



A roadmap for fiscal sustainability

STEPHEN ANTHONY



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Glossary of fiscal terminology and concepts

Automatic stabilisers – describe how government budget policies, particularly income taxes and welfare spending, help to dampen fluctuations in real GDP by reducing the severity of recessions and of overheating during booms. For example, the requirement to pay taxes diminishes during a downturn in activity, while access to certain transfer benefits related to unemployment and education increases. Both occur without any explicit policy action by governments.

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

Fiscal balance – an accrual measure of the overall budget position for a period that indicates whether a government has generated sufficient surplus to fund its operating requirements and capital expenditure (such as purchases of buildings and infrastructure). Conceptually, this measures the Australian Government's investment-savings (net lending) balance, or contribution to the current account on the balance of payments.

General government sector – those public sector agencies which mainly provide non market goods and services to the public, paid for indirectly by taxpayers.

Headline cash balance – the underlying cash balance (see page 8), plus net cash flows from investments in financial assets for policy purposes (for example, payments related to the construction of the National Broadband Network).

Net operating balance – an accrual measure of the sustainability of government operations indicating whether a government has enough revenue to cover its operating requirements.

Structural cash balance – a measure of the overall budget position based on adjusting certain line items which constitute the underlying cash balance for the impact of movements away from long run trend economic activity and long-run average commodity prices. The measure attempts to remove the influence of cyclical factors and automatic stabilisers from the budget balance while capturing discretionary policy influences.

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



Executive summary

The conduct of fiscal policy as part of overall macroeconomic management is essential to underpinning growth and stability in the Australian economy.

The sustainability of fiscal settings and the efficiency of individual budget measures help to support consumer and investor confidence, to ensure governments do their job cost-effectively and, ultimately, to assist rising living standards.

A central theme of this Monograph is that effective fiscal rules can guide budget behaviours around a sustainable benchmark, provided that benchmark is properly specified and clearly identified. The combination of transparency and high-quality information can assist political acceptance of the need for budget discipline, without removing necessary fiscal flexibility.

The experience of Australian economic reform over the last three decades supports this insight. Australia had seen its relative economic performance decline by the 1980s and arresting this trend required an effective mix of microeconomic and macroeconomic

reforms pursued by successive Australian Governments, at least up to 2000. On the fiscal policy front, this meant tackling the accumulation of historically-high levels of Commonwealth (and state and territory) net debt.

Policy reformers argued that improving the long-term credibility of policy settings would underpin strong and stable economic growth. The idea was that fiscal policy was felt most strongly through stabilising debt and national savings, via related confidence effects attached to the risk premia on interest rates and allocative efficiency improvements. In 1998, the Howard Government enacted the Charter of Budget Honesty reforms which required the explicit outlining of a “medium-term” fiscal strategy. The practicalities of this involved a fiscal strategy statement being included from the 1997-98 Budget onwards, nominating a target objective for the strategy.

This objective was defined loosely as maintaining budget balance, on average, over the course of the economic cycle. It was operationalised by successive governments as running a net lending underlying cash balance over the economic cycle. Certain economic outcomes were seen as flowing from the fiscal strategy, at least in theory. The strategy should:

- ensure the level of net debt remains stable in nominal terms over time so that, as the economy grows, net debt falls as a proportion of gross domestic product (GDP);
- improve Australia's public saving performance leading to a higher national saving position which improves longer-term growth prospects, everything else being equal;
- avoid the need to borrow in net terms from financial markets over the cycle, facilitating lower real interest rates (on average) by removing the Government's call on private and foreign saving and by maintaining the confidence of financial markets, thereby helping to minimise the risk premium component of interest rates;
- ensure Australia's current account deficit is a result of private savings and investment decisions, which are subject to market disciplines; and

- allow the automatic stabilisers of the budget to operate so enhancing the effectiveness of fiscal policy in supporting demand during a downturn, while providing an anchor for discretionary policy responses.

But there was one major flaw in the medium-term strategy. After a strong start in the late 1990s, that flaw was exposed by the "China Boom" from 2003-04.

Australian Governments were presented with windfall tax revenue receipts year-after-year based on income flows from higher mineral commodity exports. Macroeconomics estimates that commodity boom windfall revenues contributed around \$160 billion to the Commonwealth budget bottom-line up to 2011-12.

Yet all that the fiscal strategy required was for governments to run budget surpluses in good economic times. There was no acknowledgement of the windfall element of tax revenues under the strategy and no tally kept of the magnitude of these impacts on the budget. Successive Australian Governments were free to engage in fiscal largesse while still meeting their fiscal strategy objective.

Essentially, the fiscal strategy objective provided the wrong diagnostic tool as a benchmark for success over the business and

commodity cycle. As a result, governments spent up big in the boom and got caught on the down side of the cycle. Windfall tax receipts were frittered away. By 2006-07, the Commonwealth was running a *structural* budget deficit (based on adjustment of the official budget balance for movements in the real economy and the terms of trade). This structural budget deficit has widened subsequently. In the process, the Commonwealth has accumulated more than \$170 billion in budget deficits, with another deficit now in prospect for 2012-13.

Ten years on from the start of the China Boom, it is clear that Australia's fiscal strategy is in need of an overhaul. Even more concerning has been the degree to which the nation's fiscal sustainability has been compromised by a failure to maintain appropriate fiscal discipline in the "boom years".

Firstly, the nation's fiscal strategy needs to be re-oriented around a structural budget measure to take account of movements in the business and commodity cycle and to provide both policy makers and the public with a realistic assessment of the underlying position of the budget.

Secondly, reforms are needed to reverse the impact of unsustainable commitments made in boom years

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and to meet future fiscal challenges. Of course, Australian Governments must balance the goal of restoring the sustainability of budget settings with that of achieving short-term macroeconomic stability. The task of repairing the structural budget need not compromise the role of fiscal policy in mitigating the impact of the economic cycle on living standards.

This Monograph sets out why Australia needs a new roadmap for fiscal sustainability and outlines some key budget reforms to secure future fiscal sustainability.

Section 2 provides an assessment by Macroeconomics of the fiscal outlook ahead of the 2013-14 Budget, including structural budget numbers and projections of the medium to longer term budget position. The Commonwealth budget is estimated to be in underlying cash deficit of around 0.8 per cent of GDP (\$11.6 billion) in 2012-13, with similar moderate deficits over the outlook period finishing with a deficit of \$14.3 billion in 2016-17.

The structural cash deficit is more concerning in the near term (close to \$41 billion in 2012-13, or around 2.7 per cent of GDP) and, despite some improvement over the outlook period due to the Government's real spending cap, Macroeconomics finds no sustainable return to surplus over the next few years

without the imposition of one-off budget cuts of around 1 per cent of GDP or a sustained period of restrained spending growth at a rate below growth in the economy.

By the middle of the next decade, the budget is projected to still record a moderate structural deficit (around 0.7 per cent of GDP by 2024-25) even if the Australian Government manages to restrain spending for around a decade. Looking even further ahead to the middle of the century, the projection for the Commonwealth budget is for a structural cash deficit equal to around 5.6 per cent of GDP by 2056-57, due mostly to the susceptibility of a limited number of Australian Government spending programs to demographic change associated with population ageing and rising costs of health technology.

Section 3 examines Commonwealth fiscal sustainability based on a deeper analysis of historical spending trends. It shows that growth in public spending has outstripped economic growth in Australia over the past 50 years. As a result, Commonwealth spending as a share of GDP has risen from 17.5 per cent in the 1960s to 25.5 per cent in the 2000s, while the total tax burden has risen from 19.1 per cent of GDP to 24.9 per cent of GDP.

Since 1990-91, trend real spending growth has exceeded 4 per cent per annum, accelerating in the 2000s funded by windfall tax revenues. The Howard Government engaged in a major discretionary loosening of fiscal policy over its last five budgets. Even allowing for a one-off stimulus in the face of the Global Financial Crisis (GFC), the Rudd-Gillard Governments have also tended to outspend savings efforts, while continuing to raise expectations for future spending. As a result, the risk is that Australia's medium-term structural budget deficit could deteriorate further based on new spending priorities and longer term spending pressures.

Section 4 explains why long-term budget reform is needed in light of the large structural hole now in the budget and the burdens identified by three Intergenerational Reports (IGRs). Without such reform, Australia remains exposed to another global financial shock at the same time as poor quality spending undermines national productivity and living standards. A strategic review of the sustainability of Commonwealth spending is long overdue and this should occur alongside further improvements in budget transparency.

Section 5 outlines five pro-growth budget reforms which would go a long way to laying the basis for long-term fiscal sustainability.

They are:

1. Anchoring the medium-term fiscal strategy to a measure of the structural budget balance, while building in capacity for appropriate fiscal flexibility.
2. Eliminating up to \$15 billion in poorly-targeted outlays from the spending base.
3. Unifying welfare benefit payments under one broad payment, combining the current multiplicity of benefit abatement ranges into a single, more efficient and effective measure.
4. Conducting a considered public review of sustainable budget spending issues.
5. Introducing a new Budget Paper devoted solely to spending program performance assessment.

