BUDGET RESET PAPER

2022

Budget Reset Paper (2022)

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ABOUT THIS PUBLICATION

Budget Reset Paper: This paper outlines the case for and key elements of a comprehensive budget reset after the Federal election and ahead of the 2023-24 Federal Budget. It will complement the bipartisan agreement to review the Reserve Bank of Australia, reassessing the full suite of macroeconomic tools to ensure they are in the best shape to support the economy and respond to future shocks. Governments must now focus all of their policy levers on lifting Australia's capacity to grow into the future and deliver the services that will underpin Australians' health and wellbeing.

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About CEDA

CEDA – the Committee for Economic Development of Australia – is an independent, membership-based think tank.

CEDA's purpose is to improve the lives of Australians by enabling a dynamic economy and vibrant society.

Through independent research and frank debate, we influence policy and collaborate to disrupt for good, and are currently focused on tackling five critical questions:

- How can Australia develop and grow a more dynamic economy?
- How can we build vibrant Australian communities?
- How can Australia develop leading workforces and workplaces?
- How can Australia leverage the benefits of technology?
- How can Australia achieve climate resilience and regain our energy advantage?

CEDA was founded in 1960 by leading economist Sir Douglas Copland. His legacy of applying economic analysis to practical problems to aid the development of Australia continues to drive our work today.

CEDA has more than 620 members representing a broad cross-section of Australian businesses, community organisations, government departments and academic institutions. Through their annual membership, CEDA members support our research both financially and by contributing their expertise, insight and experience.

CEDA's independence and nationally dispersed, diverse membership makes us unique in the Australian policy landscape, and enables us to bring together and harness the insights and ideas of a broad representation of our society and economy.

A full list of CEDA members is available at ceda.com.au.

TIME TO RESET AUSTRALIA'S BUDGET FOUNDATIONS

Jarrod Ball
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.

The needs of the economy and community are changing, demanding a new approach to budget policy in the period ahead. By undertaking a major review of budget strategy immediately following the next Federal election, the Federal Government will ensure that the budget is better positioned to support growth, meet community expectations, and respond to future economic shocks.

The economic environment is changing

COVID-19 and the government's response has fundamentally changed the economic environment. After $500 billion of stimulus, demand in the economy has taken off and full employment is in reach.

In the next 12 months the Federal Government will be unwinding unprecedented stimulus gradually to get as many people as possible into jobs to reach full employment, while confronting growing inflationary pressures and a pandemic that is not done just yet. Getting this right is critical – every 0.1 per cent drop in unemployment will see another 14,000 odd people in jobs.[i] At the same time, unwinding the spending too slowly could add further to inflationary pressures, leading to higher interest rates than otherwise would have been the case.

i Assuming constant participation rate as at January 2022.

Beyond the immediate impetus to reach full employment, the challenges are now on the supply side of the economy. Stronger demand is showing up persistent long-term weaknesses in human capital, lacklustre productivity and slow adoption of new technologies. Addressing these issues will become increasingly important to future living standards, with economic growth expected to dip lower next year and as the headwinds of an ageing population gather pace. The economy and budget will also be increasingly exposed to the impacts of climate change, greater geopolitical instability and the transition to net zero.

Budget policy must change too

In this environment, the quality of the budget and the efficiency with which taxpayers' dollars are invested in building productive capacity in the economy and delivering effective human services will be more important than ever.

"Stronger demand is showing up persistent long-term weaknesses in human capital, lacklustre productivity and slow adoption of new technologies."

Current low interest rates have also changed the goalposts for budget sustainability. The Parliamentary Budget Office's view after the 2021-22 budget is that the fiscal position remains sustainable even if the government continues to run modest deficits and interest rates rise from record lows.[1] Against the backdrop of increasing headwinds and competing demands for increased government spending, a stronger focus on frequent evaluation of programs and prioritisation based on long-term economic and social benefit would boost fiscal sustainability and resilience.

