Many projects are constructed in areas with existing residential and commercial activity, which tends to cost more and take longer due to efforts to minimise disruption to travellers. The structure of the construction industry creates few incentives to keep costs down. There is a strong union presence, and oligopolies at the level of major construction firms as well as many materials suppliers. State

²³⁶ Davies (2010); Davies (2012)

²³⁷ Wiggins (2013)

²³⁸ Infrastructure Australia (2013)

²³⁹ Eddington (2006)

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governments effectively are single purchasers for major projects in each jurisdiction, hindering attempts to benchmark costs.²⁴⁰

There is also plenty of evidence to suggest that the way projects are regulated and run is causing delays in projects, driving costs up.²⁴¹ Project proponents face complex and overlapping regulatory standards: the Productivity Commission's draft report on major project development assessment processes indicates that streamlining is feasible.²⁴² Other governance and procurement issues include poor scoping to define the real need and the most efficient way to meet it; poor project planning and performance management; gaps in project governance skills in the relevant areas of government; and a lack of independence between project governance and project delivery agencies. Infrastructure Australia has suggested that better project management could produce cost savings of 20 to 50 per cent.²⁴³

Across the infrastructure spectrum, Australian governments seem to have a tendency to 'gold-plate' infrastructure: building projects to the highest possible specifications even if these are not necessary. This drives costs higher. In the energy industry, government-owned electricity companies invest more in capital infrastructure per customer than do private companies, at rates that cannot fully be explained by higher regulatory standards, rising peak demand, and the need to replace ageing assets.²⁴⁴ State governments have invested large amounts of money in

desalination plants and other big water infrastructure projects, when other, cheaper options were available.²⁴⁵ In transport, the trend is visible in the preference for large road tunnels rather than smaller surface projects, and in efforts to build infrastructure that can withstand natural disasters, even in places where such disasters do not happen.²⁴⁶

The Commonwealth Government has recently commissioned an Productivity Commission inquiry into infrastructure costs, competitiveness and productivity, which will be useful in better understanding how costs might be reduced.²⁴⁷

Shifting infrastructure spending off the government balance sheet, either via government-owned corporations or public-private partnerships, doesn't necessarily help the budget position. If the infrastructure generates enough revenue to cover its costs, then the budget position would be similar, whether or not government retains ownership, depending on the price for which the government sells the right to construct the project. If government has to fund a gap between future revenue and costs, then again the future budget impact is similar whether or not government retains ownership. The budget position is only improved if private sector ownership leads to lower construction or operation costs, and these benefits outweigh the fees charged by investment banks for their services in establishing the partnership and the higher borrowing costs faced by private companies compared to governments.

²⁴⁰ Infrastructure Australia (2013); Turner & Townsend (2012); Grattan analysis of ABS (2012a); ABS (2013a); ABS (2013n)

²⁴¹ Taylor, *et al.* (2012); Caravel (2013); Infrastructure Australia (2013)

²⁴² Productivity Commission (2013a)

²⁴³ Infrastructure Australia (2013)

²⁴⁴ Wood, *et al.* (2012)

²⁴⁵ PricewaterhouseCoopers (2010)

²⁴⁶ Discussed in Wiggins (2013) and Ludlow *ibid.*

²⁴⁷ Productivity Commission (2013b)

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Public-private partnerships can also impose discipline to prioritise projects where a private sector firm is prepared to invest on the basis that future revenue will be greater than the constructions costs. However, with the failure of toll roads from Clem 7 to the Lane Cove Tunnel, the private sector is increasingly reluctant to take on projects, unless governments guarantee the future revenue, which removes any private sector discipline to ensure benefits are greater than costs.

Governments are more likely to get fair value for infrastructure once usage patterns have been established in practice. Transferring existing infrastructure to the private sector can help reduce debt, although its impact on deficits will vary, as discussed in Chapter 10.

9.2 Industry support

Australian governments spend more than \$16 billion a year on industry-related policies and programs, through tariff assistance, tax concessions and direct spending.²⁴⁸ Despite popular perceptions, service industries get more in subsidies and tax concessions than do manufacturing or primary production industries, although the latter get much higher rates of support relative to the value they add to the economy.²⁴⁹ A 50 per cent cut to Commonwealth and state budgetary support to small business, specific industry sectors and industries, and regional adjustment programs, could improve the budget bottom line by more than \$5 billion.²⁵⁰

²⁴⁸ Productivity Commission (2013c); Daley, *et al.* (2013)

²⁴⁹ Productivity Commission (2013c)

²⁵⁰ Grattan analysis of *ibid.* and Daley, *et al.* (2013)

There is little confidence that traditional industry support leads to additional innovation, employment or productivity. Evidence suggests that industry subsidies are not effective at supporting regional economic growth, or at creating growth industries, and that government subsidies distort industry decision-making.²⁵¹

Much modern industry support at least nominally pursues policy aims other than supporting industry for its own sake. Examples include subsidies to encourage carbon emissions reduction or research and development.²⁵² There is little evaluation of most industry support, so it is difficult to tell if the subsidies drive activity beyond what would occur anyway. In some cases, these goals may be better pursued through other means.