The thrust of these reforms is to identify effective performance benchmarks and to employ transparent, high-quality public reporting frameworks. These reforms are necessary to assist policy makers charged with maintaining long-term fiscal sustainability in the face of inherent pressures for more and more public spending. ■

SECTION

01

Budget trends and outlook

Budget trends and outlook

This section provides an assessment of the Commonwealth fiscal outlook for the general government sector ahead of the 2013-14 Budget to be tabled on 14 May 2013. It also provides structural budget estimates and projections of the medium to longer term budget position.

These estimates and projections are based on economic and fiscal data released prior to mid-March 2013 and assume no policy change since the Mid-Year Economic and Fiscal Outlook (MYEFO) update released in October 2012.

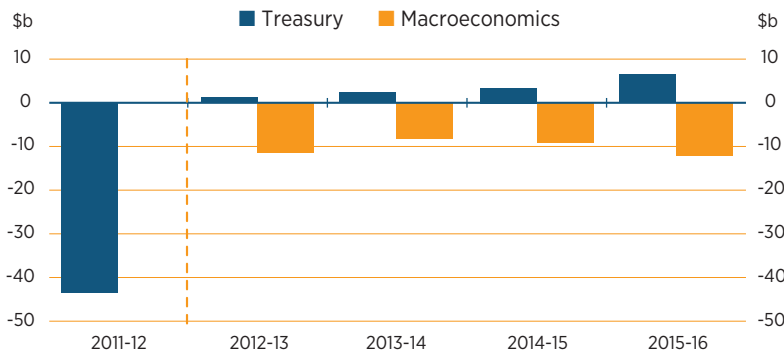
Budget outlook

Macroeconomics' budget tracking model has the Commonwealth

budget in underlying cash deficit by \$11.6 billion dollars (around 0.8 per cent of GDP) in 2012-13 (Chart 1). This is a \$13 billion deterioration compared with the 2012-13 MYEFO due in large part to a shortfall in expected business tax receipts of \$7 billion, including as a result of a more rapid than expected decline in the prices of Australian mineral commodities.

Chart 1

Budget forecasts comparison



Source: Macroeconomics estimates and Budget Papers

Table 1 **Key budget aggregates - General government**

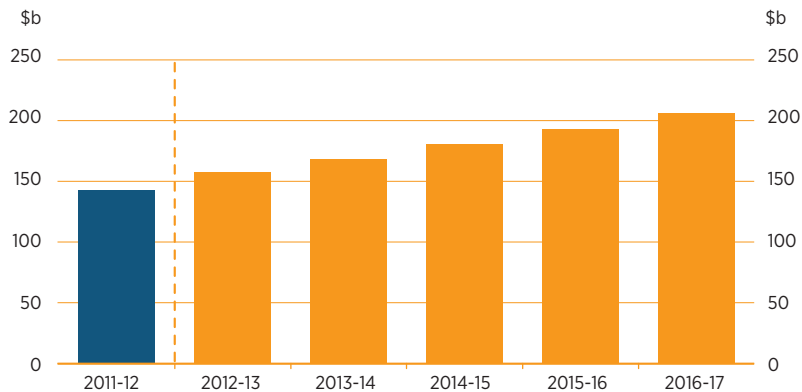
	Actual	Estimates			Projections	
	2011-12 \$b	2012-13 \$b	2013-14 \$b	2014-15 \$b	2015-16 \$b	2016-17 \$b
Underlying cash surplus	-43.7	-11.6	-8.3	-9.2	-12.2	-14.3
<i>Percentage of GDP</i>	-3.0	-0.8	-0.5	-0.6	-0.7	-0.8
Net debt	142.5	156.7	167.8	180.1	192.2	206.3
<i>Percentage of GDP</i>	9.7	10.2	10.6	10.9	11.1	11.4

Source: Budget Papers and Macroeconomics estimates. Subject to rounding.

While the MYEFO Budget Outlook projected small surpluses rising in size over the fiscal out-years, Macroeconomics expects the Australian Government to run moderate deficits of at least 0.5 per cent of GDP over the outlook period finishing with a deficit of \$14.3 billion dollars in 2016-17 (Table 1).

As a result, general government net debt is expected to rise to around \$157 billion (10.2 per cent of GDP) in 2012-13 and continue rising to around \$206 billion (11.4 per cent of GDP) by 2016-17 (Chart 2). In contrast, the MYEFO had net debt falling to around \$138 billion in 2015-16.

Chart 2 **Commonwealth net debt**



Source: Budget Papers and Macroeconomics estimates

Structural budget position

The Australian Government structural underlying cash budget position – that is, the budget position adjusted for the impact of the real business cycle and terms of trade – is more concerning in the near term. Macroeconomics’ structural budget balance model suggests a Commonwealth structural cash deficit of over \$41 billion in 2012-13 (around 2.7 per cent of GDP). The structural budget position is projected to improve over the forward estimates period with the deficit expected to be around \$21 billion (or 1.2 per cent of GDP) in 2016-17 (Chart 3).

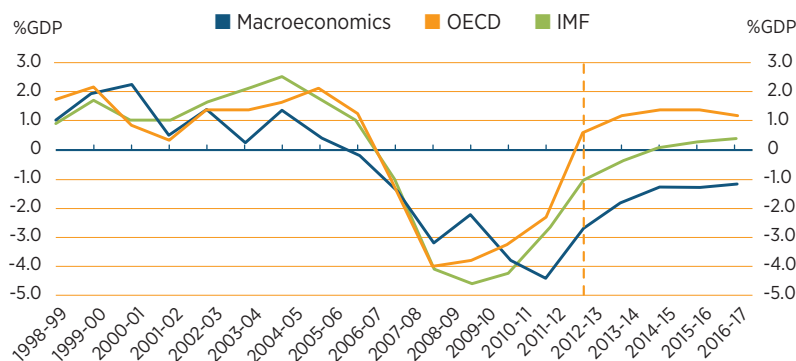
Relatively high commodity prices (at least compared with the long-run average prior to 2003) are still contributing windfall budget

revenues to the underlying cash position, estimated on average at around \$26 billion *in each year* of the outlook period. As such, they continue to underpin any hope the Gillard Government has of returning the budget to surplus, even if those surpluses are not sustainable.

Official international forecasts of the structural net lending position by the Organisation for Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF) more or less track Macroeconomics’ structural model estimates for the the past decade, although they show a more rapid improvement in the structural budget from 2012-13 onwards.

Given these measures are based on the total general government sector (not just central government), they are not directly comparable.

Chart 3 Structural budget balance (alternate measures)



Source: Macroeconomics estimates, OECD Economic Outlook No. 92 and IMF country statistics

Nor do they appear to adjust adequately for the commodity cycle. As a result, the Macroeconomics measure shows a more gradual path for the discretionary policy adjustment by the Australian Government, with measures of the OECD and the IMF appearing more variable over time.

The Macroeconomics structural balance measure continues to show a deficit of around \$21 billion (or 1.2 per cent of GDP) by 2016-17 (Table 2). This suggests there will be no sustainable return to surplus without the imposition of one-off budget cuts of around 1 per cent of GDP or a sustained period of

restrained spending growth at a rate below growth in the economy.

The structural budget position has improved in part due to the Treasurer's real spending cap of 2 per cent which, if realised, will help to curb the growth of discretionary spending. However, if this commitment is breached each percentage point of additional real discretionary spending growth would add around \$4 billion to the structural deficit in 2016-17 dollars. Any return to more "typical" levels of real spending growth would likely see structural deficits in excess of \$30 billion (around 2 per cent of GDP) for the rest of the decade.

Table 2 Commonwealth underlying cash and structural budget position

	Actual	Estimates			Projections	
	2011-12 \$b	2012-13 \$b	2013-14 \$b	2014-15 \$b	2015-16 \$b	2016-17 \$b
Underlying cash balance	-43.7	-11.6	-8.3	-9.2	-12.2	-14.3
<i>Impact of the economic cycle</i>	15.1	4.2	8.7	15.5	12.6	9.8
<i>Impact of the commodity cycle</i>	-36.0	-33.9	-29.1	-27.3	-22.6	-16.7
Structural balance	-64.7	-41.3	-28.8	-21.1	-22.2	-21.3
<i>Percentage of GDP</i>	-4.4	-2.7	-1.8	-1.3	-1.3	-1.2

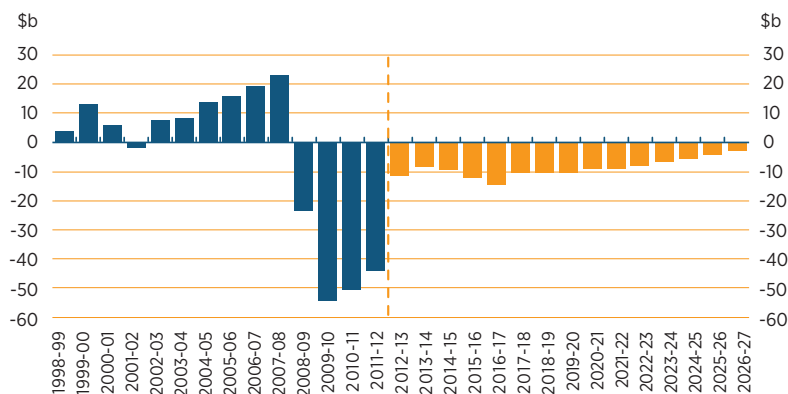
Source: Budget Papers and Macroeconomics estimates. Subject to rounding.