Past approaches are no longer fit for purpose

The arbitrary targets and narrow focus on budget surplus that have underpinned Australia's recent budget approach do not guarantee budget sustainability and will carry significant economic costs in a supply-constrained economy.[2] Budget targets, while necessary to anchor the fiscal strategy, are often blunt tools that constrain choices, leading to an over-reliance by policymakers on temporary indexation, efficiency dividends, levies and other short-term savings that don't improve value for money or budget sustainability over the long-term. Many Australians bore the brunt of a temporary deficit levy only to find that the measure never met its intended objective to repair the budget.

> *"Budget caps and other attempts at expenditure restraint have also failed to address the underlying funding and demand challenges across programs growing at a quicker pace than the economy – health, aged care and the NDIS."*

Budget caps and other attempts at expenditure restraint have also not been sufficient to address the underlying funding and demand challenges across programs growing at a quicker pace than the economy – health, aged care and the NDIS. These programs require a far more sophisticated approach to policy design, review and evaluation, and a willingness to present and discuss the trade-offs with the community transparently.

In 2019, CEDA noted in *Sustainable Budgets: underwriting Australia's social contract* that extremely low expenditure growth in several areas of the budget was likely to prove unsustainable in the longer term. Any attempts to artificially constrain these expenditures in the short-term ultimately leads to a deferral of costs and unintended consequences. The community then bears the burden of arbitrary caps and artificial constraints through inadequate services in the longer term. This has been seen all too painfully in areas such as the aged care system, hospital funding and higher education, as evident in Box 1.

BOX 1

Examples of unsustainable expenditure caps and restraints

AGED CARE	• In the five years leading up to the Royal Commission, aged care expenditure for each person over the age of 65 was increasing by around one per cent a year in real terms.[3] • The aged care system was subject to 18 major reports and inquiries from 1997 until the Aged Care Royal Commission just over 20 years later.[4] Many of these reports highlighted inadequate care driven by funding and resource constraints and the need for a significant lift in spending per resident. • This rate of spending growth has tripled since the Royal Commission.
HOSPITAL FUNDING	• The National Health Reform Agreement 2020-2025 between the Commonwealth and the States includes a 6.5 per cent annual growth cap in Commonwealth contributions to public hospital services. • Backlogs of elective surgery and delayed medical care due to COVID-19 is now placing considerable pressure on state government run hospitals. • Such unusual circumstances render the growth cap unworkable if State Governments are to sustainably meet demand.[5]
HIGHER EDUCATION & VOCATIONAL EDUCATION	• Between 2010 and 2020, combined Commonwealth Government expenditure on higher education and vocational and other education grew at an annual average of just 1.6 per cent in nominal terms.[6] • Projections point to Australians needing to spend a third more time on education and training in the next two decades to keep up with technological change in modern workplaces.[7] • This trend was reversed in 2020-21 with major investments in research and vocational education capacity.