Some industry support, such as some manufacturing industry assistance, maintains relatively low-skilled jobs in regional areas. Without support, the jobs would probably not exist. If it is withdrawn, these areas are likely to face high unemployment rates and consequent social dislocation, with consequent costs to the welfare and education systems. If the industry is the major employer in a region, as tends to be the case in automotive and agriculture, there may be significant economic and social effects on the local community. People are often reluctant to move, and this results in higher unemployment.

Ironically, governments that continue to prop up struggling industries can exacerbate this problem. By providing hope that a region will continue to offer the same jobs as in the past,

²⁵¹ For a more detailed discussion of the effectiveness of industry policy, see Daley, *et al.* (2012a) and Daley, *et al.* (2012b)

²⁵² See Wood and Mullerworth (2012)

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governments encourage people to put off the hard decision of moving. In practice, when substantial industries close, most workers rapidly find alternative employment²⁵³ – although it is often at a lower wage precisely because the new job is in an unsubsidised industry.

In this sense, industry support can be less about supporting an industry and more about assisting a community through a transition. Even so, this type of industry support is highly inefficient. For example, steel industry assistance under carbon price compensation measures will cost \$36,000 per year per worker.²⁵⁴ Such a sum would be better directed to more sustainable initiatives such as education and training to prepare workers for jobs in growth industries.

Cutting all industry support would thus have some detrimental social and economic outcomes, at least in the short term. Yet the evidence – or lack of evidence – of benefits from current support suggests there is significant scope for savings.²⁵⁵ The reduction proposed leaves untouched support for research and development, carbon emissions reduction, and export assistance. In all these cases, there is at least an arguable case for broader public benefit.

As with many of the spending proposals identified, high quality execution would be required. Governments would need to make good decisions about which industry assistance is and is not

justified, in the face of a range of special interest groups with much to lose.

9.3 Health spending

Reducing high levels of health spending could save up to \$9 billion per year through a variety of measures. Few health proposals on their own create significant savings, but when combined, can save a large amount offsetting the recent growth in health spending. These measures include abolishing the private health insurance rebate, improving pharmaceutical pricing and reducing avoidable hospital costs. While some proposals will have positive economic impacts, there are moderately negative social impacts should these proposals affect access to and timeliness of treatment for some people.

Growth in health spending over the past 10 years accounts for the largest increase in Australian government expenditure above GDP growth. The increase is largely due to an increase in spending on hospitals. If health expenditure continues to grow, it will consume an extra 1.5 percentage points of GDP by 2023.²⁵⁶

This additional spending brings substantial benefits. Life expectancy continues to increase and quality of life has improved. Life expectancy in Australia is among the highest in the world, and health spending per person is relatively modest. This suggests that only genuine innovations will produce savings that do not harm the quality of health care.²⁵⁷

²⁵³ Beer (2008), p. 324

²⁵⁴ Productivity Commission (2012)

²⁵⁵ Daley and Lancy (2011)

²⁵⁶ See above Figure 2.6

²⁵⁷ OECD (2010)

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Within the health system, there is no one magic bullet that will rein in spending. Rather, a number of smaller measures to improve efficiency may reduce health costs below projections:

- **Private health insurance rebate:** Removing the private health insurance rebate could save \$3.5 billion in expenditure. Savings of \$5.5 billion²⁵⁸ from the cost of the rebate would be offset by an increase in demand for public hospital services.²⁵⁹
- **Pharmaceutical pricing:** A previous Grattan Institute report estimated that up to \$2 billion per year could be achieved by changing the way government pays for pharmaceuticals.²⁶⁰
- **Avoidable hospital costs:** A forthcoming Grattan Institute report suggests there is wide variation in costs between hospitals for the same procedures.²⁶¹ Reducing costs that may be avoidable could reduce hospital spending by up to \$1 billion per year.
- **End of life care:** Initial Grattan analysis suggests that the cost of hospital admissions in the year before death (for people aged over 65) may be around \$2 billion a year. Offsetting costs are not captured in this analysis, including alternative health care and support provided outside hospital, which would probably reduce the budget impact to less than \$1 billion. Although the cost of end of life care is substantial, there are few concrete proposals to reduce it.

²⁵⁸ Treasury (2013a), p. 6-27

²⁵⁹ Grattan analysis of Segal (2004) and Cheng (2013)

²⁶⁰ Duckett, *et al.* (2013)

²⁶¹ Duckett, *et al.* (Forthcoming)

- **Cost effectiveness of treatments:** Costs could be reduced by systemically using lowest cost procedures and medicines that provide the same benefit to patients as more expensive options. Costs could also be reduced by not using procedures if on balance they are not beneficial or if there is no evidence that they work.²⁶² Based on the UK experience, these approaches could save up to \$2 billion in Australia.²⁶³
- **Preventative strategies:** Strategies to prevent illness, such as increasing alcohol taxes, could help to reduce health costs in the long run.²⁶⁴

The Grattan Institute Health Program continues to contribute to work to define these policy options more precisely.

9.4 Other spending reductions

We have analysed a number of other proposals, including plausible reductions in defence spending, increasing school class sizes, and reducing student subsidies for higher education. Individually, each of these is worth \$2 billion to \$3 billion. Collectively they could improve the budget bottom line by \$8 billion. They are described in more detail in *Balancing budgets: Supporting analysis*.