Medium-term outlook

Looking beyond the forward estimates period, the underlying cash budget will not return to surplus by the middle of the next decade without discretionary spending cuts, even if average annual real spending growth can be kept below 2 per cent to 2015-16 and below 2.5 per cent beyond 2016-17 (Chart 4). Some historical context for this assumption is provided in the next section. Such low spending growth has not been achieved by Australian Governments for any sustained period of time over the last 50 years. Hence, these projections may be considered optimistic.

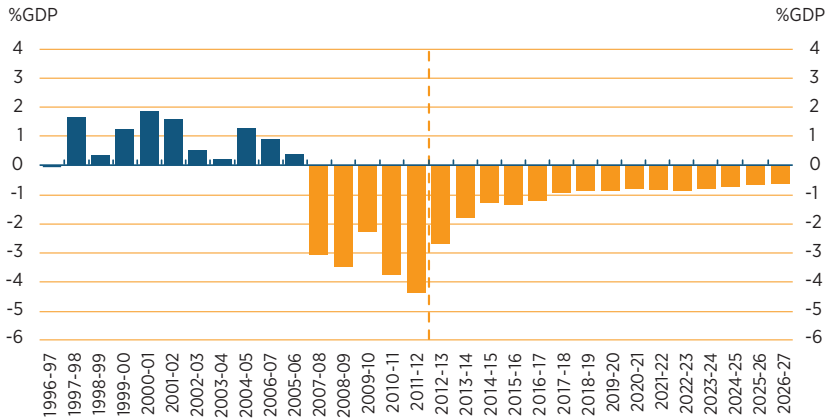
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...there will be no sustainable return to surplus without the imposition of one-off budget cuts of around 1 per cent of GDP.
 ”

Chart 4 Underlying cash budget projections to 2026-27



Source: Budget papers and Macroeconomics estimates and projections

Chart 5 Structural budget balance projections to 2026-27



Source: Macroeconomics estimates and projections

Moreover, even if Australian Governments manage to restrain spending for around a decade, there will still be a small structural deficit of just below 0.7 per cent of GDP by 2024-25 (Chart 5).

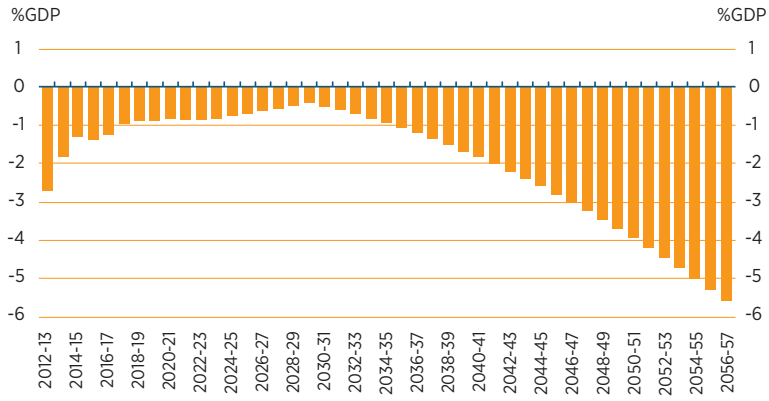
Longer term outlook

Looking even further ahead towards the middle of the century, Macroeconomics' revenue and expenditure projections suggest there is no possibility that existing policy settings will allow for average real spending growth rates below 3 per cent each year. This is due

mostly to the susceptibility of a limited number of large Australian Government spending programs to demographic change associated with population ageing and rising costs of health technology.

The Macroeconomics long-term projection of the Commonwealth Budget is for a structural cash deficit equal to around 5.6 per cent of GDP by 2056-57. In the 2010 Intergenerational Report, Treasury forecast a Commonwealth underlying cash deficit of around 3.8 per cent in 2049-50. ■

Chart 6 Structural cash balance projections to 2056-57



Source: Macroeconomics estimates and projections

SECTION

02

Real spending: A deeper analysis

SECTION 2

Real spending: A deeper analysis

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

When assessing overall fiscal sustainability and the sustainability of public spending over time, a useful benchmark is to compare the growth rate of public spending to that of the economy (using comparable real or nominal growth rates). Government spending is generally held to be sustainable provided it does not grow faster than the economy.

However, some important caveats to this general rule should be kept in mind.

- Just targeting the growth rate of spending ignores the quality of existing and new spending, as well as other issues such as the best way to manage key policy challenges such as the impacts of an ageing population.
- As living standards in society rise, it could be argued that the size of government should fall in output

terms over time. Most categories of government expenditure are driven by program-specific demand and/or indexation which policy makers can control. Most of these factors should grow more slowly than the economy over time, so the spending share of GDP should fall.

- In theory, a government spending/GDP ratio should emerge from a bottom-up, “evidence-based” approach to budget policy through Cabinet processes such as the Expenditure Review Committee.¹ Needless to say, there has been little sign of evidence-based policy in recent years. The absence of such policy making has highlighted the need for greater transparency and more useful information as part of a medium-term fiscal strategy.

Table 3 Assessing the sustainability of Australian general government spending

	1961-62 to 1970-71 %	1971-72 to 1980-81 %	1981-82 to 1990-91 %	1991-92 to 2000-01 %	2001-02 to 2010-11 %
Economic growth					
<i>Nominal</i>	9.6	14.3	10.6	5.5	7.1
<i>Real</i>	5.7	3.0	3.1	3.6	3.1
Spending growth					
<i>Nominal</i>	10.4	17.4	10.9	6.3	7.2
<i>Real</i>	7.6	6.7	3.0	4.0	4.4
Share of GDP					
<i>Total spending</i>	17.5	21.9	25.0	24.8	25.5
<i>Total revenue</i>	19.1	21.7	23.7	23.6	24.9

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

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For most of the past 50 years, both nominal and real public spending growth has outstripped growth in the economy.
 ”

When public spending grows at, or below, the rate of growth in the economy over time, the size of government should not rise, the tax burden should not increase and governments should not run deficits or accrue public debt (which is a form of deferred taxation).² Table 3 illustrates the reality. For most of the past 50 years, both nominal and real public spending growth has outstripped growth in the economy. Consequently, spending as a share of GDP has risen from 17.5 per cent in the 1960s to 25.5 per cent in the 2000s. At the same time, the total tax burden has risen from 19.1 per cent of GDP to 24.9 per cent of GDP.

Despite periods of restraint, the long-run track record of Federal Government expenditure control is not strong. For example, since 1991-92 trend real spending growth has remained above 4 per cent per year, exceeding growth in the real economy which has averaged around 3.3 per cent annually.³

Whether the increasing size of government has weakened growth prospects is a matter of debate. The Federal Treasury has argued that the optimal size of government is not a question that can be answered by technical economic analysis.⁴ Yet there is strong international evidence that an overly large and growing size of government is not conducive to growth or rising living standards.⁵ The

main reason is that the welfare loss from growth in the public sector rises exponentially with increases in the tax burden. Hence, it is reasonable to conclude that living standards in Australia will be impacted adversely if the size of government is not stabilised over time.

Historical drivers of spending growth

Since the 1960s, expenditures on social security, health and education have been key drivers of growth in the Commonwealth Government spending share of the economy. Between the 1960s and 2000s, the share of total budget spending on social security and welfare payments has risen from 23 per cent to 37 per cent (Table 4).

Table 4 Growth in the social security budget

	1961-62 to 1970-71 %	1971-72 to 1980-81 %	1981-82 to 1990-91 %	1991-92 to 2000-01 %	2001-02 to 2010-11 %
Social security and welfare (total)	23.4	29.9	31.7	37.7	37.3
Average real growth	4.0	12.0	4.2	5.9	3.3
Income support in total	22.7	28.6	29.5	33.9	32.3
Average real growth	3.8	11.9	3.6	5.6	2.9
Welfare services for the aged	0.2	0.4	0.5	1.4	2.8
Average real growth	9.8	15.0	15.2	23.6	8.1

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

A more detailed picture of the growth of social security payments category areas over the last decade is provided in Table 5.

Another major source of expenditure growth has been health spending which has risen from 7.6 per cent to 15.9 per cent of total spending since the early 1960s, and grown by 5.4 per cent in real

terms over the last decade alone (Table 6). Key drivers of recent growth in the health budget are community health service programs (including Medicare and the Private Health Insurance rebate), public health service programs (population health, hearing services, blood products, e-Health etc.), the Pharmaceuticals Benefits Scheme and medical research funding.