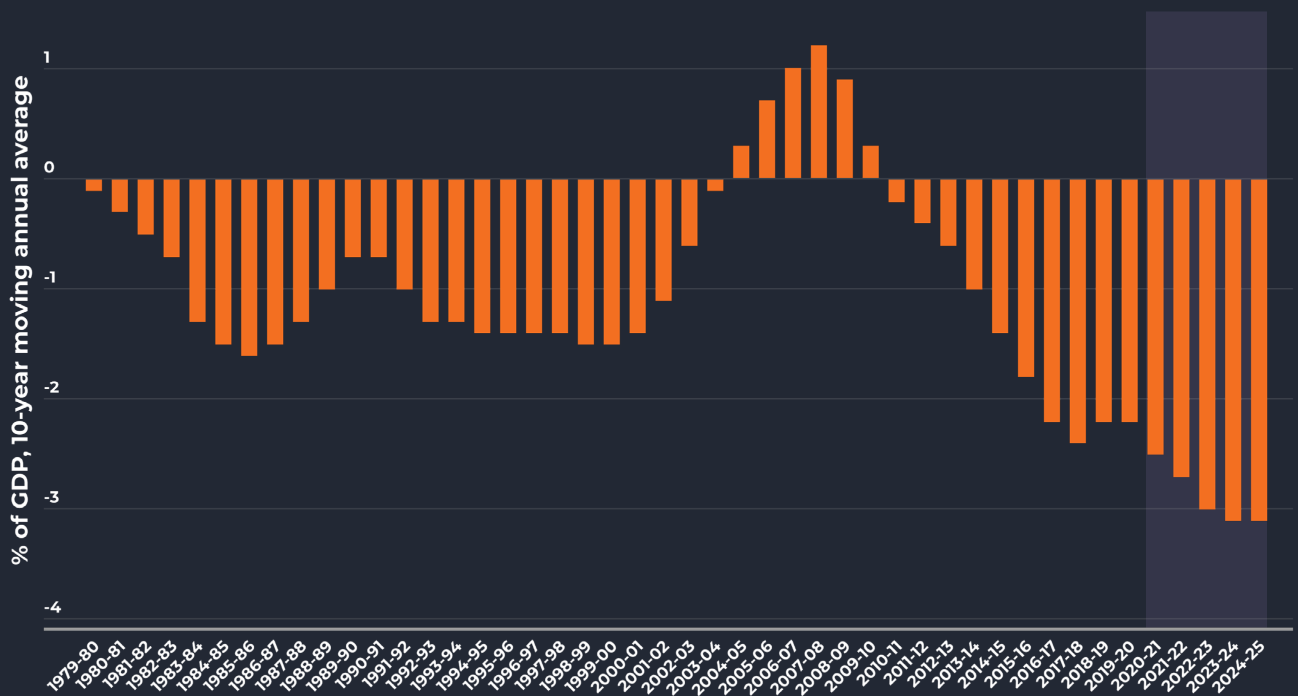
Several targets in the current fiscal strategy have been there in one form or another since the early 2000s, despite being unmet, unsound, or inappropriate in the economic environment.

Targeting a budget balance on average over the economic cycle

Australia has now recorded 14 consecutive deficits and over the last 40 years, there are only six years in which Australia could claim to have been running a balanced budget on average over the preceding decade. This rule also has no mechanism to prevent net debt from blowing out and debt sustainability will be an increasing focus for policymakers in the period ahead.[8]

FIGURE 1

Underlying cash balance



Source: Parliamentary Budget Office

Includes estimates for 2021-22 to 2024-25

"After the election, whoever forms government must move quickly to review and reset the foundations of fiscal policy in Australia, ready for the 2023-24 Budget."

A hard tax to GDP ratio of 23.9 per cent of GDP

Being bound to hard tax caps sees cyclical improvements in the budget used for permanent tax cuts that may not be prudent over the longer term.[9] Such a rule also takes no account of the quality of the tax base (i.e. the relative reliance on the most damaging taxes), which will be increasingly important with an ageing population narrowing the personal income tax base. This rule also constrains expenditure at a time when ageing will be placing upward pressure on expenditure. Political leaders need to be transparent about the options for funding growing demands on services, the implications for the size of government and the trade-offs involved.

How to reset the budget's foundations

Budget policymaking has necessarily been rapid and reactive with a short-term focus during COVID-19. But meeting the budget's legislated aim of maintaining ongoing economic prosperity and welfare must now turn to proactively preparing the budget to be responsive to long-term challenges. To do this, the government must begin to strengthen the budget's foundations sooner rather than later.

Next month's pre-election budget does not provide the time or political space to hit the reset button. But it will be critical that it does not lock in permanent tax and spending changes that constrain future choices.

After the election, whoever forms government must move quickly to review and reset the foundations of fiscal policy in Australia, ready for the 2023-24 Budget. This review requires four actions to reset the frameworks and improve the quality of information upon which budgets are set. It will enable a more concentrated focus on delivering quality budget measures directed to lifting the capacity of the economy to grow while maintaining long-term budget sustainability.

