committee for economic development of australia

BUDGET RESET 2: MIND THE GAP

2023

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About CEDA

CEDA is Australia's leading member-driven think tank. Our purpose is to achieve sustainable long-term prosperity for all Australians.

Our trusted independence, and a deep and broad membership base that extends across all sectors, states and territories, enables us to bring diverse perspectives and insights to guide and advance policy debate and development in the national interest.

We aim to influence future economic, social and environmental outcomes by:

- Promoting public discussion of the challenges and opportunities facing Australia;
- Enabling members to shape future outcomes through policy and their own actions;
- Partnering and collaborating to tackle emerging opportunities and entrenched challenges; and
- Advocating for policy change based on our independent research insights.

Our work is overseen by our independent Board of Directors and our research is guided and approved by an independent Research and Policy Committee whose members are leading economists, researchers and policy experts.

BUDGET RESET 2: MIND THE GAP

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Chief Economist, CEDA

Jarrod Ball joined CEDA as Chief Economist in 2017 with over 15 years of experience as an economist across the public and private sectors. He has held senior roles at the Business Council of Australia, in EY's advisory services practice and at BHP. Jarrod also worked in the Federal Government and was a lead adviser on microeconomic reform for the Victorian Departments of Premier and Cabinet and Treasury and Finance. He is a member of CEDA's Council on Economic Policy and the Melbourne Economic Forum.

Treasurer Jim Chalmers will hand down the 2023-24 Federal Budget amid an increasingly uncertain and challenged global economy. Inflationary pressures are proving stubborn, interest rates are rising and the global financial system is under increasing strain.

Despite these pressures, higher than forecast commodity prices, an outperforming labour market and strong company profits have lowered the deficit in the short-term. But these favourable conditions are unlikely to continue. Higher costs of living and rising interest rates are starting to dampen spending and the broader economic environment is weighing on business activity.

This year's Budget and the policy decisions that follow must enable the nation to weather the difficult fiscal and economic period ahead,

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moving in lockstep with monetary policy to bring inflation under control while still supporting the most vulnerable in the community. Beyond this, the Government must lay the foundations on work to close the stubborn fiscal gap that will otherwise persist over the next decade.

The immediate priority

The Government should stick to the script laid out in its October Budget, ensuring it does not stoke inflation and staying in lockstep with the Reserve Bank of Australia (RBA). It must also keep directing higher tax revenues towards budget repair and limit spending growth until debt declines.

This is a difficult balance to strike when many Australians are struggling under the pressure of increased costs of living. As CEDA analysis shows, interest costs are set to exceed 40 per cent of average disposable income for low-income households.[1] These households will need to cut discretionary spending by more than 10 per cent to absorb increases in the cost of essential items without their overall spending increasing more than income. CEDA therefore supports targeted increases in support for these households, and particularly vulnerable groups such as single parents.

Closing the long-term gap

While this immediate strategy is the right one to pursue, the Government has admitted the last Budget did not do enough to rebuild the fiscal buffers and close the yawning deficit over the next decade.