Table 5 Social security expenditure by category

	Real growth 2001-02 to 2010-11 %	Total budget share 2010-11 %
Assistance to the aged	3.2	12.5
Assistance to veterans and dependants	-0.1	2.0
Assistance to people with disabilities	8.2	5.8
Assistance to families with children	3.8	8.8
Assistance to unemployed and sick	-0.1	2.0
Common youth allowance	-0.9	0.0
Other welfare programs	54.7	0.6
Aboriginal advancement n.e.c. (not elsewhere classified)	-1.9	0.3
General administration	2.9	0.9
Total social security	3.3	32.9

Source: Australian Government Final Budget Outcomes

Table 6 Growth in the health budget

	1961-62 to 1970-71 %	1971-72 to 1980-81 %	1981-82 to 1990-91 %	1991-92 to 2000-01 %	2001-02 to 2010-11 %
Health spending share (% of budget)	7.6	10.8	12.6	15.0	15.9
Average real growth	8.4	18.2	6.1	4.8	5.4
Other community health services	1.3	2.7	3.9	5.3	6.1
Average real growth	12.9	17.8	12.7	5.4	5.9
Admitted patient services in acute care institutions	2.7	4.5	5.1	4.8	4.3
Average real growth	4.8	46.3	2.3	2.3	3.4
Pharmaceuticals, medical aids and appliances	2.7	1.9	1.3	2.2	3.0
Average real growth	6.7	-2.4	5.7	11.9	4.8
Public health services	0.2	0.4	0.2	0.4	1.4
Average real growth	4.7	40.5	-14.4	43.0	12.9
Health research (total)	0.0	0.1	0.1	0.3	0.7
Average real growth	8.4	19.9	13.8	19.4	14.3

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

Other key drivers of the rising Commonwealth general government spending share over recent years are summarised in Table 7. While total spending on education has declined slightly in recent decades, spending on primary and secondary education is growing by around 7.6 per cent in real terms. Even higher growth rates have been seen in the “Other

economic affairs” programs of the budget which relate primarily to labour market assistance and asylum seekers. Fuel and energy programs have also had strong growth in the last decade due to the mining boom.⁶ This trend will likely reverse over the next decade as growth in the mining sector diminishes from historically high levels.

Table 7 Other growth areas in the budget

	1961-62 to 1970-71 %	1971-72 to 1980-81 %	1981-82 to 1990-91 %	1991-92 to 2000-01 %	2001-02 to 2010-11 %
Education (total)	3.0	8.6	8.2	7.7	7.5
Average real growth	19.7	78.4	1.5	2.3	10.1
Primary and secondary education n.e.c	0.5	2.6	2.8	2.8	3.4
Average real growth	62.2	9.9	2.1	5.4	7.6
Other economic affairs (total)	1.1	1.7	2.3	2.6	2.2
Average real growth	9.2	12.7	5.7	3.1	9.3
Fuel and energy (total)	0.3	0.3	0.7	0.9	1.9
Average real growth	2.3	14.6	12.4	16.0	7.3

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

Projected spending growth over the longer term

The Macroeconomics long-term projection of the Commonwealth budget is for a structural cash deficit equal to around 5.6 per cent of GDP by 2056-57. This projection relies on line-item modelling of most revenue and expenditure items.

This longer term modelling is predicated on three key assumptions over the projection period:

- real GDP growth averaging 2.5 per cent;

- a productivity growth rate of 1.6 per cent; and
- an inflation rate of 2.5 per cent.⁷

On the expenditure side, the assumed real annual growth rate in most spending categories is around 2.1 per cent. However, certain high-growth categories are projected to grow by rates in excess of 2.1 per cent based on current and future growth pressures. Key results are presented in Table 8.

Overall, average real spending is projected to increase by around 3.0 per cent per annum over the period. Health expenditure is the dominant driver of spending growth based on real average growth of around 4.9 per cent per annum over the projection period. This is driven by growth in excess of 5 per cent in each of the key sub-functions:

namely, *Medical services and benefits, Hospital services, National health and hospitals network, Pharmaceutical services and benefits and Health services.*

Remaining areas of high-growth risk in the modelling include *Assistance to the aged, Government superannuation benefits and Public debt interest.*

Table 8 Longer term spending growth projections

Functional spending categories	Long-term trend Nominal %	Long-term trend Real %
General public services		
Government superannuation benefits	7.6	5.1
Health		
Medical services and benefits	7.9	5.4
Hospital services	8.0	5.4
National health and hospitals network	8.0	5.4
Pharmaceutical services and benefits	8.0	5.5
Aboriginal and Torres Strait Islander health	7.2	4.7
Health services	7.9	5.4
General administration	4.7	2.1
Health assistance to the aged	7.7	5.2
Total health	7.4	4.9
Social security		
Assistance to the aged	7.7	5.2
Assistance to people with disabilities	5.9	3.4
Assistance to families with children	5.5	3.0
Total social security	6.4	2.9
Public debt interest		
Interest on the Australian Government's behalf	7.0	4.5

Source: Macroeconomics estimates. Subject to rounding.

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...governments must actively manage those spending programs with real growth rates in excess of 3 per cent annually, while balancing new spending commitments by eliminating underperforming programs.

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Underpinning these intergenerational projections by Macroeconomics is the “optimistic” assumption that future governments can keep spending growth below 2.1 per cent across most portfolios in an era of subdued economic growth, while also keeping expenditure growth in high-growth portfolios (such as health) at manageable levels. If this discipline can be maintained, then the modelling outcome of a structural cash deficit equivalent to 5.6 per cent of GDP by 2056-57 is a worst case scenario.

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

The Australian Government’s recent track record on expenditure control

How successful has the Federal Government been in controlling discretionary spending in recent times? Analysis by Macroeconomics, based on the expenditure reconciliation tables in Budget Paper No.1, suggests

that in five budget rounds since coming to office the Rudd-Gillard Governments have generated new net discretionary spending (including fixed assets purchases) totalling \$153 billion. This includes temporary GFC Mark I stimulus spending worth around \$70 billion.

Hence, we find a net increase in policy spending of around \$83 billion over five years.⁸ Higher spending was funded partly by higher discretionary revenues (taxation and charges) of around \$72 billion over five years, with the remainder “funded” by higher public net debt. Thus the Rudd-Gillard Governments have failed to impose strict control over discretionary policy. Rather, they have relied on future growth to fund additional spending.

A comparable analysis of the last five budget rounds of the Howard Government reveals an even poorer performance, with net discretionary spending of around \$133 billion over five years. Note that this period also witnessed net discretionary tax cuts of around \$117 billion. Of course, this major discretionary loosening in fiscal policy was funded mostly by windfall business tax revenue increases driven by the China Boom.

Ironically, policy spending has been largely pro-cyclical since the mid-2000s, often providing stimulus to support an already strong economy, while the more

recent withdrawal of stimulus has coincided with softening activity. One lesson from this period is that an activist fiscal policy must be applied symmetrically through the business cycle. In other words, years of high spending and deficits must be offset by years of lower spending and surpluses. The alternative (less activist) approach would be for governments to maintain a tight rein on policy spending and allow the automatic stabilisers of the budget to help stabilise the business cycle.

Treasurer Swan often refers to the extensive budget “savings” achieved by the Labor Government. In reality, these include *revenue measures* while further confusion is sown by reference only to *gross savings* (which are more than offset by other spending decisions). The Treasurer can claim to have enacted some crucial longer term structural budget reforms, including:

- increasing the pension age to 67 by 2023;
- piecemeal tightening of the family payments system;
- means testing of the private health insurance rebate;
- reforms to personal tax offsets (such as the net medical expenses offset and dependent spouse tax offset); and
- means testing for aged care recipients.

However, the central problem

with the Rudd-Gillard era has been the tendency to outspend savings efforts, while continuing to raise expectations about future government spending. The list of aspirational commitments is long and getting longer. It now includes the National Disability Insurance Scheme (NDIS), Gonski education reforms, top-up in wages for low-paid social workers, and a 12 ship submarine build program for South Australia.

The Treasurer has also erred with some crucial reforms, including linking the raising of the Superannuation Guarantee to 12 per cent to the Minerals Resource Rent Tax (MRRT). In this case, the value of the concession will rise over time with the value of superannuation assets, while the supposed funding source for the concession relies on the value of two key commodity prices remaining well above their long-run average levels. Previous modelling by Macroeconomics suggests the gap between these two sources could reach around \$6 billion by 2019-20.

A key plank of the Gillard Government's fiscal strategy is the robustness of the Treasurer's real spending cap announced in February 2009. The idea was to assist the structural repair of the budget by keeping spending growth low, while allowing tax receipts to recover gradually from the GFC. The crux

of this approach was to spread the adjustment burden over many years, rather than undertake a discretionary fiscal tightening in one hit.

The modelling in this paper does anticipate that from 2012-13 onward the Treasurer will manage to achieve his real spending growth target. The Macroeconomics' budget model predicts low average real growth in the base spending rate at 1.5 per cent, on average, over each year of the forward estimates to 2016-17 (Table 9). If achieved, this real spending profile will lead to a significant lowering in the structural deficit.

However, our modelling does *not* include any new policy spending. In other words, new aspirational spending programs such as the NDIS and Gonski will have to be fully offset. This sounds too good to be true and is a key reason why the Australian Government's structural budget deficit is likely to rise. The strategy is also very risky because one poor budget outcome can jeopardise its feasibility over time. The track record of Australian Governments over recent decades suggests that a once-and-for-all adjustment may be a more effective strategy.