1. **Parliament should request the Parliamentary Budget Office (PBO) to undertake a whole of federation Intergenerational Report**

   Over time the quality of Intergenerational reports has diminished. There is an opportunity to improve and broaden them to deliver a more robust assessment of the intergenerational equity and budget sustainability. The IGR should be prepared in consultation with the states and territories to provide a more complete assessment of Australia's finances. The independent review of the PBO led by Dr Ian Watt AC also noted that the PBO should build its capacity to analyse the underlying long-term drivers of the budget and that it would have been well-positioned to take responsibility for the 2020 Intergenerational Report.[10]

   State government expenditure amounts to over 14 per cent of GDP[ii], with almost half of this expenditure funded

ii Based on pre-covid expenditure in 2018-19.

14%

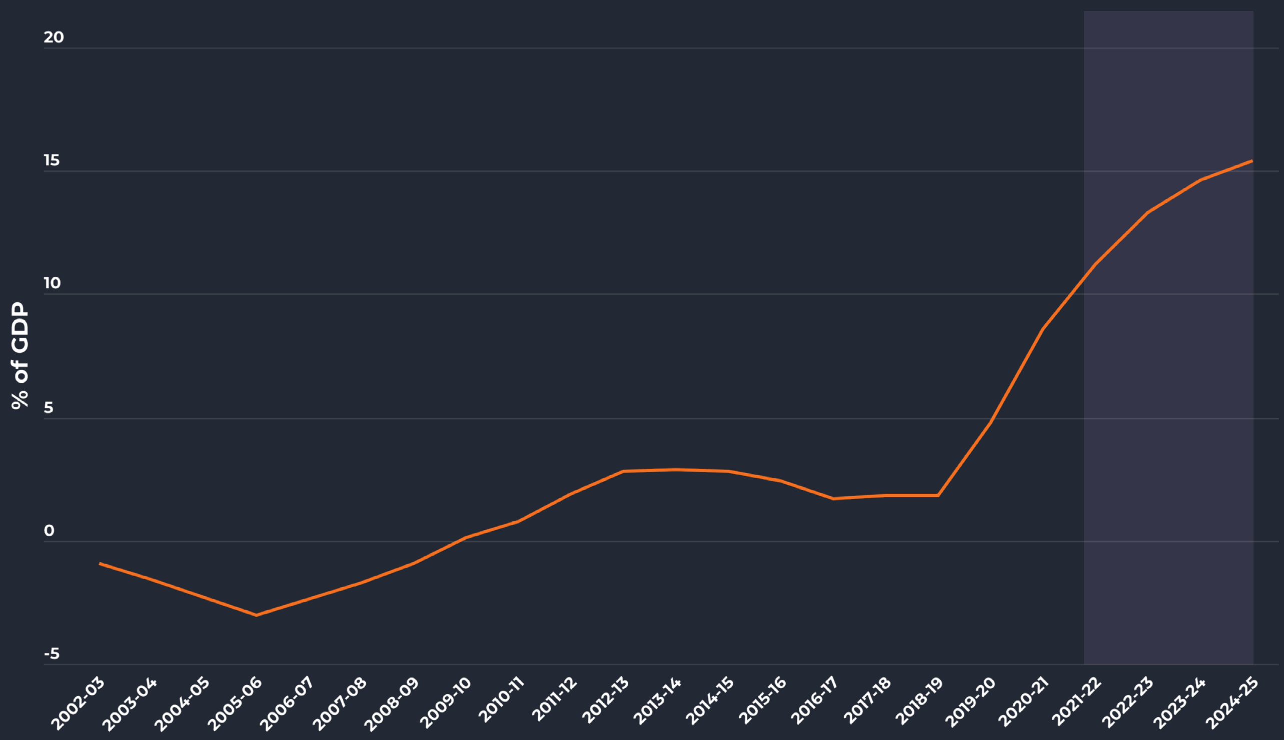
of Federal GDP is state government expenditure

by transfers from the Commonwealth Government. State governments have also increased their debt levels considerably during the crisis. The long-term picture of budget sustainability will be incomplete without assessing the substantial expenditure and revenue pressures faced by the states, who are responsible for delivering many of the fastest-growing services such as health and school education. These services are not just about expenditure but rather investments, as they are some of the fastest-growing areas of employment and significant sources of potential productivity improvement.