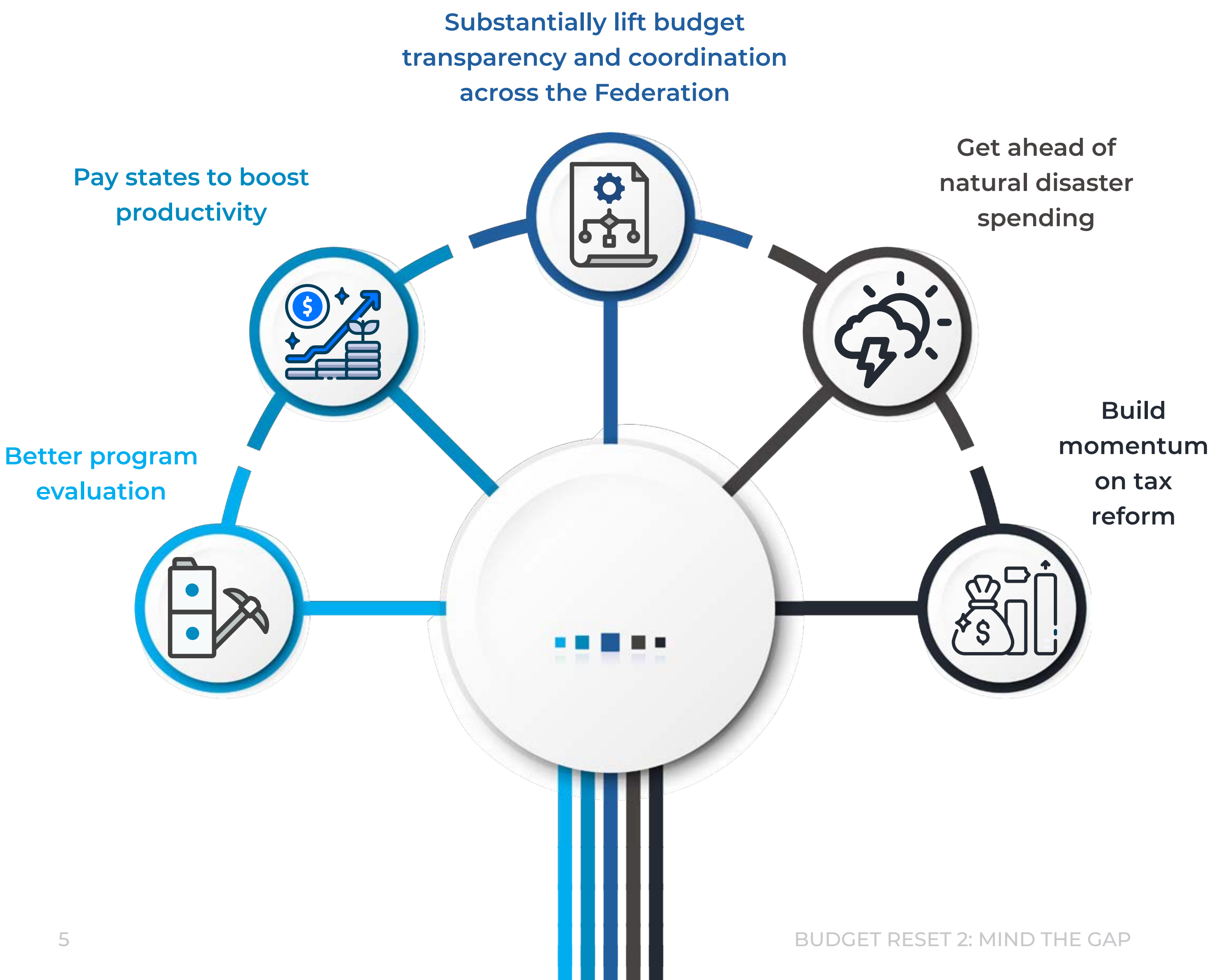
Some have suggested a key shortcoming of that Budget was weak fiscal rules, with much greater prescription needed to instil greater discipline. CEDA does not see this as a priority in 2023. As long as the Government is meeting the commitments outlined in its fiscal strategy, stronger rules are neither necessary nor desirable at this time.

The Government's priorities are well aligned with the International Monetary Fund's assessment of the Australian economy. In addition, as previous CEDA research and eminent international economists have found, prescriptive and arbitrary fiscal rules often do more harm than good, or are simply ignored.[2]

We must instead place priority on getting the right institutions, tools and policies to meet the government's fiscal commitments to:

- Improve the efficiency, quality and sustainability of spending.
- Focus new spending on investments and reforms that build the capability of our people, expand the productive capacity of our economy and support action on climate change.
- Deliver a tax system that funds government services in an efficient, fair and sustainable way.

RECOMMENDATIONS FOR REFORM



> Without a material change in the budget position over the decade, the Federal Government will be spending more each year on interest to service debt than it will on aged care or Medicare.

Without better policies and practice in these areas, the Government will be unable to close the $50 billion fiscal gap between revenue and spending that stretches across the next decade. Without a material change in the budget position over the decade, the Federal Government will be spending more each year on interest to service debt than it will on aged care or Medicare.[3]

With the RBA review complete and a government response in train by the time of the Budget in May, the Government must now prioritise the fiscal side of the macroeconomic framework. This should be achieved by:

1. Improving the efficiency of spending by introducing a rolling schedule of program evaluations through the Federal Government's plan to establish an independent Evaluator-General.
2. Paying states and territories to introduce reforms that boost productivity, which will bring both a fiscal and economic dividend.
    a. The Federal Government should establish a productivity funding pool. States could receive productivity payments by bidding into the pool with appropriate reform proposals that could be drawn from the recent Productivity Commission five-yearly reviews or state-based inquiries.

