ISSUEANALYSIS

Australia's Future Fiscal Shock

Robert Carling

EXECUTIVE SUMMARY

No. 134 • 28 September 2012

- Long-term prospects for Australia's public finances are not receiving the attention they deserve. It is one thing for Commonwealth and state governments to balance their budgets in the short term, as they are attempting to do, but spending commitments are being made as though nothing beyond the four-year horizon of the forward estimates matters.
- Under current policies, Australia is heading in the long term for a substantially larger share of government spending in the economy, which will bring pressures for higher taxation or borrowing or both. Spending by governments at all levels as a proportion of gross domestic product (GDP) (currently around 36%) could rise to well above 40% over the decades ahead, if not sooner.
- The financial and economic crisis in the developed countries in the Northern Hemisphere can in part be attributed to the risks those countries took with their public finances over many years, and particularly the very high levels of government spending, which in some cases exceed 50% of GDP. Their experiences should serve as a warning to Australia.
- The Commonwealth's 2010 *Intergenerational Report* looks ahead to 2050 and projects that over the long term, an unsustainable fiscal gap of expenditure over revenue will open up under spending policies as they existed three years ago. It also shows that over the next several years, there is a window of opportunity to anticipate this problem and adjust policies to avoid it.
- But governments are showing few signs of using this opportunity wisely. To the contrary, new spending commitments are accumulating at an alarming rate, and more are piling up at government's doorstep. Commitments are being entered into with deferred start dates, which means the full fiscal consequences will only become apparent well into the future.
- The 2010 IGR outlook, being based on 2009 policies, incorporates none of this new spending. A review of policy announcements and other budget pressures shows that new spending measures adopted in the three years since the 2010 IGR could easily add $28 billion a year to spending by 2020. How this is shared between the Commonwealth and the states is a secondary issue. The total public sector picture is more important.

Robert Carling is a Senior Fellow at The Centre for Independent Studies. He was a senior official with the New South Wales Treasury until 2006, and before that, with the Commonwealth Treasury, the World Bank, and the IMF.

He thanks Percy Allan and Michael Shadwick for comments on drafts of this paper. However, the views expressed are his own and the responsibility for any errors rests with him.

THE CENTRE FOR INDEPENDENT STUDIES

www.cis.org.au

- So far in the current decade, spending appears to be following the pattern of the decade to 2010, when new initiatives accounted for more than half the very substantial real growth in Commonwealth spending. In those 10 years, growth was paid for by a revenue boom. Governments should not count on another revenue boom this decade. There are significant risks to revenue, both of a general kind and those specific to the mining resource rent tax and the carbon tax.
- Governments and oppositions need to curb their enthusiasm for launching or promising new spending initiatives. This will require a change in behaviour not only from politicians but also the community, whose expectations of government need to be lowered. Governments should also step up the search for expenditure savings, and adhere to a rule that requires new spending to be offset by savings in existing programs. A compete audit of spending under existing programs would allow spending to be re-based to a lower level and create more fiscal headroom.
- The alternative is to increase revenue through higher tax rates, broader bases, and cuts to concessions. This approach would entrench, rather than avoid, expanding the government sector. The increase would need to be very large, spread over the next several decades, and take the proportion of tax in GDP from around 30% to 40%. This would expand the deadweight economic costs of taxation by a large order of magnitude and is inferior to policies to contain government spending.
- Governments are more likely to take a long-term view under the pressure of transparency. Four-year forward estimates have passed the limits of their usefulness and are now 'gamed' by governments. There should be more focus on intergenerational reports, which should in future be prepared for the whole public sector (Commonwealth and states combined). Major reviews every few years should be complemented by annual fiscal sustainability updates that capture the net impact on long-term fiscal gaps of all expenditure and tax policy decisions taken in the preceding year.

Introduction

For a number of reasons, this is a good time to reflect on the long-term prospects for Australia's public finances. Commonwealth and state governments are struggling to balance their budgets after several years of big deficits. Whether or not they succeed in the short term, looming in the distance is a growing list of costly ideas for new government programs that may well become policy over the next few years. Right now, the costs of these programs lie largely beyond the conventional four-year horizon of government budgeting. Once the potential magnitude of these costs is calculated, a renewed surge in government spending—and a greater difficulty in balancing budgets—appears more likely in the longer term.