Finally, the Australian Government budget is also impacted strongly by tax concessions (large and small) which reduce the taxable incomes

Table 9 Real spending and receipts growth under the Rudd-Gillard Government

	Actual		Estimates		Projections	
	2011-12 \$b	2012-13 \$b	2013-14 \$b	2014-15 \$b	2015-16 \$b	2016-17 \$b
Payments spending base	371.0	362.2	383.9	403.1	423.9	449.5
Real growth in payments (CPI deflator) [%]	4.9	-4.8	3.7	2.5	2.7	3.5
Receipts base	329.9	353.7	378.7	396.7	414.7	437.2
Real growth in receipts (CPI deflator) [%]	7.9	4.8	4.8	2.2	2.0	2.9
Margins of receipts growth over payments	3.0	9.6	1.1	-0.2	-0.6	-0.6
Budget balance	-43.7	-11.6	-8.3	-9.2	-12.2	-14.3

Source: Budget Papers and Macroeconomics estimates.

and tax payable by households or business. The 2012 Tax Expenditure Statement details 363 income tax concessions which collectively cost the budget \$111 billion (or around one third of budget revenue) before account is taken of likely behavioural impacts which reduce these estimates.⁹

Some of the larger concessions, including those related to taxes on employer superannuation contributions and on super earnings,

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

SECTION

03

The case for long-term budget reform

SECTION 3

The case for long-term budget reform

By various estimates, the Commonwealth budget will remain in structural deficit in 2012-13.¹⁰ And Australian Governments – Federal and state/territory – are already on a trajectory to accumulate total public sector financial liabilities exceeding \$700 billion in 2016-17 (around 40 per cent of GDP).

An economic downturn would see the government sector in Australia more rapidly accumulate public debt and be exposed to global debt markets at a time when the foundations of global macroeconomic policy remain compromised. Global monetary policy is leading to asset misallocation (as central banks of major economies continue to grow their balance sheets to provide relief to stagnant economies), a situation compounded if governments consume valuable investable funds.¹¹

Government debt when combined with high household indebtedness, which though moderating recently is still expected to be around \$600 billion (around 34 per cent of GDP) in 2016-17, implies a genuine risk that credit ratings agencies will look hard at sovereign risk in the Australian economy. While

credit ratings agencies usually only track public indebtedness once it rises above 70 per cent of GDP, Australia's high level of private indebtedness and exposure to residential real estate presents a potential risk in the face of another global financial shock. The government sector must do more to contribute to net national savings to guarantee the steady inflow of foreign capital needed to build the plant and infrastructure that will grow prosperity.

In terms of longer term fiscal sustainability, the burdens identified in three Intergenerational Reports loom larger each year.¹² Without policy change, taxation revenue will largely track GDP growth in coming decades, while government expenditure is likely to rise more rapidly, placing budgets under considerable pressure.

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The future scenario is one of higher public debt and/or higher taxes as a share of GDP in the absence of concerted fiscal consolidation.

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As noted above, in the 2010 IGR Treasury forecast a Commonwealth underlying cash deficit due to population ageing of around 3.8 per cent of GDP in 2049-50, with the gap opening towards the end of the next decade.¹³ Macroeconomics estimates the gap will be around 5.6 per cent by 2056-57. In addition, governments at the state and local levels in Australia will carry a fiscal burden from population ageing which is expected to add around 1.5 per cent of GDP to the overall burden according to a 2005 study by the Productivity Commission.¹⁴

Added to this prospect, certain longer term risks to the Federal budget are not subject to scrutiny in the IGR. They include longer term environmental risks and challenges associated with defence capital. For example, the project cost of building 12 diesel submarines at TechPort in South Australia is expected to be in excess of \$100 billion.

When taken together – current public indebtedness, the Australian Government’s structural deficit, intergenerational pressures and other longer term spending commitments – the future scenario is one of higher public debt and/or higher taxes as a share of GDP in the absence of concerted fiscal consolidation.¹⁵

Effective rules can guide better budget decision-making

A central theme of this Monograph is that effective fiscal rules can guide budget behaviours around a sustainable benchmark, provided that benchmark is properly specified and clearly identified. The combination of transparency and high-quality information can assist political acceptance of the need for budget discipline, without removing necessary fiscal flexibility.

The experience of Australian economic reform over the last three decades supports this insight. Australia had seen its relative economic performance decline by the 1980s and arresting this trend required an effective mix of microeconomic reforms and macroeconomic policy pursued by successive Australian Governments, at least up to 2000. On the fiscal policy front, this meant tackling the accumulation of historically-high levels of Commonwealth (and state and territory) net debt.

Policy reformers argued that improving the long-term credibility of policy settings would underpin strong and stable economic growth. The idea was that fiscal policy was felt most strongly through stabilising debt and national savings, via related confidence effects attached to the risk premia on interest rates and allocative efficiency improvements. In 1998,

the Howard Government enacted the Charter of Budget Honesty reforms which required the explicit outlining of a medium-term fiscal strategy. The practicalities of this involved a fiscal strategy statement being included from the 1997-98 Budget onwards, nominating a target objective for the strategy.

This objective was defined loosely as maintaining budget balance, on average, over the course of the economic cycle. It was operationalised by successive governments as running a net lending underlying cash balance over the economic cycle. Certain economic outcomes were seen as flowing from the fiscal strategy, at least in theory. The strategy should:

- ensure the level of net debt remains stable in nominal terms over time so that as the economy grows, net debt falls as a proportion of gross domestic product (GDP);
- improve Australia's public saving performance leading to a higher national saving position which improves longer term growth prospects, everything else being equal;
- avoid the need to borrow in net terms from financial markets over the cycle, facilitating lower real interest rates (on average) by removing the Government's call on private and foreign saving and

by maintaining the confidence of financial markets, thereby helping to minimise the risk premium component of interest rates;

- ensure Australia's current account deficit is a result of private savings and investment decisions, which are subject to market disciplines; and
- allow the automatic stabilisers of the budget to operate so enhancing the effectiveness of fiscal policy in supporting demand during a downturn, while providing an anchor for discretionary policy responses.

But there was one major flaw in the medium-term strategy. After a strong start in the late 1990s, that flaw was exposed by the China Boom from 2003-04.

Australian Governments were presented with windfall tax revenue receipts year-after-year based on income flows from higher mineral commodity exports. Yet all that the fiscal strategy required was for governments to run budget surpluses in good economic times. There was no acknowledgement of the windfall element of tax revenues under the strategy and no tally kept of the magnitude of these impacts on the budget. Successive governments were free to engage in fiscal largesse while still meeting their fiscal strategy objective.

Essentially, the fiscal strategy

objective provided the wrong diagnostic tool as a benchmark for success over the business and commodity cycle. As a result, governments spent up big in the boom and got caught on the down side of the cycle. Windfall tax receipts were frittered away. By 2006-07, the Commonwealth was running a *structural* budget deficit. This structural budget deficit has widened subsequently. In the process, the Commonwealth has accumulated more than \$170 billion in budget deficits, with another deficit now in prospect for 2012-13.

Ten years on from the start of the China Boom, it is clear that Australia's fiscal strategy is in need of an overhaul. Even more concerning has been the degree to which the nation's fiscal sustainability has been compromised by a failure to maintain appropriate fiscal discipline in the "boom years".

Firstly, the nation's fiscal strategy needs to be re-oriented around a structural budget measure to take account of movements in the business and commodity cycle and to provide both policy makers and the public with a realistic assessment of the underlying position of the budget.

Secondly, reforms are needed to reverse the impact of unsustainable commitments made in boom years

and to meet future fiscal challenges. Of course, Australian Governments must balance the goal of restoring the sustainability of budget settings with that of achieving short-term macroeconomic stability. The task of repairing the structural budget need not compromise the role of fiscal policy in mitigating the impact of the economic cycle on living standards.

Review of the spending base is long overdue

A strategic review of the sustainability of Commonwealth spending is well and truly overdue. The last time there was a so-called “root and branch” review of Commonwealth Government expenditure was following the election of the Howard Government.¹⁶ The National Commission of Audit undertook a broad-ranging review of government direct spending, tax expenditures and capital purchases, as well as of budget reforms. Yet even the National Commission of Audit was not a complete review of spending issues in the sense that it was undertaken over a three month period. Thus there was hardly time to conduct a thorough examination in each area.

The National Commission of Audit paved the way for spending cuts in the first and second Howard-Costello Budgets (1996-97 and 1997-98) of between 0.5 to 1 per cent of GDP. These budget cuts did little

for the Canberra property market, but seemed to spur the domestic economy in concert with lower official interest rates and a lower exchange rate (following the Asian financial crisis). Since the late 1990s, various piecemeal review processes have been conducted through normal budget processes, but nothing that has provided such a strategic framework or such wide coverage.