3. Substantially lifting budget transparency and coordination across the Federation.
    a. Parliament should ask the Parliamentary Budget Office to update its previous work on off-budget financing mechanisms, assessing their current application across Australian governments and best-practice guidance for future reporting and application.
    b. The Council on Federal Financial Relations should publish a consolidated intergenerational fiscal assessment for all governments either before or as part of the next Commonwealth Government Intergenerational Report after the 2023 edition.
4. Accelerating the shift towards climate adaptation through disaster prevention, increasing allocations to the Disaster Ready Fund over time and providing longer term certainty of ongoing funding to assist project proponents' investment decisions.
5. Building momentum on tax reform.
    a. In the short-term, the Federal Government should continue to pursue pragmatic changes to the tax system that broaden the base and strengthen the budget position (eg. work-related expense deductions).
    b. In the longer term, it should use the 2023 Intergenerational Report to start a public discussion of the future tax system that will be required to address the economic, fiscal, social and environmental challenges Australia will confront over coming decades.

Better program evaluation

In the 2022-23 Budget, the Government took immediate steps to cut spending by reprioritising infrastructure projects and reducing spending on external contracts. From the 2023-24 Budget onwards, these savings will be much harder won, coming instead through program redesign and longer-term improvements in value for money. This recognises that the community's expectations of service delivery have increased and income support is already targeted at the most vulnerable in the community.

Leveraging its proposed Evaluator-General model, the Government should establish a rolling schedule of program evaluations. This would establish a pipeline of ideas for the Expenditure Review Committee each year to lift the efficiency and effectiveness of spending over time and reduce the need for blunt savings targets as far as possible. It should prioritise evaluating the largest spending programs that are growing faster than the economy. CEDA will provide further detail on best practice evaluation arrangements in the upcoming third report in our Disrupting Disadvantage series just before the Federal Budget is handed down.

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Pay states to boost productivity

Funding productivity-enhancing reforms should be a high priority for the economy and the Budget. Lifting labour productivity from 1.2 per cent per annum back to its 30-year average of 1.6 per cent would improve GDP by 1.75 per cent by the end of the next decade, while reducing debt by 2 per cent of GDP.[4]

To achieve this, the Commonwealth Government should establish a productivity funding pool that states can bid into with appropriate reform proposals to receive productivity payments. Proposals could be drawn from the two Productivity Commission (PC) five-yearly reviews or state-based inquiries (eg. NSW Productivity Commission review). States must have flexibility in how they pursue the recommendations of such inquiries, rather than the prescriptive model underpinning many fiscal transfers, for the funding to provide the maximum benefit.

The Federal Budget typically seeks to fund the capabilities that underpin productivity, such as education and health, to enhance human capital, and new or improved infrastructure, to support better business performance. It has been far less common to fund reforms that boost regulatory incentives and flexibility in the economy.

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The exceptions to this are the National Competition Policy (NCP) and Seamless National Economy (SNE) reforms, which provided payments to states for implementing regulatory reforms. NCP payments averaged around $600 million a year while making the economy up to 5.5 per cent bigger over the long term, while $550 million was provided for SNE reforms.[5]

The two PC five-year inquiries have demonstrated the critical role of the states and territories in productivity-enhancing reform. This includes areas such as removing inefficient taxes on insurance and stamp duty, improving occupational licensing arrangements and planning and zoning regulation.

Apart from the fiscal dividend of increased productivity growth, inequities in the federal financial system also add to the case for introducing productivity payments. For example, past analysis has shown states that go it alone in slashing inefficient taxes on insurance and stamp duty risk losing up to $1 billion in GST payments.[6] Further, the Commonwealth always stands to gain the greatest fiscal dividend from productivity reforms given the breadth and strength of its tax base.