Meanwhile, the global financial crisis, and its evolution into the Great Recession at the global level and a generalised economic crisis in Europe, has injected new vigour into old controversies surrounding the appropriate role and size of government in developed economies. Among the several dimensions to the crisis, an important one is the very high level of government spending in most European countries. Government is somewhat smaller in the United States, but there is intense political and public debate over the appropriate level of spending: some want more, some less. While the protagonists fight this out, massive deficits persist and the public debt climbs to dangerous levels. This report starts from the premise that those who, for many years, have warned of the dangers inherent in the growth of government spending to very high levels relative to gross domestic product (GDP) are being proven correct by events in Europe and elsewhere.

A radical rethink of public financial management is needed to steer Australia clear of long-term threats to fiscal sustainability.

Australia is often credited with having a relatively small government sector, a low tax burden, and a low level of public debt, at least by the standards of developed countries. This interpretation of the facts is too generous to Australia, but now is an appropriate time to question whether the relatively favourable condition of our public finances is likely to continue in the long term. Even if a case can be made that we do not already have a big government, are we destined to join the ranks of the countries that do, with all the attendant problems that are increasingly evident around the world?

Intergenerational reports commissioned by the Commonwealth and some state governments have peered 40 years into the future and established that even if the recent budget deficits are eliminated in the short term, an unsustainable fiscal gap between expenditure and revenue will reopen in the long term. Even those projections, let alone annual budgets that look only four years ahead, understate the fiscal shock that lies ahead because as a working assumption, they do not take into account any future government spending initiatives. A radical rethink of public financial management is needed to steer Australia clear of long-term threats to fiscal sustainability.

What's wrong with big government?

As mentioned above, a premise of this report is that the current international economic turmoil vindicates those who for many years warned of the dangers of large government spending. How can this be when the global financial crisis had other causes? It is true that the crisis of 2008 was triggered by the bursting of the US housing bubble and the consequent collapse or near collapse of financial institutions both in the United States and in other major financial centres. Although high levels of government expenditure did not cause the crisis, the crisis has evolved into a more complex form and exposed the fundamental weaknesses in a number of countries stemming from their very high levels of government expenditure, and consequently, tax and/or debt burdens that were excessive even before the crisis hit. In this sense, the legacy of high levels of government expenditure over many years is now a key factor perpetuating the crisis. In Europe, it is impossible to separate the threat to the viability of the euro common currency project from the risk of public debt default in a number of Eurozone countries. On a broader scale in developed countries, high levels of government spending necessitated very heavy tax burdens or very high public debt burdens or both.

High levels of government spending and deficits are sometimes described as a consequence rather than a cause of the current crisis. It is true that spending and deficits increased dramatically as a result of stimulus spending in response to the recession; the budgetary cost of bank bailouts; and the operation of automatic stabilisers in lifting spending on items such as unemployment benefits and depressing revenue at unchanged tax rates. This vicious cycle is now at work in a number of key countries (Japan, the United Kingdom, and Spain, among others) under fiscal stress, with sluggish or contracting economies placing more pressure on public finances, which in turn helps perpetuate economic weaknesses. However, high levels of government spending and deficits existed in many countries long before the crisis hit and left them in a weaker position to cope with the crisis when it did hit. The global financial crisis resulted in the fiscal chickens finally coming home to roost in a number of countries such as the United States, the United Kingdom and France (let alone the likes of Greece) that had taken excessive risks with their public finances for many years before 2008.

The economic costs of government expenditure come from the economic efficiency and compliance costs of taxation, the economic consequences of public debt, and the low benefit/cost ratio of much government spending once governments go beyond their basic functions.

With public expenditure at around 36% of GDP, Commonwealth and state governments need to tread with caution in setting their expenditure policies.

This is not the place to delve into the issue of the optimal size of the public sector. There can be no single figure for the optimal size because it must depend partly on how efficiently and productively the money is spent. Conceptually, government spending at 30% of GDP can be more productive than spending at 25% of GDP. However, a large swathe of literature shows that countries whose government spending has passed 30% of GDP also have exceeded the optimal size of government (the benefits of the marginal dollar spent are very unlikely to justify the economic costs of the taxation needed to finance it).[1] Australia's public spending share (including Commonwealth, state and local government) is around 36%.

As for government borrowing, some of it can be justified to finance well-chosen capital expenditures that will generate a stream of benefits. Beyond a certain level, however, public debt takes on a life of its own and becomes such a burden that it slows economic growth and may even threaten the solvency of the state. Based on empirical research spanning many years and countries, Carmen Reinhart and Kenneth Rogoff have argued that 90% of GDP is the critical level beyond which the public debt burden significantly slows economic growth and exposes countries to the risk of a sovereign debt crisis.[2]

Australia's tax and public debt burdens are well below the critical levels that other developed countries have already reached, but with public expenditure at around 36% of GDP, Commonwealth and state governments need to tread with caution in setting their expenditure policies. Australia gets too much credit for having a 'small' government sector when it is 'small' only in comparison with the extremely large government sectors of many of our OECD comparators.