Given the precarious fiscal position of the Commonwealth and that nearly two decades have passed since the Commission of Audit, it is time for an Australian Government to undertake another broad review. Ideally, it should comprise a panel of eminent Australians with a strong background in economic analysis and extensive knowledge of the internal workings of the budget process. A string of recent state reviews (including those undertaken by the ACT, South Australia, Tasmania, Victoria, NSW and Queensland) may provide some valuable lessons.

The tendency in recent years for government to throw money at policy problems as if that was some sort of cure-all needs to be systematically reversed. As Gary Banks, then Chairman of the Productivity Commission, observed in 2009 “Australia’s productivity slump was not caused by any lack of spending on education and training, R&D or even infrastructure”.¹⁷ Unfortunately,

the Australian Government's existing spending review processes are piecemeal, without an overarching strategic framework.

A better budget system would assess all spending priorities side-by-side, specifying feasible real policy outcomes in advance, and allocating base spending according to which programs have the highest expected rate of economic and social return. Each year, each program would be evaluated to assess whether outcomes were being achieved and, if necessary, modified or terminated – with resources shifted to higher performing areas.

The illusion of transparency

Any careful review of Commonwealth or state Budget Papers reveals there is very little information provided about the things that taxpayers actually care about when it comes to spending. For example, you will find almost no meaningful discussion of the following questions:

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

Program-based performance reporting would be a fundamental transparency check on governments. Yet it has been a very long time (since the mid to late 1980s) since this information was included in budget documentation. Unfortunately, program-specific budget estimates were basically abolished and removed from Budget Papers in 1998-99 with the start of accrual accounting.¹⁸ As a result, the public can find lots of accounting data in Budget Papers, but very little information that is actually useful in assessing the policy performance of government programs.¹⁹

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

Without this level of analysis, Budget Papers tend to create the illusion of transparency, rather than the reality. Ministers and/or senior public servants for the most part are not held accountable for the adequacy and efficiency of public resource use. And most parliamentary processes (such as Senate Estimates hearings) become exercises in futility.

Lax expenditure control can undermine productivity and growth

Genuine waste or spending on areas with low economic and/or social returns has no lasting impact on the national economy (debt stock and public debt interest aside). By contrast, public investment which leaves households, public agencies and private firms better placed to contribute to economic and social outcomes raises productivity.

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*Budget Papers
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the illusion of
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Maintaining a tight rein on public spending also helps to drive dynamic efficiency gains over time, helping to keep costs down, to accelerate innovation and to raise growth rates.

Fiscal consolidation can also be expansionary in an open economy if it contracts public consumption expenditure.²⁰ This may seem counterintuitive, but if foreign investors respond to tighter budgets by lowering the required return on their lending, then domestic interest rates will tend to be lower, as will the exchange rate. This will help to promote private investment and exports.

Australian policy makers could exploit this channel by demonstrating their intention to tighten policy settings as part of a coherent medium-term fiscal strategy which improves the structural position of the budget and lowers the future tax burden. So while the direct demand impact of fiscal austerity is negative in most instances, the net effect may be positive via the impact on expectations which underpin investor sentiment and lower risk premia.²¹ Some significant international studies support the possible expansionary impacts from fiscal tightening in certain instances, especially where there is a perception that fiscal policy has been mismanaged.²² Perhaps even

more importantly, maintaining a tight rein on public spending allows more room for easing of monetary policy which tends to magnify positive impacts on key variables.²³

For example, supportive monetary and fiscal policy settings seemed to help the Australian economy avoid recession during the Asian financial crisis. A rapid depreciation of the currency enabled Australian exporters to enhance their competitiveness, while tight fiscal policy supported low interest rates and a pick-up in business investment. As noted above, the Howard Government's net spending cuts amounted to between 0.5 to 1 per cent of GDP, with one study concluding that GDP growth was around $\frac{3}{4}$ of a percentage point higher over two to three years after the budget cuts.²⁴

Another example is the "Banana Republic" episode in the mid-1980s, when the exchange rate came under pressure from lower terms of trade. Again, a subsequent fiscal consolidation did not appear to impact adversely on growth:

- the 1987-88 Budget cut real policy outlays by 1.2 per cent of GDP in 1987-88 and 0.6 per cent in 1988-89; and
- the 1988-89 Budget cut real policy outlays by 2.2 per cent of GDP in 1988-89 and a further 0.3 per cent of GDP in 1989-90.²⁵

Genuine waste or spending on areas with low economic and/or social returns *for whatever reason* means that the community is worse off because higher valued priorities, whether they be spending on schools, hospitals, medical technology or aged care facilities, or even tax cuts, are crowded out. Real strategic spending cuts should actually benefit the nation by helping to raise the quality of spending overall and so assist productivity. The real enemy of quality public services is not spending cuts, but needless waste.

Reforming fiscal strategy, spending priorities and budget frameworks are all examples of “no regrets” policy making. They are worth doing in and of themselves in order

to improve use of resources in the economy, regardless of some of the wider economic dividends likely to flow in the form of lower long-term real interest rates, higher investment and higher productivity.

At the same time, even small gains in terms of productivity and lower risk premia can generate big output effects. For example, Macroeconomics’ general equilibrium model of the Australian economy finds that:

- a ½ of a percentage point reduction in the risk premium raises GDP around ¼ of a percentage point after two years; and
- a ½ of a percentage point increase in total factor productivity raises GDP around 1 percentage point after two years.²⁶ ■

SECTION

04

Five pro-growth budget reforms

Five pro-growth budget reforms

This section outlines five fiscal reforms that would help to underpin economic growth in the Australian economy and put the Commonwealth budget on a more sustainable long-term footing.

Reform 1: Anchoring fiscal strategy (while preserving flexibility)

The Australian Government's medium-term fiscal policy of achieving budget balance, on average, over the economic cycle has been in place since the mid- to late 1990s. It helped to achieve reasonable budget outcomes for the first few years. In particular, it encouraged:

1. Transparency, as high-level fiscal benchmarks were at the centre of public debate.
2. Sustainability, as the strategy helped to reinforce the need for governments to add to national savings by running surpluses when activity was above trend.
3. Flexibility, in the sense that it does not force "hard and fast" rules on reluctant governments with their independent policy objectives.²⁷

Undoubtedly, however, the performance of the fiscal strategy has been less impressive since the beginning of the commodity price boom in 2003-04.

- over the period 1994-95 to 2003-04, Australia achieved a modest cumulative budget surplus totalling \$5.7 billion
- over the period 2004-05 to 2011-12, Australia has achieved large cumulative deficits totalling \$79 billion (remembering that the GFC stimulus totalled around \$70 billion)
- over the past four years to 2011-12, Australia has accumulated deficits of over \$172 billion.

Australia's fiscal performance should have been better over the period from 2004-05. Successive governments had the benefit of the commodity boom revenue windfalls which contributed around \$160 billion to the budget bottom-

line up to 2011-12. Certainly, the GFC and its aftermath had a significant cyclical impact on taxation revenues, mainly through lower business tax receipts. But the truth is successive governments used the proceeds of the China Boom to fund a significant loosening in discretionary policy. Little structural reform was achieved.

If successive Australian Governments from 2004 had linked the medium-term fiscal strategy to the structural budget balance position (allowing for the real business cycle and terms of trade) then the gradual deterioration in the structural budget position from the mid-2000s would have been transparent in budget papers and perhaps public opinion would have helped to limit the subsequent discretionary policy easing which frittered away revenues from the mining boom.

Unfortunately, the Australian Government's medium-term fiscal strategy:

- provided no guide as to the suitable size of the budget balance given current economic circumstances;
- provided no guidance regarding the target range of ideal budget balances given the stage of the real business cycle and commodity cycle; and
- provided no measure of the structural budget balance even though the Commonwealth

Treasury has a structural model in place for internal use.²⁸

For those who think this is all simply with the benefit of 20:20 hindsight, there were individuals back in 2004 and 2005 (including Ross Garnaut, Saul Eslake and Chris Richardson) who warned the Howard Government of the need to tighten fiscal strategy in the face of the mining boom.²⁹

Yet from 2004-05 onwards, successive Commonwealth budgets did the opposite of that which was required for responsible fiscal management. Nor did Treasury or any other official agency make any attempt to quantify the size of windfalls or alert the public to a once-in-a-lifetime event that was propping up bad budget decision making. This strengthens the case for making the structural position of the budget more transparent so that such poor management will receive closer scrutiny in future.

A key reform, therefore, is for the Commonwealth (and even state governments) to include a structural budget measure as part of the budget outlook and to specify achieving a structural budget balance as part of the fiscal strategy.³⁰ This would promote greater public understanding of the magnitude of temporary factors impacting the budget bottom line in any given period and help to reveal a more

accurate picture of the underlying condition of public finances.

Over time, such an initiative would help to restore the structural foundations of the Australian Government's budget, or at least arrest the decline. It would also be a useful transparency step to have the structural budget balance estimates reviewed by the new Parliamentary Budget Office (PBO) at the end of each budget update. Alternatively, the PBO could release its own structural budget balance estimates, complete with confidence intervals and ranges incorporating the sensitivity of their structural budget model to various parameter assumptions.