²⁶² The UK's National Institute for Health and Care Excellence (NICE) is an independent body that provides evidence-based guidelines and advice in public health, develops standards and performance metrics for public health and social services and information services. It provides a 'do not do' database outlining clinical practices that should be discontinued or not used routinely by health professionals. See NICE (2013b)

²⁶³ Grattan analysis of NICE (2013a) and Department of Health - UK (2010)

²⁶⁴ Doran, *et al.* (2013)

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However, in order to reduce school or defence spending without significant adverse effects, execution would have to be unusually high quality. Governments would have to selectively keep the better teachers as teaching workforces reduced. They would have to keep high value, and cut low value defence spending, despite regional political pressures. By contrast, reducing student subsidies for higher education would be relatively straightforward to execute.

9.5 Middle-class welfare

Conversations about Australian government budgets frequently assert that there are large savings in 'middle-class welfare'. A small number of high-profile payments to families with children seem to drive this discussion. Yet compared to the scale of Australian government budgets, the amount going to well-off families via these payments is small: around half a billion per year. Australia has the most tightly targeted welfare system in the world. The major recipients of middle class welfare in Australia are people over the age of 65, and proposals to address this are discussed in Chapter 6.

The idea that governments should provide some support to families in need for the costs of raising children is relatively uncontroversial. The Henry Tax Review found that appropriately targeted family payments were important for supporting lower-income families with the cost of raising children; supporting parents of young children to balance work and family; and improving horizontal equity between taxpayers who support children and those who do not.²⁶⁵

²⁶⁵ Treasury (2010a)

Most family payments are made through Family Tax Benefit (FTB) Part A, which will cost the budget \$14.3 billion in 2013-14.²⁶⁶ Families with an adjusted taxable income of \$48,837 or less receive the full rate of payment.²⁶⁷ Families earning more than this have their FTB payment reduced as their earnings increase. The upper income limit varies depending on family composition, but a two-child family that earns more than \$113,000 pre-tax will not get FTB Part A payments.²⁶⁸

Family Tax Benefit Part B, which will cost the budget \$4.6 billion in 2013-14, has more generous thresholds, and so is available to more middle and upper-income families.²⁶⁹ It is paid to single-parent families with an annual adjusted taxable income under \$150,000, and to two-parent families where one parent has little or no income and the other parent earns up to \$150,000 p.a.²⁷⁰

Payment rates for FTB taper rapidly, so relatively little of the payment goes to families earning incomes above the median for their household type.²⁷¹ Less than \$2 billion of FTB are paid to families in the top 40 per cent of households ranked by income (Figure 9.3)

²⁶⁶ FaHCSIA (2013)

²⁶⁷ For reference, a couple with children at the median of the working age population earns \$90,500 in equivalised disposable income. See Phillips and Toohey (2013).

²⁶⁸ DHS (2013b)

²⁶⁹ FaHCSIA (2013)

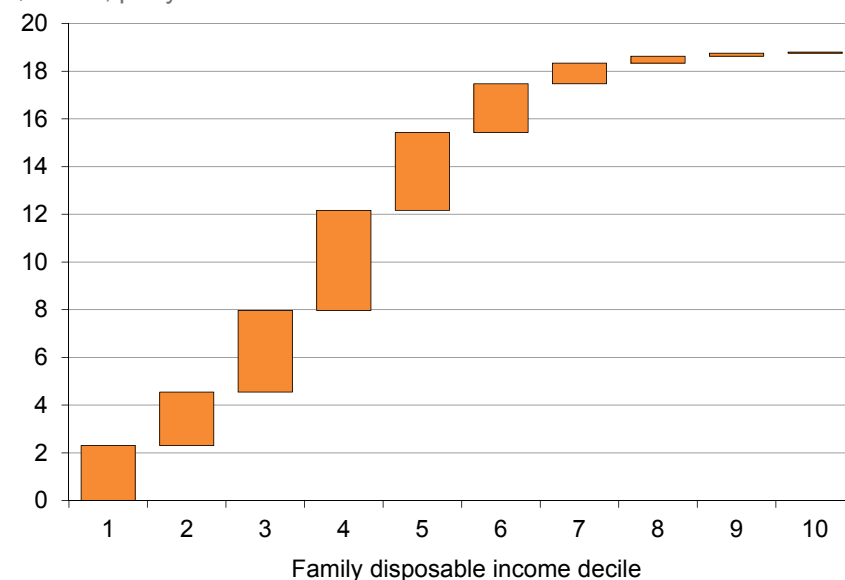
²⁷⁰ DHS (2013c)

²⁷¹ Phillips and Toohey (2013)

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Figure 9.3 Distribution of Family Tax Benefits payments by family disposable income decile

\$ billion, per year



Note: Includes Family Tax Benefits Parts A and B. Income deciles refer to equivalised household disposable income for families whose survey reference member (generally the 'head' of the household) is under 60.