Box 1: Sizing up the public sector

The size of government is most commonly measured by spending as a percentage of GDP. However, this leaves many questions unanswered.

As well as expenditure, government intervention also takes the form of regulation, which does not necessarily require much expenditure. Regulation can be as intrusive, costly and burdensome as expenditure, but its impact is not captured in the ratio of government spending to GDP.

Tax expenditures, which arise from concessions and exemptions from standard tax rates, are also excluded from the ratio of spending to GDP, but they can be as much a burden on the general taxpayer—and as much a cause of deficits—as spending.

Then there is the question of which levels of government to include for multitier systems of government such as Australia's. Commonwealth government budget expenditure has been around 25% of GDP in recent years, which makes government look small in Australia, but there is no reason to exclude state and local governments. Australia's government sector, including all levels of government, is currently around 36% of our GDP.

Another issue is whether to look only at general government or the total public sector. The difference is that general government is confined to the spending of government departments that is recorded in budgets, whereas the total public sector includes public enterprises such as Australia Post, the National Broadband Network, and state water utilities. Provided the activities of these enterprises are genuinely commercial, there is a basis to distinguish them from general government. Even then, however, their borrowings are usually guaranteed by the government and should be included in measures of public debt burden.

Finally, care is needed in selecting which year or years to use as data points, as there is some variation in the government spending to GDP ratio over the business cycle. Australia's ratio reached 37.6% in 2009, when fiscal stimulus spending was at its peak, and has since receded to around 36%. It is likely to shrink a little further this year and the next, but it appears unlikely to fall much below 35%.

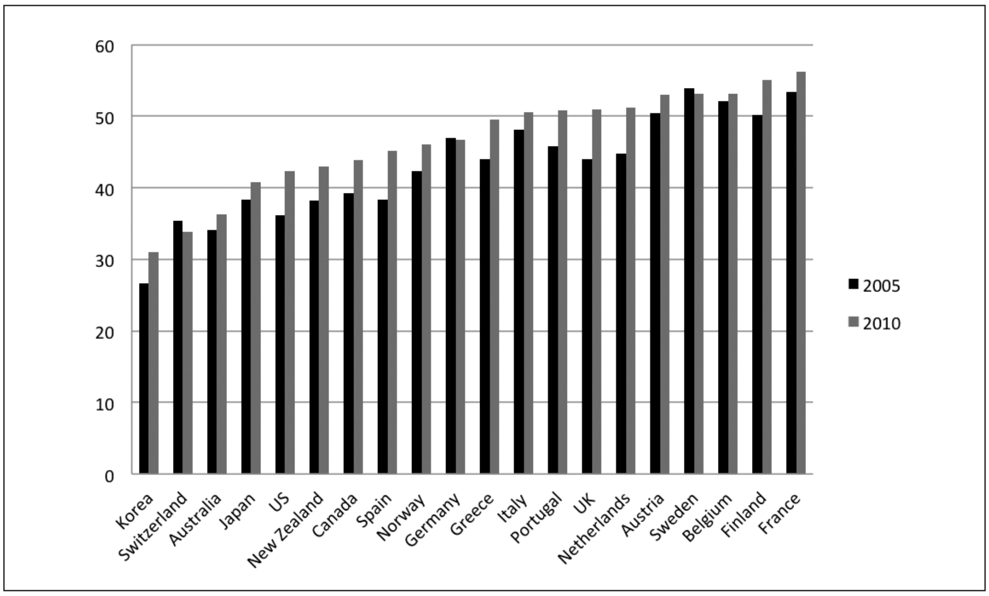
The following discussion is based on general government expenditure as a percentage of GDP in various countries for the years 2005 (pre-crisis) and 2010 (in crisis).

Australia gets too much credit for having a 'small' government sector when it is 'small' only in comparison with the extremely large government sectors of many of our OECD comparators.