Substantially lift budget transparency and coordination across the Federation

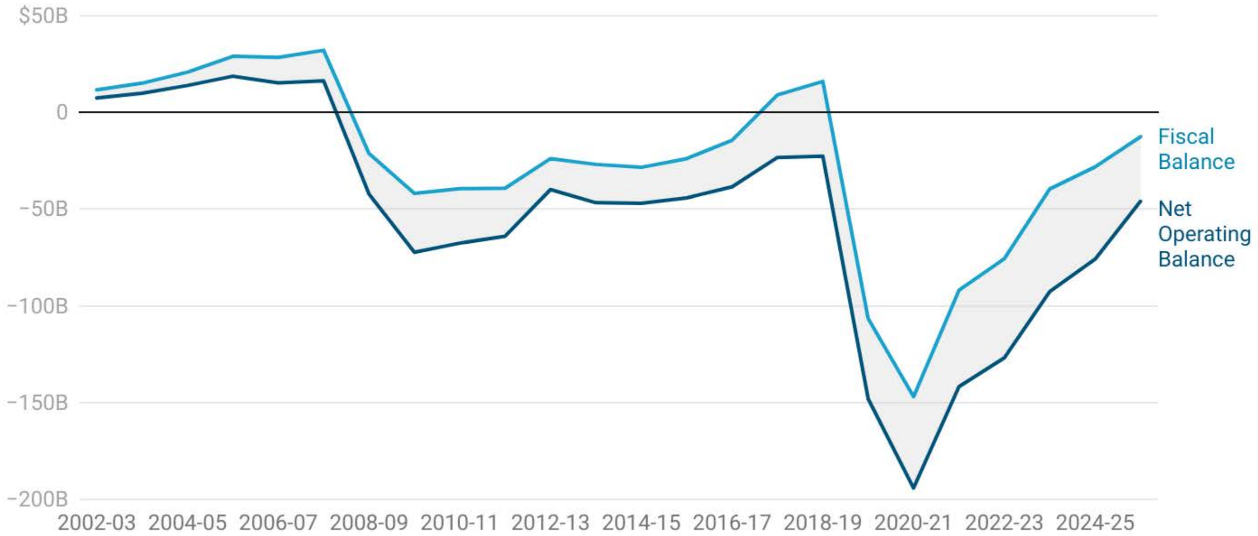
Recent debate regarding the inflationary stance of fiscal policy in Australia has further reinforced the lack of a consolidated, coordinated and transparent approach to Australian budgets.

A contemporary example is the recent proliferation of off-budget or below-the-line spending that does not contribute to the underlying fiscal balance. The gap between the fiscal balance, which most commentators focus on, and the net operating balance (which includes net capital investment), has grown since the early 2000s. This alternative financing has also been leading to increased net cash outflows over the last decade.[7]

FIGURE 1

Budget balance (all governments)

$ billion



Source: Commonwealth Budget Papers, October 2022 • Created with Datawrapper

The historical justification for such off-budget items is that they earn a commercial return. But this is not always the case, as seen with the National Broadband Network. At the Commonwealth level, the International Monetary Fund has noted that investment vehicles such as the National Reconstruction Fund, Rewiring the Nation and the Housing Australia Future Fund should be phased appropriately, and, more broadly, that we should prevent a proliferation of such vehicles.[8]

To address this, Parliament should ask the Parliamentary Budget Office to update its previous work on off-budget financing mechanisms, assessing their current application across Australian governments and best-practice guidance for future reporting and application.

Over the longer term, Australia also has an incomplete picture of the intergenerational pressures on government budgets. Only the Commonwealth and New South Wales governments prepare regular intergenerational reports, despite state and territory government spending accounting for more than 14 per cent of GDP, with half of this funded by transfers from the Commonwealth Government.[9]

While the Commonwealth Government's IGR will be revitalised in 2023, it will still not provide a consolidated fiscal picture across the Federation. The Council on Federal Financial Relations should publish a consolidated intergenerational fiscal assessment either before or as part of the next Commonwealth Government Intergenerational Report after the 2023 edition.