Source: ABS (2011c)

Abolishing FTB Part B payment for families with combined taxable incomes of above \$100,000 would save the budget around \$0.5 billion a year. Applying tougher participation requirements for those with children of school age, similar to those now required for

parenting payments, would save an additional \$1.5 billion a year.²⁷²

The two payments most often condemned as 'middle-class welfare' are the Schoolkids Bonus and the Baby Bonus, but they're a small problem that's getting smaller. Both are now restricted only to recipients of FTB Part A, and so are more closely targeted to lower-income families than before. The Schoolkids Bonus (which the current government has pledged to abolish²⁷³) will cost \$1.3 billion in 2013-14.²⁷⁴ The Baby Bonus will cost \$0.4 billion in 2013-14. From 1 March 2014 it will no longer exist as a separate payment, but will be paid as a loading on FTB Part A. Families who take up Paid Parental Leave will not get the loading.²⁷⁵

'Middle-class welfare' will increase over the coming years if the incoming government implements its Paid Parental Leave scheme.²⁷⁶ The scheme will provide mothers with 26 weeks of paid parental leave at their actual wage (capped at \$150,000) plus superannuation. The existing scheme pays mothers the minimum wage for 18 weeks, and is not available to those earning over \$150,000.²⁷⁷ The gross cost of the scheme is estimated at \$5.7 billion in 2016-17, compared with \$2 billion for the scheme currently in place. Taking into account the further \$1.6 billion in reduced costs and increased revenue to government expected to

²⁷² Unpublished NATSEM modelling, cited in Karvelas (2013)

²⁷³ Hockey and Robb (2013)

²⁷⁴ FaHCSIA (2013)

²⁷⁵ Ibid.

²⁷⁶ As discussed in Box 4.1 on p. 18, this is not included as a potential saving because it is not yet legislated.

²⁷⁷ Loughnane (2013a)

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arise from the scheme, the net budget impact is around \$2.1 billion.²⁷⁸ The majority of this additional funding will go to middle- and high-income earning women. A woman earning \$32,000 per year will be around \$5,000 better off under the new scheme, while a woman earning \$85,000 will be around \$31,000 better off.²⁷⁹

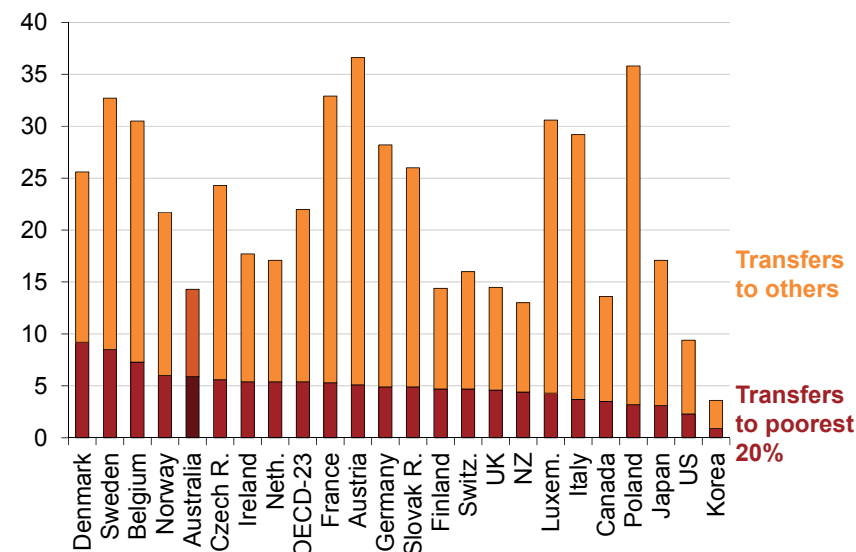
Looking more broadly than specific payments to families, Australia has one of the world's most tightly targeted welfare systems. Figure 9.4 shows that Australian government payments do more to redistribute welfare payments to the poorest 20 per cent of households than does any other OECD country except Denmark. 42 per cent of transfer spending goes to the poorest 20 per cent, while only 3 per cent of transfer spending goes to the richest 20 per cent.²⁸⁰

Looking more broadly at 'in kind transfers' – government spending on services that people use – these are fairly constant in dollar terms across income groups and age groups.²⁸¹

If Australia has a problem with 'middle-class welfare', most of the recipients are aged over 65. Australian welfare policies systemically favour older people over the young, and older people pay less tax and receive more benefits than younger households with similar incomes.²⁸² As discussed in Chapter 6, current arrangements for the Age Pension and superannuation provide significant benefits to those in the middle- and upper-income

deciles, and reforms are attractive choices for repairing budget balances.

Figure 9.4 Redistribution of welfare payments in OECD countries
Public payments to households as a proportion of population disposable income, mid-2000s



Note: Incomes are equivalised
Source: Grattan analysis of Whiteford (2010)

²⁷⁸ PBO (2013b), p. 30

²⁷⁹ Loughnane (2013a)

²⁸⁰ Whiteford (2013)

²⁸¹ Daley, *et al.* (2013), p.43

²⁸² Tapper, *et al.* (2013)

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9.6 Public service cuts

Other conversations about budgets frequently assert that large deficits could be remedied by cutting a bloated public service.