Following the tabling of a comprehensive independent, long-term intergenerational assessment of the fiscal position, the Council on Federal Financial Relations could respond to the report.

FIGURE 2

State government net debt



Source: Parliamentary Budget Office

Includes estimates for 2021-22 to 2024-25

2. **Review and refresh the Charter of Budget Honesty Act**

The Act is now almost 25 years old and in need of modernisation to lift the quality, public transparency and scrutiny of federal finances. It is central to budget policy as it codifies principles of good fiscal management and the critical considerations for putting these into practice in the annual budgeting process.

There is a range of issues that the review should consider in determining how the Act could be made more contemporary and contribute to better budget decision-making, transparency and scrutiny in future:

"The Act is now almost 25 years old and in need of modernisation to lift the quality, public transparency and scrutiny of federal finances."

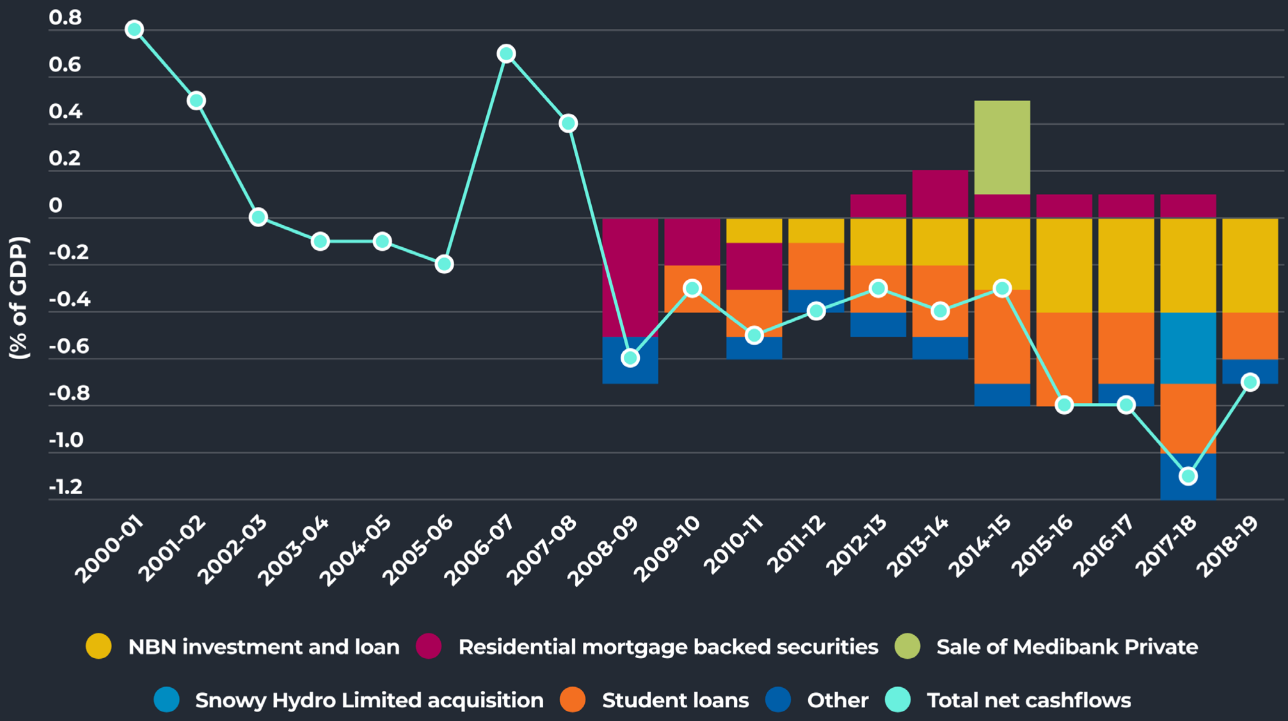
- The evolving role and capability of the Parliamentary Budget Office, which should be more comprehensively enshrined in the Act to strengthen its mandate for improving transparency and understanding of budget matters;
- The significant increase in superannuation savings, given the focus in the Act on achieving national savings as a principle of sound fiscal policy;
- The increased need for fiscal policies and the budget to apply a gender lens to address women's economic security, as evident in the Women's Budget Statement and landmark NSW review of women's economic opportunities;
- The need for a Parliamentary Committee or other body to assess ongoing compliance with the Act as necessary;