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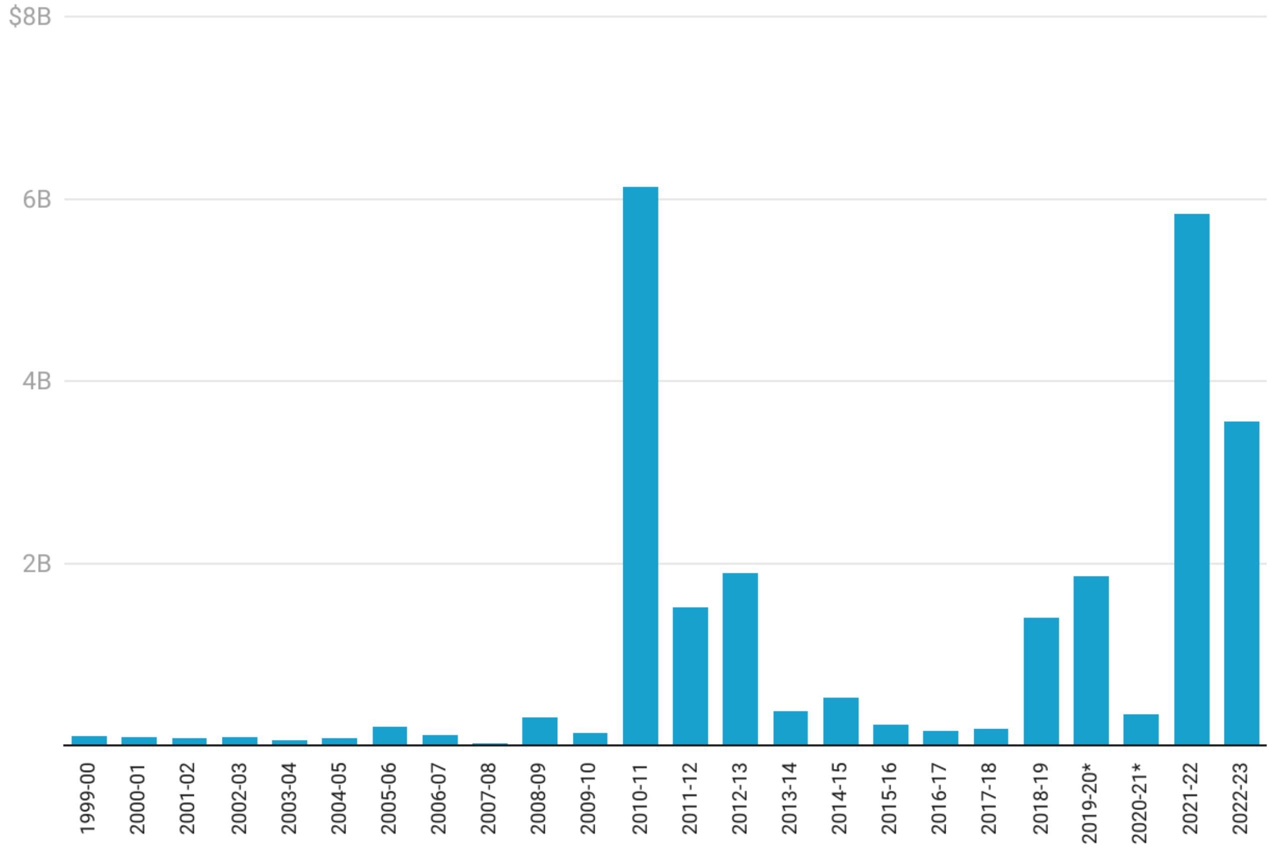
Get ahead of natural disaster spending

The Federal Government has accelerated the development of programs to encourage climate adaptation. This is important recognition of the growing economic and fiscal costs of climate change. In New South Wales alone, natural disasters will cost the economy $17.2 billion on average each year by 2060.[10] Natural disasters also have a prolonged impact on communities, reducing incomes for years after the disaster.

FIGURE 2

Natural disaster relief

$bn, Commonwealth Government



The total cost of relief and recovery from past events may not be completely realised for some years.

Source: PBO • Created with Datawrapper

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on average each year by 2060.

In line with the Productivity Commission's 2015 inquiry into national disaster funding, the Government's Disaster Ready Fund takes the first step in shifting more of the fiscal investment into disaster prevention, with $1 billion of funding over five years matched by states and territories. But with the Commonwealth Government spending almost $10 billion on natural disaster relief in the last two years alone, there must be more investment in prevention and reducing the relief bill.

As the Disaster Ready Fund matures and the market for disaster-prevention projects becomes more sophisticated, the Government should increase the fund's financial allocation and provide longer term certainty of ongoing funding to assist project proponents' investment decisions. Some estimates suggest that a $2 billion investment in the right prevention and resilience projects could save governments and households at least $19 billion to 2050.[11]

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Build momentum on tax reform