By international standards, the Australian public sector is relatively efficient. The OECD identifies Australia as an example for other countries to follow in this regard, with small general government employment and large efficiency gains in recent years.²⁸³

Across-the-board reductions in funding for government departments have long been used to improve efficiency and reduce costs. In recent years, annual reductions, or 'efficiency dividends' of 1.25 to 1.5 percent have been applied to the departmental expenditure of most Commonwealth and state agencies. Some governments have made further cuts above this base rate.²⁸⁴

While such cuts may be useful discipline to reduce wasteful spending and drive efficiency, they do not raise significant funds. In 2011, the Commonwealth imposed an additional efficiency dividend of 2.5 per cent (on top of the base rate of 1.5 per cent) for the 2012-13 budget year.²⁸⁵ This was estimated to raise \$0.5 billion a year.²⁸⁶ In this year's budget, the Victorian Government projected that increasing its efficiency dividend from 2 to 2.5 per cent would raise \$0.05 billion a year.²⁸⁷ Extrapolating

nationally, this suggests that a 2.5 per cent cut across all levels of government (with similar exemptions for front line staff as in Victoria) would save only \$1.5 billion a year. The new Commonwealth Government has committed to an additional 0.25 per cent efficiency dividend on the Australian Public Service, which will raise \$0.2 billion in 2016-17.²⁸⁸

Beyond a certain point, efficiency dividend-style approaches may reduce the capacity of the public service to fulfill the functions of government.²⁸⁹ Cuts are indiscriminate, making little distinction between high-value and low-value functions of government, or between departments which are already operating efficiently and those with fat available to trim. Given the relatively large efficiency dividends imposed in recent years, the scope to reduce savings via the usual suspects of travel, hospitality and advertising is small.²⁹⁰ That leaves staff cuts.

Another proposed option for savings is to simply reduce the public sector headcount. The new government has already announced that it will cut 12,000 staff from the Australian Public Service, which if implemented as planned will save \$1.2 billion in 2014-15 and \$1.9 billion by 2016-17.²⁹¹ It is not obvious that these savings are feasible. When the public sector is being squeezed, attrition rates fall, as people hold onto existing jobs for fear of not finding another. When the Howard Government began public service cuts in 1996, the resignation rate fell by 11 per cent, the retirement rate

²⁸³ OECD (2012b)

²⁸⁴ Horne (2012); Horne (2013)

²⁸⁵ Horne (2012)

²⁸⁶ Treasury (2011)

²⁸⁷ Victorian Government (2013)

²⁸⁸ PBO (2013b), p. 42

²⁸⁹ MacDermott and Stone (2013)

²⁹⁰ Bartos (2011)

²⁹¹ PBO (2013b), p. 41. This cut is in addition to the effect of the efficiency dividend and cuts to the former Department of Climate Change.

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by 60 per cent, and dismissals by 80 per cent.²⁹² To achieve staff cuts of the size proposed, retrenchments may be needed and redundancy payouts will erode proposed savings.

Staff cuts tend to be pursued via voluntary redundancies, which weaken the public service as high-quality people who are confident of finding another role are more likely to leave. They may also reduce the quality of services: even though frontline staff are usually nominally quarantined from such cuts, having fewer back office staff may push administrative work onto frontline staff, leaving them with less capacity to deliver services. A much better approach to public sector savings is to take the time to identify functions that no longer need to be delivered, or can be delivered differently, and target savings appropriately.

9.7 Federalism reform

Some suggest that there are significant savings in abolishing one or more departments – usually health or education – and transferring their functions to the states. The first stated task of the new National Commission of Audit is to ‘assess the current split of roles and responsibilities between and within the Commonwealth Government and state and territory governments’.²⁹³

There is obvious room to reduce duplication between Commonwealth and state public services.²⁹⁴ However, the budget savings are likely to be small relative to the budget problem

Australia faces.²⁹⁵ For example, the Commonwealth Department of Health and Ageing will only spend \$0.6 billion on employee expenses in 2013-14.²⁹⁶ If the entire department were abolished, some of this money would be saved, but much of the work those staff were doing would need to be taken up by state governments, which would have to spend more. And some functions, such as regulating the safety and efficacy of medications, should stay with the Commonwealth Department rather than being duplicated by eight states and territories.

The primary value of reducing federal-state overlap may be not in budgetary savings, but in better use of senior management. Federal-state interactions inevitably consume a large portion of senior management time in both Commonwealth and state bureaucracies. With less overlap, more of this time would be spent in managing and pursuing substantive reform.

In any case, governments of both political colours have been reluctant to give up control. For example, the 1996 Officer Commission of Audit recommended that the Commonwealth transfer many functions, including health and education, to the states, but this recommendation was never implemented.²⁹⁷

The Commonwealth can relieve pressure on its budget by simply ending its spending in an area of shared responsibility (such as hospitals), and leaving states to manage the entire area – but with no change in funding. This would be particularly tempting in

²⁹² Mannheim (2013)

²⁹³ Hockey and Cormann (2013)

²⁹⁴ See, for example, the reforms proposed in OECD (2012b)

²⁹⁵ There is little good evidence on the savings possible from changes to federal financial arrangements, and much of what does exist is contradictory. See Daley, *et al.* (2012b), p. 28-9

²⁹⁶ DoHA (2013)

²⁹⁷ Officer, *et al.* (1996)

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health, where spending is growing much faster than GDP. However, this would simply transfer the Commonwealth's budgetary problems to the states – which generally have less ability to adjust given their constitutionally limited tax bases.