- The processes for grants funding, including assessing the need for greater transparency and binding principles to guide grants;
- Technological advances in the tax and transfer system such as single touch payroll and Services Australia, which alter the speed and accuracy with which the government can target stimulus and support in response to economic shock events;

- Growth of off-budget spending, including alternative financing where the government provides financial resources to another entity, like a corporation or individual, in return for a financial asset[11];
  - » The share of transport infrastructure financed under these methods is estimated to have quadrupled over the last 15 years.[12] This alternative financing has also been leading to increased net cash outflows over the last decade, as evident in Figure 3;
- The growing financial risks of climate change, which are becoming increasingly evident across several aspects of the budget, including the increasing quantum and frequency of natural disaster relief provided by the Commonwealth in the last decade (Figure 4). The NSW Government is projecting up to $17.2 billion of economic costs from natural disasters on average each year by 2060 in their state alone[13]; and
- The need for standardised use of budget accounting rules by the Commonwealth and the states for capital investment, given the growth of infrastructure investment in recent years;

FIGURE 3

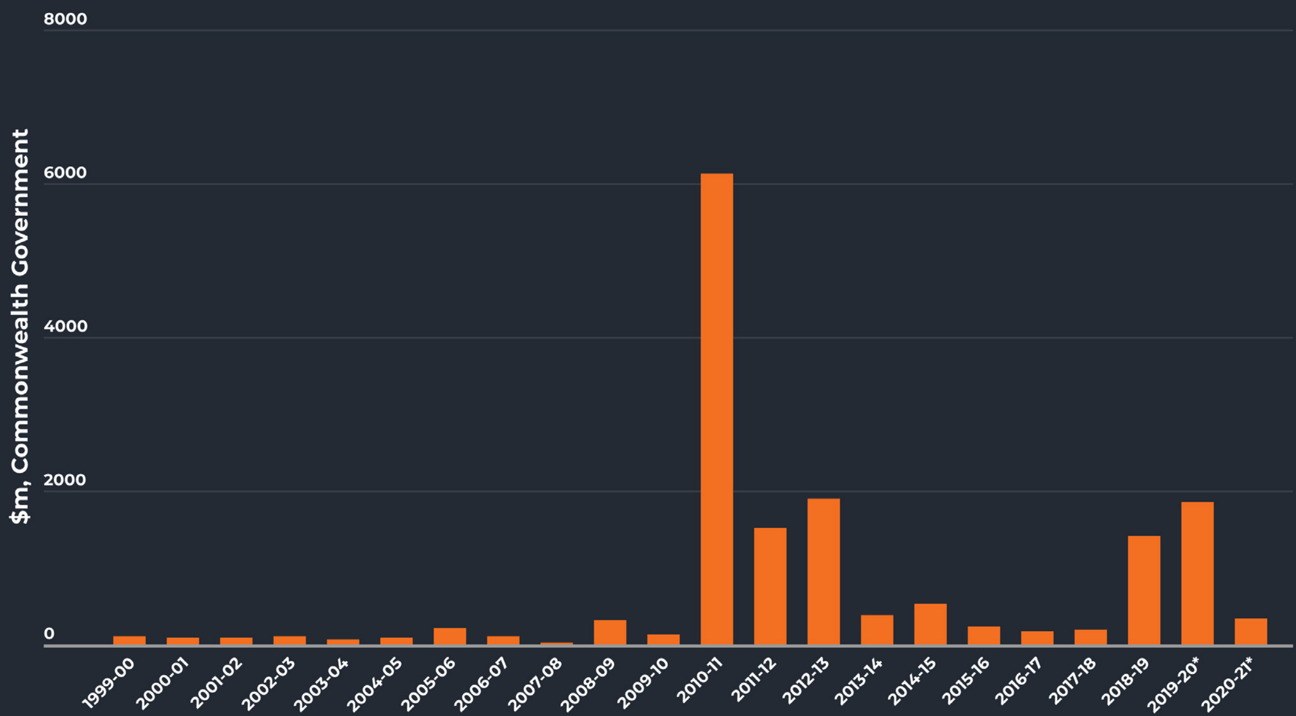
Net cash flows from investments in financial assets for policy purposes