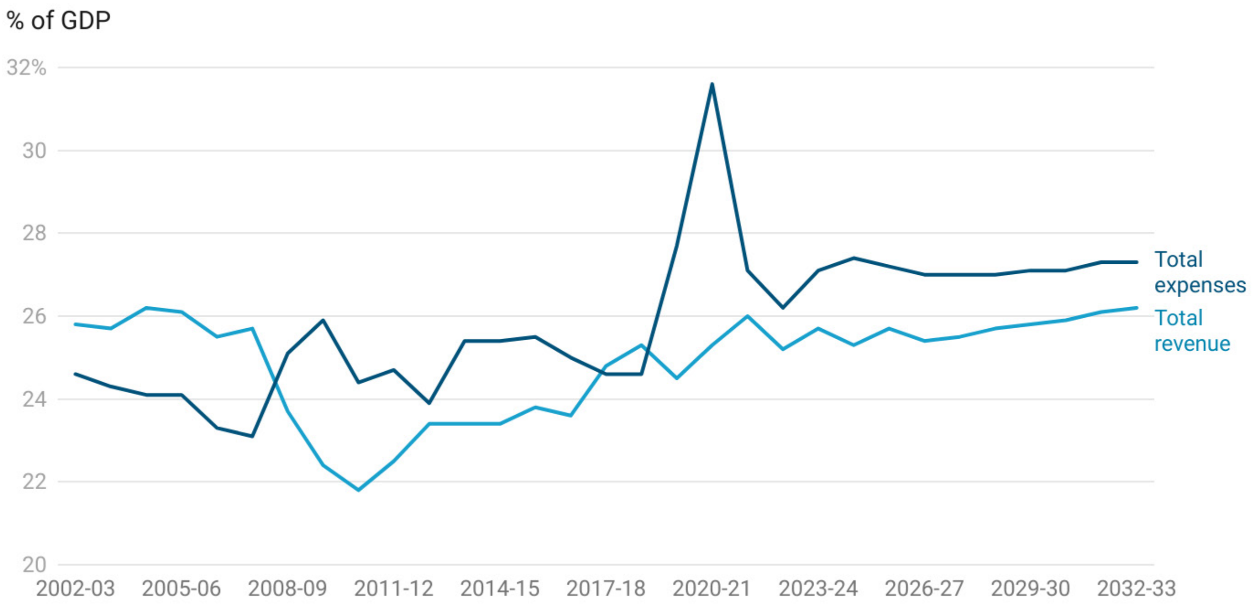
Over the last 15 years governments have tried and failed to implement broad tax reform. Instead, modest, incremental changes have become the default approach to Australia's tax system. Incremental reform is desirable and necessary for any tax system, but it is insufficient to address the growing fiscal and economic challenges Australia confronts.

The Federal Budget faces a stubborn annual fiscal gap of around $50 billion over the next decade. This will not shrink without higher than expected economic growth and/or policy change.

Incremental tax reform also runs the risk of introducing greater complexity and reducing the coherence of the system overall. For example, the Government's policy to increase the rate of taxation on earnings from superannuation accounts with balances over $3 million enhances equity and reinforces the role of superannuation for retirement savings, rather than as a tax-effective wealth accumulation vehicle.

FIGURE 3

Expenses vs revenue



Source: PBO, Beyond the Budget 2022-23. • Created with Datawrapper

However, the tax treatment of capital gains across housing, shares, savings and superannuation is not neutral, and drives capital flight to assets such as housing and superannuation in the first place. A dual income system where labour and income are taxed separately and there is more consistent concessional treatment of investment income is an example of a more comprehensive reform to address this issue.

The difficult trade-offs of incremental change are also illustrated by the proposed Stage 3 personal income tax cuts. On the one hand, these changes are not affordable amidst the stubborn fiscal gap. On the other, leaving the personal income tax system completely untouched is neither good tax policy nor a long-term panacea for our budgetary challenges. Left untouched, the system will become less progressive. The Government should undertake a thorough assessment of the affordability of the planned cuts, and the best options for both addressing bracket creep and maintaining progressivity.

In the short-term, the Government should continue to pursue pragmatic changes to the tax system that broaden the base. For example, CEDA has previously supported proposals to standardise and reduce work-related expense deductions. The current ad-hoc and incomplete list of allowable deductions creates distortions that do not meet the equity objective of the deduction.[12] They also drive greater need for individuals to use tax agents to manage their tax affairs.

In the longer term, further reforms are likely to be unsuccessful if they simply start from the point of guiding principles and most desirable future tax bases. The policy discussion must start by asking what Australia is seeking to achieve through tax reform in the context of the economic, fiscal, social and environmental challenges we will confront over coming decades. The 2023 Intergenerational Report will provide the best foundation for this discussion, testing the level of consensus and appetite for change.

Conclusion

Much of the focus of this Budget will be on the rapid short-term improvement to the bottom line from better-than-expected commodity prices. But the steps it takes to introduce the institutions, tools and policies needed to close the deficit in the next decade will be even more important to sustainably funding future services and support for the community. The Federal Government must lay the foundations for better budget policy now.

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