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10. Asset sales

Asset sales, or privatisations, are frequently put forward as part of proposals to improve budget balances and reduce debt.²⁹⁸

However, the relationship between selling assets and improving the budget bottom line is not straightforward, with the impact depending on the type of asset and the budget measure used.²⁹⁹

Selling a government business enterprise (a financial asset) provides a cash inflow to government which, if used to pay off debt will reduce net debt. However, the proceeds of the sale are not directly included in either of the main measures of the budget balance (underlying cash or fiscal balance).

The impact of selling a government business enterprise (such as Medibank Private) on the budget balance is indirect. The government will no longer earn dividends from the sold asset, reducing future revenues. If the government uses the revenue from the sold asset to pay off debt, it will pay less interest on the debt. Ultimately, budget balances are only improved if the government's dividends from the sold asset are less than the interest on the sale price of the asset.

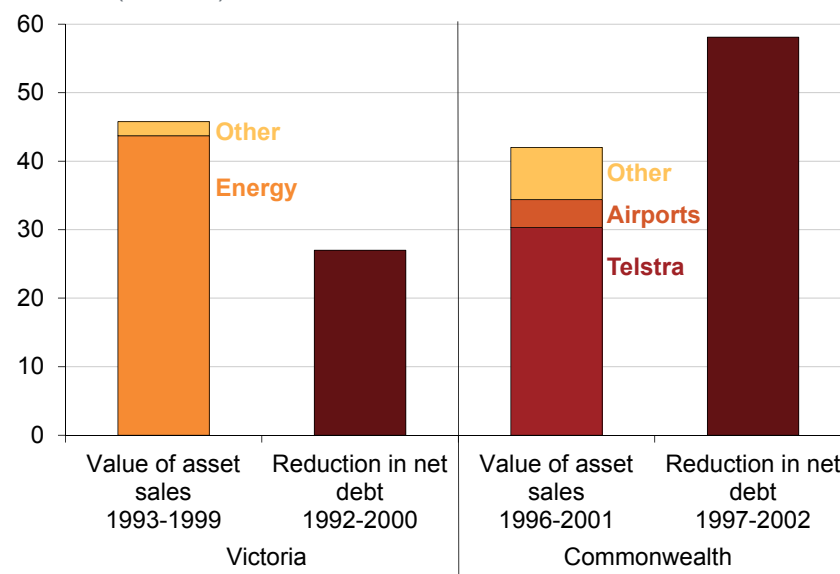
Given the many variables involved, it's difficult to quantify the potential of asset sales to contribute significantly to budget repair.

²⁹⁸ Analysing the broader costs and benefits of privatisations, while a subject of lively debate, is beyond the scope of this paper: see Abbott and Cohen (2013)

²⁹⁹ For example, the effect of an asset sale will be different for each of: headline cash balance, underlying cash balance, fiscal balance, net debt, net financial worth, net worth.

The sale of government business enterprises has played an important role in reducing the existing stock of debt in Australia. As Figure 10.1 shows, most of the net debt reduction achieved in the early years of both the Kennett and Howard governments came from asset sales.

Figure 10.1 Value of asset sales and net debt reduction
\$ billion (nominal)



Source: Treasury (2013a); Kamener and Tan (2012); Abbott and Cohen (2013)

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However, assets can only be sold once. The Commonwealth has relatively few remaining options for asset sales. Most of the infrastructure it still owns is not likely to be attractive to the private sector.³⁰⁰ The sale of Medibank Private is expected to raise around \$4 billion.³⁰¹ Commentators have suggested that the Australian Rail Track Corporation, Snowy Hydro Australia Post, Air Services Australia, Defence Housing Australia and the HELP higher education debt could also be sold.³⁰²

In some states there is more potential for asset sales. Infrastructure Australia estimates that Australian governments hold more than \$100 billion worth of commercial infrastructure assets, including in energy, water, transport and plantation forestry.³⁰³ For example, the New South Wales, Queensland and Western Australian governments still own major energy businesses that could be sold.³⁰⁴

³⁰⁰ Infrastructure Australia (2012)

³⁰¹ Crowe (2013)

³⁰² AAP and Swan (2013); Creighton (2013); Norton (2013)

³⁰³ Infrastructure Australia (2012), p. 5

³⁰⁴ Wood, *et al.* (2012), p. 10

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11. Budget maintenance

Assuming that governments balance Australian budgets, what can help to maintain this balance?

Governments of all political colours have a tendency to let budget discipline lapse. As Figure 11.1 shows, the commitments of the Commonwealth and state governments to reduce spending growth over the forward estimates are extremely ambitious compared to their recent records.

11.1 Budget processes and mindsets

By and large, Australian governments already have robust and transparent structures for budgeting.³⁰⁵ Many of the mechanisms that bodies such as the OECD recommend for this purpose have been in place in Australia for many years and are unremarkable to most Australian policy-makers. These include the use of accrual accounting; the publication of forward estimates for spending and revenue beyond the budget year; establishment of the Future Fund and the Intergenerational Report; outcomes-based budgeting; and the processes for pre-election budget accountability and the formulation of fiscal policy set out in the Charter of Budget Honesty.³⁰⁶ The relatively recent establishment of the Parliamentary Budget Office provides a further layer of scrutiny. Even the Department of Defence, notorious for lack of

transparency in forward expenditure planning, has improved its practices in recent years.³⁰⁷

Australia's public policy culture has long been averse to budget deficits and public debt.³⁰⁸ Politicians are expected to explain how

Figure 11.1 Real expenditure growth by government term
Cumulative annual growth in real expenditure, % p.a.