Source: Alternative financing of government policies: Understanding the fiscal costs and risks of loans, equity injections and guarantees, Parliamentary Budget Office Report no. 01/2020, March 2020, Commonwealth of Australia.

FIGURE 4

Natural disaster relief



Source: Parliamentary Budget Office
*Current as at 2021-22 MYEFO. MYEFO notes that the total cost of relief and recovery from past events may not be completely realised for some years. In recent media statements, the Federal Government has noted that since 2019-20 it has provided $17 billion in disaster relief reflecting further changes in these estimates since MYEFO. A large proportion of this funding relates to COVID-19 relief.

"A comprehensive budget reset will complement the bipartisan agreement to review the Reserve Bank of Australia, reassessing the full suite of macroeconomic tools to ensure they are in the best shape to support the economy and respond to future shocks."

3. **Review and update the medium-term fiscal strategy**

   The medium-term fiscal strategy should be reset. The priority in the next decade is to stabilise and reduce net debt while also facilitating the right investments to boost the productive capacity of the economy, including human capital, physical and social infrastructure and better service delivery.

   This means updating the relevant benchmarks for budget sustainability after canvassing a range of options (e.g. relevant measures of debt sustainability); outlining disciplines that will be employed to lift the quality of program outcomes; and ensuring suitable weight is given to the need for effective investment in the supply side of the economy.

   Past episodes of debt stabilisation and reduction suggest that there is more than one way to reduce the debt-to-GDP ratio and strengthen fiscal firepower for future economic shocks.[14] Establishing a debt stock or serviceability target rather than more prescriptive budget balance targets would give the government flexibility to determine the extent to which stronger economic growth and/or fiscal consolidation drive debt stabilisation and reduction this time.[15] The greater the extent to which this can be achieved through economic growth and productivity, the lower the cost to the community will be.

   The strategy should also be communicated clearly to ensure that business and the broader community understands the approach that will be taken to the budget.

4. **Establish a rolling schedule of program evaluations**

   This would establish a pipeline of ideas from the 2023-24 budget onwards 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 the largest spending programs growing faster than the economy. Regular evaluation was a standard requirement of budget programs during the 1990s and made a substantial contribution to Cabinet debate and development of policy options.[16] Such evaluations should not simply identify what is wrong with a program, but assess a range of options for greater efficiency and effectiveness in the future in meeting program objectives and outcomes. Options should include how data and technology can be utilised to lift program effectiveness and long-term fiscal sustainability.

A comprehensive budget reset will complement the bipartisan agreement to review the Reserve Bank of Australia, reassessing the full suite of macroeconomic tools to ensure they are in the best shape to support the economy and respond to future shocks. Governments must now focus all of their policy levers on lifting Australia's capacity to grow into the future and deliver the services that will underpin Australians' health and wellbeing.

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