As part of a more tightly-specified fiscal strategy, the Australian Government should also consider introducing a *size of government* sub-objective tied to the long-run tax to GDP ratio. Currently, the size of government objective specifies a tax share target of no more than 23.7 per cent of GDP based on the 2006-07 outcome, prior to the last change of government. However, this period coincided with the height of the mining boom when revenue was inflated and so is an unrealistic benchmark. A better outcome would be to target a long-run average such as the tax share of the last 50 years. That suggests a target closer to 22.1 per cent of GDP. The point is that the Australian

Government should align its spending objectives to a sustainable revenue share objective over the longer term, whatever that may be.

A more clearly specified fiscal strategy need not compromise the capacity for fiscal stimulus in the event of a major economic downturn. Hence an added dimension to the fiscal strategy would be for the Australian Government to enshrine its capacity to undertake a 2 to 3 per cent of GDP fiscal stimulus under certain circumstances (essentially the total size of the initial GFC fiscal stimulus). At the moment, the Australian Government has much less capacity than it did in 2008 to deliver a large stimulus.

Having to acknowledge this reality might in itself spur corrective action. Government might also consider setting in place a dedicated "rainy day" fund with a specific savings target to pre-fund the stimulus objective and put in place necessary safeguards to prevent this fund being raided.

The Australian Government could also demonstrate its preparedness for an economic downturn by specifying sensible policy reforms that would be rolled out in the event of a downturn requiring budget stimulus. For example, specific taxation reforms and high-value infrastructure projects could be included in an attachment to the budget outlook each year. The

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Looking ahead over the next 40 years, it makes sense to take corrective measures today to manage a fiscal gap which is well understood and likely to occur in coming years.

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Productivity Commission could be charged with producing a list of reforms and ranking them in order of merit. The policy implementation unit in the Prime Minister's department could be charged with the job of ensuring that each policy could be enacted within a few weeks of an economic downturn justifying a discretionary easing in policy.

Looking ahead over the next 40 years, it makes sense to take corrective measures today to manage a fiscal gap which is well understood and likely to occur in coming years. It appears certain that Commonwealth and state governments will face a combined fiscal gap in the order of 5 to 6 per cent of GDP, before allowing for significant funding commitments such as the NDIS, the Gonski education reforms, national dental schemes and the like. Making some small provision each year to meet future deficits (say less than 0.4 per cent of GDP) would probably be sufficient to pre-fund most of the fiscal deficit if governments act immediately.

Of course, the benefits of immediate action compound such that speedy action is preferred. Intergenerational prefunding is fair provided that the same taxpayers who bear the burden benefit from a sustainable aged care and health system in the future. Governments should undertake preventive expenditure program

reforms in high-growth areas to mitigate future outlays, as well as undertaking farsighted economic reforms to grow the future economy.³¹

Reform 2: Eliminating wasteful spending and tax concessions

The most obvious way to control spending pressures is to cut areas of waste or profligacy. Certain other government programs require adjustment because they are so poorly targeted.

Some clear savings can be made by focusing on the following areas.

- Alternative energy development programs operated by the Commonwealth remain in need of reform. As Gary Banks has noted, it is not clear why we have a \$10 billion *Clean Energy Finance Corporation*, a \$3.2 billion *Renewable Energy Agency* and a \$200 million *Clean Technology Innovation Program*. Total savings from administrative consolidation of these programs could be worth as much as \$100 million to the budget bottom-line.
- The *First Home Owners Grant* is a scheme which pays eligible homebuyers \$7,000 for purchasing an established home, or \$14,000 for purchasing a new home. It was introduced by the Howard Government to provide compensation for GST on the cost of home purchases. The grant adds pressure on house prices while doing nothing to assist supply; hence making housing less affordable. Most states have similar schemes which exacerbate the distortion. The total cost per year to taxpayers of this concession has been estimated at around \$771 million in 2013-14.
- Staff levels in the Federal Health and Education Departments were 4,759 and 4,738, respectively, in 2011-12. It is not clear why these departments need so many staff when neither is involved in service delivery. Reorganising these agencies on an economic basis could save around \$249 million in 2014-15.
- The budget estimates make provision for irrigation infrastructure purchases and water buy-backs up to \$4.7 billion in 2015-16. Much of this spending is simply a handout to irrigators with no requirement for full cost recovery on the beneficiaries of new infrastructure.
- The Commonwealth procures around \$8 billion in capital equipment and buildings each year through multi-year engineering projects. None of these contracts include explicit incentives which allow the contractors to benefit if they save money for the Australian Government.³² Why not use contract incentives? Governments could save a risk margin of anywhere between 1 to 10 per cent

on Defence procurement each year, with annual savings between \$80 million and \$800 million in 2013-14.³³

- The tax-free treatment of superannuation income lets senior Australians pay only \$5.80 for prescription drugs compared with \$35.40 for someone on the minimum wage of \$30,000. This is true even if the senior earns \$1 million in superannuation income. This is because super income is exempt from the \$50,000 means test for the seniors' health card. This is estimated to yield a total saving for taxpayers of around \$28 million in 2013-14.³⁴
- Overstaffing in certain program delivery agencies is a significant budget impost. In 2011-12, the Defence Materiel Organisation had 5,592 workers and AusAID a further 1,887 workers. Governments should look to deliver policy administration in these areas through smaller, more technically-focused teams. Reducing staff in these agencies by half would save around \$390 million in 2013-14.
- The *School Kids Bonus* pays parents of school aged children either \$410 or \$820 per year for each of their primary or secondary school aged children based on eligibility for other family tax transfers. The Bonus replaced the *Education Tax Refund* that was previously claimed through

the tax system and was always undersubscribed. The Bonus does not require families to keep receipts and has no link to education spending. The total saving per year to taxpayers from abolishing this program would be around \$1.2 billion in 2013-14.

- The budget estimates include provision for the *Caring for Country* program of up to \$2 billion over five years. This is an example of a poorly targeted community grants scheme, like the former *Natural Heritage Trust*, that provides the Minister with enough discretion to direct funding for political objectives.
- *Family Tax Benefit B* grants extra assistance to families where one parent chooses to stay home and look after the children. At the moment, households with incomes of up to \$175,000 can still receive some level of benefit. Reducing this threshold to \$120,000 would save around \$811 million in 2013-14.

Reform 3: Better targeting of welfare policies (including corporate welfare)

More comprehensive reform of Federal spending requires renewed government focus on household assistance payments and corporate welfare. As noted earlier, as a share of the total budget, Federal spending on social security has risen by around 14 percentage points

since the 1960s. In many ways, the tendency towards “entitlement politics” has worsened since the mid-2000s when the Howard Government became prone to gifting benefits to certain groups without a strong policy case.

One approach to social security reform would be to unify benefit payments under one broad payment, combining the current multiplicity of benefit abatement ranges into a single, more easily understood measure. An agency such as Treasury’s Retirement Income Modelling unit could be charged with developing options to establish a unified means test for welfare benefits aimed at targeting genuine economic hardship in all its forms. A revenue-neutral variant of this reform would be a significant microeconomic reform that would raise incentives for workplace participation whilst more effectively targeting need. In the process, it could fund personal tax cuts, while removing significant layers of welfare benefit payments and reducing inefficient churn in the tax system.

More should also be done to reduce corporate welfare, with industry subsidies costing Australian taxpayers around \$18 billion each year. Most of this is paid out to uncompetitive or declining industries such as the car industry. Payments typically have no linkage to policy outcomes or structural

adjustment that might raise competitiveness. Nor in many cases is assistance time-limited.

Assistance should only be used to overcome some identifiable market failure and all levels of government should be made to publish subsidies paid to each Australian industry by firm, together with the effective rate of assistance provided to each sector by spending program.

Reform 4: A sustainability review of all spending programs

Another key strategic focus should be the evaluation of all existing spending programs employing a “zero base” approach – in other words, assess the merits of all programs from the first dollar, no matter how long they have been in place.

The overarching focus of this review process would be sustainability. This would not be a one-off exercise in finding savings. Rather, it would take the time to access the relative performance of each spending program and set up performance benchmarks to assess the desirability of new spending proposals relative to base spending. Benchmarks should assess the efficiency and effectiveness of spending programs, with all programs reviewed in one cycle so that consistent comparisons can be made. Any such activity would necessarily take longer than a Commission of Audit review.

In terms of the examination of new spending proposals, the Department of Finance could be given a mandate to conduct cost-benefit analysis on all new policy proposals above \$50 million. At the moment, similar requirements (such as rules relating to regulatory impact statements) can be breached by Ministers with no consequence. One option would be for the *Charter of Budget Honesty Act* to be amended to require that every new spending proposal worth more than \$50 million in a single year be subject to a full cost-benefit analysis conducted by an independent expert agency prior to receiving Cabinet approval. Sponsoring Ministers who breached this requirement could be made to face the equivalent of disclosure penalties faced by a director of a public company director under corporations law.

Reform 5: A Budget Paper devoted to spending performance assessment

A comprehensive reform of Australian Government spending would require formal review of base spending worth around \$370 million, or 25 per cent of GDP in 2011-12. As argued here, such a process is long overdue and would normally include establishing an expert panel to review all major administered spending and tax concession programs, departmental outlays,

capital budgets and the staffing level of each major agency. The effectiveness of budget rules and processes would also need to be assessed.