Source: Grattan analysis of Commonwealth and state budget papers

³⁰⁵ See Blondal, *et al.* (2008) for a comprehensive overview of budgeting in Australia, and OECD (2012b) for more recent developments.

³⁰⁶ See Officer, *et al.* (1996); Blondal, *et al.* (2008); OECD (2012b) and IMF (2013b) for more detailed discussion of optimal budget institutions.

³⁰⁷ Lewis (2012)

³⁰⁸ Macfarlane (2006)

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they will pay for their promises, and accusing an opponent of increasing government debt is a potent political weapon. This puts Australia in a much better fiscal position than most other developed nations, whose governments have been able to run large deficits with little public pressure.

Yet some things could be done better. There could be more use of lapsing programs with a fixed deadline for evaluation before further funding is committed. It would help to have a better culture of assessed pilots and program evaluation, with approaches more resistant to being gamed by departments and interest groups. This would also require a change in political culture, to give governments the space to admit that they had spent money on something that did not work, rather than pretending that it did to save face.

Budgets will continue to face pressure from ‘entitlement’ programs – such as Medicare and the Pharmaceutical Benefits Scheme – that grow in response to demand rather than due to specific government decisions. Given that health is the biggest source of expenditure growth for Australian budgets, governments will have to find ways to address this.³⁰⁹

In some senses, maintaining discipline over revenue is more straightforward. There are simply fewer opportunities for the Commonwealth Government to cut into its own revenue streams than to increase spending. The Commonwealth will need to ensure that any new revenue sources are well-designed (in contrast to the previous government’s mining tax regime) so that they raise the funds they are intended to.

³⁰⁹ Daley, *et al.* (2013), p. 14

11.2 Fiscal rules

Unlike many other countries, Australia does not have legislated fiscal rules that specify a numerical budget target. Instead, it takes a principles-based approach that requires the Commonwealth to release an annual ‘Fiscal Strategy Statement’ that complies with legislated ‘Principles of Sound Fiscal Management’. The Statement must specify the government’s long-term fiscal objectives and the measures by which fiscal policy will be set and addressed. There are no legislated penalties for non-compliance with these targets, but the government must report on its performance via the budget papers and related documents.³¹⁰

Since this framework was introduced in 1998, governments on both sides of politics have used the Statement to set medium-term fiscal strategies to achieve a ‘balanced budget over the economic cycle’. Both sides have committed to fiscal rectitude outside the Statement, usually by promising to achieve a specified surplus in a defined timeframe, and to constrain growth in taxes or spending.

A principles-based approach has the great advantage of flexibility in the case of a period of below-trend growth or an international fiscal crisis. While flexibility carries risks, in the right circumstances it can have significant advantages.³¹¹ Some argue that the success of Australia’s inflation targeting regime is due to the level of discretion given to policy-makers to adjust to circumstances. While initially criticised when established, the flexible regime has come to be seen as a benefit rather than a

³¹⁰ A more detailed discussion of the regime can be found in Blondal, *et al.* (2008)

³¹¹ IMF (2013b), p. 41

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cost, and has been emulated by other countries. When combined with Australia's traditionally conservative fiscal mindset, and proper transparency, the flexibility of our fiscal rules may bring the same benefit.³¹² Certainly, the OECD's view is that Australia's current system has served it well.³¹³ There is also some evidence that "appropriate institutional arrangements deliver better fiscal outcomes than simple, mechanical fiscal rules."³¹⁴

The risk with Australia's approach is that while governments commit to a balanced budget 'over the economic cycle', there is no clear way of defining where the current year sits in the cycle. This gives governments plenty of wriggle room to continue to run budget deficits by claiming that the economy is not yet in good enough shape to justify a surplus.

Some have proposed avoiding this problem by establishing an independent body to set fiscal rules for government, as the Reserve Bank does for monetary policy.³¹⁵ This is problematic for a number of reasons, not least that it would require constant adjustment of tax rates to maintain budget balances within the recommended range.

In any case, the recent experience of fixed fiscal targets in other countries has not been edifying. The European Union's Stability and Growth Pact requires countries to deal with normal cyclical fluctuations while keeping the government deficit below 3 per cent

of national income.³¹⁶ In practice, countries have either manipulated their fiscal data to appear to comply, or ignored the rules altogether when crisis hit.³¹⁷ Many countries also have their own deficit rules that have proved similarly problematic.³¹⁸ Chile has had a more successful experience, but it appears to be somewhat of an outlier.³¹⁹

A better approach may be to follow the United Kingdom's new approach, which combines short-term flexibility with a firmer timeframe for a return to a balanced budget. The UK government replaced the Fiscal Responsibility Act with a 'fiscal mandate' that states that the structural current budget must be forecast to be in balance or in surplus by the end of the rolling, five-year forecast horizon. As the Institute for Fiscal Studies states:

*The fiscal mandate has much to recommend it [] It constrains the government over the medium term to borrow only to finance investment spending, while allowing the flexibility to provide short-term stimulus in periods when the economy is underperforming and giving time for fiscal policy to adjust to shocks.*³²⁰

Australia's budget processes would be strengthened if the new Commonwealth Government adopted such a rule as part of its first Fiscal Strategy Statement, rather than continuing the vague commitment to a balanced budget over the economic cycle.

³¹² Gruen and Sayegh (2005)

³¹³ OECD (2012a)

³¹⁴ Daban (2011)

³¹⁵ Gruen (1997); Carling and Kirchner (2009)

³¹⁶ European Council on the Stability and Growth Pact (1997)

³¹⁷ Uren (2013)

³¹⁸ See, for example, discussion of the UK situation in Emmerson, *et al.* (2013)

³¹⁹ Daban (2011)

³²⁰ Emmerson, *et al.* (2013)

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Combined with Australia's stronger culture of deficit aversion, it would sharpen the government's incentive to balance the budget in the medium term. State governments should adopt a similar rule.

Ideally, the Parliamentary Budget Office should be given a mandate to report on whether budget outcomes are consistent with the Fiscal Strategy Statement, again following the approach in the UK, where the Office for Budget Responsibility has a remit to assess government's compliance.³²¹ This year Australia's Parliamentary Budget Office also produced an estimate of the structural budget balance.³²² Repeating this exercise annually would inform fiscal policy. Similar reports should be produced for state governments.

Those advocating budget rules sometimes relate them specifically to saving the proceeds of the Australian mining boom. Some countries, such as Norway, reserve commodity price windfalls into a sovereign wealth fund. As Grattan Institute's report '*The mining boom: impacts and prospects*' notes, Australia's situation is sufficiently different to such countries to justify a separate approach.³²³ The OECD, while suggesting that Australia consider establishing a stabilization fund, also notes the differences between Australia and other nations, and acknowledges the difficulty in establishing such a fund.³²⁴

³²¹ *ibid.*; Uren (2013)

³²² PBO (2013a)

³²³ Minifie, *et al.* (2013)

³²⁴ OECD (2012a)

11.3 Data and reporting

No government entity has a remit, or much incentive, to consider Australian budgets as a whole rather than on a jurisdiction-by-jurisdiction basis. This distorts our understanding of the real fiscal situation, and reduces accountability if governments try to balance their budgets by cost-shifting onto other jurisdictions (see Section 9.7). The OECD has suggested extending the scope of the Parliamentary Budget Office to enable it to report on state as well as Commonwealth budget issues.³²⁵ Extending the scope of the Intergenerational Report to include state governments would further improve the information available to policy-makers.

Good budgeting requires good data, and fiscal analysis in Australia is hampered by a lack of it. A good start would be for jurisdictions to make the data in their budget papers available in a form that can be easily analysed by those outside government (for example, as a spreadsheet rather than a PDF file). Improving the comparability of data over time and between jurisdictions would also enable better analysis. The Uniform Presentation Framework (UPF) and the ABS's Government Finance Statistics are useful in ensuring that basic financial data such as operating statements and balance sheets is comparable. Governments also need to ensure they maintain appropriate central records of their own activities so that expenditure can be tracked over time when responsibilities move between departments and ministries.

³²⁵ *Ibid.*

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11.4 Tax expenditures

Budget discipline could also be improved by being more explicit about tax expenditures. Tax expenditures are concessions and exemptions that reduce the revenue that a government otherwise would have collected. Examples include the exclusion of fresh food from the GST, exemption of owner-occupied housing from capital gains tax, and exemption of small businesses from payroll tax.

In 2011-12, the Commonwealth reported tax expenditures of \$111 billion, and the states reported \$28 billion.³²⁶ While the reliability of these estimates varies, the sums involved are clearly big enough to make a difference to the budget outcome. However, they are not usually counted when considering the amount government spends on a particular policy area and are not subject to ongoing Parliamentary scrutiny as they do not appear in appropriation bills.³²⁷ In general, they get far less attention from the media and policymakers than direct budget expenditures.

Not all tax expenditures are bad. They can be significant loopholes that enable tax avoidance, but they can also produce beneficial social outcomes and improve efficiency. However, their relative lack of transparency and accountability can impair budget sustainability.³²⁸

The Commonwealth Government publishes a Tax Expenditures Statement each year, and states provide similar information in

their budget papers. But tax expenditures are inherently challenging to measure and interpret, and the figures provided cannot be reliably compared with budget expenditures.³²⁹ There are no uniform reporting standards that enable comparisons over time, or between different state governments.³³⁰

³²⁶ Treasury (2013e); Grattan analysis of state and territory budget papers

³²⁷ ANAO (2013)

³²⁸ Martin (2013); Treasury (2010b); Officer, *et al.* (1996)

³²⁹ Treasury (2013e); ANAO (2013)

³³⁰ Treasury (2010b)

Conclusion

This report shows the tough choices that Australian governments need to make to balance their budgets. If they ignore their substantial and widening deficits, they will hand a heavy burden of debt and interest payments to the next generation.

Many of the choices we have discussed are sacred cows. Even to raise them may sound crazy-brave. But governments not prepared to tackle any of these reforms are unlikely to rein in their deficits. There just aren't enough feasible alternatives big enough to bridge the gap. If governments rule out all the tough choices discussed in this report, then they are obliged to propose plausible alternatives.

We inherited a prosperous Australia. We need our governments to make tough choices so that it stays that way.

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