At the same time, it would be helpful to have certain agencies perform supportive analytical tasks including:

- have the Department of Finance score the performance of all government programs based on criteria of efficiency and effectiveness;
- have Treasury score the performance of all tax expenditures based on the same criteria;
- have the Productivity Commission develop an independent measure of the productivity of large agencies such as Defence and Health with a view to benchmarking public service performance standards;
- have an independent external body map public sector staffing levels back to the core business activities of each government agency. For example, the Federal Treasury's core business is macroeconomic and revenue policy and forecasting. Those activities should employ around 150 staff, but the agency now has roughly another 740 staff. The key to efficiency would be to tie public sector employment to the efficient delivery of core business activities; and

- have the Productivity Commission examine the adequacy of public spending on capital so as to establish whether existing levels of public investment are adequate.³⁵

A final important transparency reform to ensure ongoing effectiveness and efficiency of spending program delivery would be for the Australian Government to introduce a new Budget Paper (Budget Paper No. 6) to report estimates and actual outcomes for all government spending by portfolio. This document could provide a brief assessment of each program performance and so would help inform the public if there were ongoing problems in a particular area that require reform.

A new budget statement would ensure that each department put in place a list of meaningful programs linked to the budget appropriations framework, with performance measures based on value for money criteria. The Australian Government could then extend this reporting framework to the states and territories by linking all recurrent and capital grants paid to (and through) each jurisdiction to the adoption of similar performance reporting standards via Council of Australian Government processes.

The philosophy behind a consolidated expenditure program

performance review statement is that the review processes should be ongoing, with fine-tuning occurring each year if problems arise. The standard approach at the moment is to call in the Auditor General when a problem has become too serious to ignore. Surely, it is better to maintain a state of continuous review and avoid ever having to solve major problems.

In addition, a new Budget Paper No. 6 should include information on the Top 20 long-term growth risks. These are spending programs and tax expenditures expected to have long-term growth in excess of 4 per cent per year. ■

SECTION

05

Conclusion

Conclusion

The Australian Government's fiscal strategy is in need of comprehensive reform, the primary aim of which should be to return the Federal budget to a sustainable footing and to keep it there.

Effective fiscal rules can support this objective through an appropriately specified, sustainable benchmark. The combination of greater transparency and high-quality information can help to guide budget decision-making processes towards necessary outcomes, not least by assisting political acceptance of appropriate budget discipline.

This Monograph outlines five specific reforms which can provide part of the necessary policy architecture for returning the Federal budget to a sustainable position through time.

The key indicator of fiscal strategy performance should be the structural underlying cash balance, to reveal how fiscal strategy performance is tracking abstracting from the business cycle and trade cycle. The China Boom which began in 2003-04 exposed flaws

in the existing medium-term fiscal strategy as developed in the 1990s.

Australian Governments were presented with windfall tax revenue receipts year-after-year and the simple underlying cash balance objective was the wrong diagnostic tool for assessing fiscal policy success. As a result, there has been a marked deterioration in the structural foundations of the Commonwealth budget position.

Additional reforms are now needed to reverse the impact of unsustainable commitments made in the boom years and to meet future fiscal challenges. Without such reform, Australia remains exposed to global financial shocks, while poor quality spending in itself undermines long-term growth in productivity and living standards. ■

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Endnotes

Endnotes

- ¹ An evidence-based approach to budget policy making ideally needs to pass through seven stages:
 - I. Identify the “problem”
 - II. Provide a case for government intervention
 - III. Identify the objectives of government intervention
 - IV. List the policy options for addressing the problem (in addition to doing nothing)
 - V. Assess the options according to their merits
 - VI. Make policy decision
 - VII. Monitor the impacts of the policy decision.
- ² Public debt has a role in helping government to smooth out variations in revenue and expenditure caused by the business cycle and to fund the acquisition of necessary “lumpy” public infrastructure purchases which generate sufficient economic and social returns, but which are underprovided by the private sector.
- ³ Kirsty Laurie and Jason McDonald, 2008, provide a very detailed overview of Commonwealth spending trends with a focus on the Howard Government era.
- ⁴ Ken Henry, 2009, p.12.
- ⁵ Vito Tanzi and Ludger Schuknecht, 2000 and Atul Dar and Sal Amir Khalkhali, 2002, pp. 679-692.
- ⁶ The fuel tax credit scheme designed to reduce or remove a tax on business inputs – in this case, fuel used by businesses off road – is the principal source of this growth. Fuel tax is paid by business and later credited which accounts for its appearance on both sides of the Budget. As Treasury has noted repeatedly, fuel tax credits are not a subsidy and those who support the abolition of the scheme are arguing for industry to pay higher taxes.
- ⁷ Assumptions on growth rates for productivity and economy are consistent with long-term forecasts contained in the 2010 Intergeneration Report released by Treasury.
- ⁸ As detailed in the Macroeconomics 2010-11 Budget Bulletin, we believe that around \$45 billion of the \$70 billion in temporary GFC Mark I stimulus spending was wasted on uneconomic projects.
- ⁹ Australian Government, January 2013.

- ¹⁰ Jacob Greber, *Australian Financial Review*, 8 March 2013.
- ¹¹ Artificially low interest rates may spur sub-optimal infrastructure projects leading to misallocation of investment flows over the longer term. This tendency is exacerbated where governments borrow to fund consumption decisions. The financial and social returns to government spending projects must exceed the long term cost of borrowing.
- ¹² Each successive IGR has revealed a lower overall long-run burden for taxpayers. However, this has more to do with a relatively optimistic view about the strength of long-run commodity prices and nominal GDP, not a reduction in underlying spending pressures.
- ¹³ Australian Government, January 2010, Appendix A, Table A1.
- ¹⁴ Productivity Commission, 2005, xxxvi.
- ¹⁵ The relationship between budget flows, the public balance sheet and debt is examined in David Woods and Michael Xanthis, 2011, pp. 1-14.
- ¹⁶ Australian Government, December 2009, and National Commission of Audit, June 1996.
- ¹⁷ Gary Banks, 2009, p.3.
- ¹⁸ The accrual reforms of the late 1990s, while theoretically sensible, led to a decision to do away with program reporting. By the mid-2000s, the Budget Group of the Department of Finance had no sure way of explaining the policy drivers of variations in agency accounting data. Since then the situation has been remedied, but this data is still not released to the public.
- ¹⁹ Some of the program information can be found in agency budget documentation and annual reports, but there is no single statement which brings together all this information in a straightforward way that is accessible to the general public.
- ²⁰ Anthony Makin, 1998, pp. 419-25.
- ²¹ Blair Comley, et al, 2002 and Yong Hong Yan and Shane Brittle, 2010.
- ²² See, for example, Alberto Alesina and Silvia Ardagna, 1998, pp. 487-545 and Alberto Alesina and Silvia Ardagna, 2010, pp. 35-68.
- ²³ Nicolaas Groenewold, 2012.
- ²⁴ Lei Lei Song and John Freebairn, 2006, pp. 35-46.
- ²⁵ Owen Covick, 1990, p. 197. Former Hawke Government Finance Minister Peter Walsh was legendary among Finance Department staff for by-passing senior management and calling middle-level and junior departmental staff directly to get the full story on various issues.

- ²⁶ Macroeconomics, 2012. BARRIE stands for Bayesian Australia and Regions Response to Impulse Economy.
- ²⁷ See Graeme Davis and Stephen Anthony, 2002 and David Gruen and Amanda Sayegh, 2005, pp. 618-635.
- ²⁸ See Benjamin Ford, 2005, pp. 63-74 and Tony McDonald, et al, 2000, pp. 51-79.
- ²⁹ See Ross Garnaut, 2004.
- ³⁰ State budgets are just as exposed to cyclical revenue streams associated with property sales and mining through stamp duties on conveyances and royalty payments. Each state government could establish its own PBO which could oversight structural budget issues.
- ³¹ This section of the paper draws on the fiscal reform strategy outlined by Tony Cole and Karen Chester, *The Australian*, 31 October 2012.
- ³² The idea is developed in Stephen Anthony and Shane Evans, September 2010.
- ³³ Industry Commission, 1994.
- ³⁴ See Brian Toohey, 2008.
- ³⁵ See Greg Coombs and Chris Roberts, 2007, pp. 1-16 for a primer on the issue.



A roadmap for fiscal sustainability

STEPHEN ANTHONY

Australia's fiscal strategy is in need of an overhaul. In recent years, the Commonwealth has accumulated more than \$170 billion in budget deficits, with another deficit now in prospect for 2012-13. This is despite windfall revenues since the start of the "China Boom" estimated at around \$160 billion.

Stephen Anthony sets out why Australia needs a new roadmap for fiscal sustainability and outlines some key budget reforms to secure this objective. Firstly, the nation's fiscal strategy needs to be re-oriented around a *structural* budget measure to take account of movements in the business and commodity cycle. Secondly, reforms are needed to reverse the impact of unsustainable commitments made in the boom years and to meet future fiscal challenges.

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