Australia's government sector in perspective

Australia belongs to a small group of OECD countries with government sectors in the range of 30% to 40% of GDP in 2010, the others being South Korea and Switzerland. All other developed OECD countries have government sectors above 40%, with many above 50% of GDP. From the smallest to largest size of public sector, Japan, the United States, New Zealand, Canada, Spain, Norway and Germany are in the 40% to 50% range, and others (all of them in Europe) are at or above 50% (see Figure 1). It is no coincidence that all the countries involved in the current sovereign debt crisis, with the exception of Spain, are at around 50%.[3] Of the others, some (such as Sweden) are above 50% but not under fiscal stress because their tax burdens are extremely high, while some of those below 50% (such as the United States and Japan) are under fiscal stress because of accumulated debt burdens and/or because they have tried to remain relatively low tax countries while increasing their spending.

Figure 1: Government spending as a percent of GDP



Source: OECD (Organization for Economic Cooperation and Development), www.oecd.org/statistics.

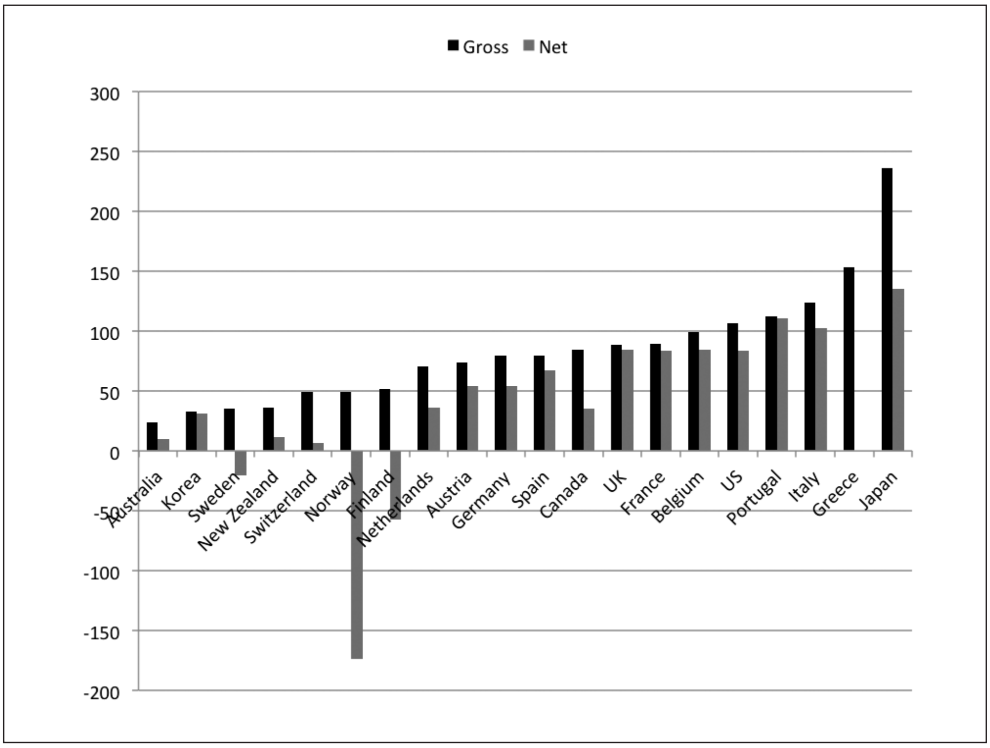
Although Australia already has many of the public policies that have created the larger public sectors of other countries, two features have kept us from reaching 40% of GDP. One, the public age pension has been kept relatively lean, with more adequate retirement incomes being kept within the domain of the private superannuation system. In most other OECD countries, public pension schemes are contributory and the benefits—often linked to final earnings—are larger. These contributions and benefits are classified as part of public sector revenue and expenditure, thereby inflating public sector size, whereas in Australia, they are inside the superannuation system and outside the public sector.

The other reason Australia's public sector appears relatively smaller is that many social benefits are subject to means tests and are therefore more targeted than in European countries. It is not that the benefits themselves are small but that the eligible population is contained by tighter criteria. This is unlikely to change. The policy of targeting is well entrenched, and if anything, the recent trend has been to further reduce eligible populations through more means testing. However, as explained below, there are other pressures for government spending to increase over time, raising the prospect of Australia becoming more like Europe in the size of its public sector.

If the trends of the last 40 years are maintained, then Australia is on track for a government sector well above 40% of GDP.

Australia's public debt burden is low both in absolute and comparative terms (see Figure 2). Many other developed countries have gross public debt of more than 50% of GDP and half the countries shown in Figure 2 even have net debt above that level. However, Australia's household and financial sector debts are high, and a high proportion of the total debt is external. So while some further increase in Australia's public debt may appear harmless in itself, its implications for total debt should be worrying.

Figure 2: General government debt as % of GDP (2012)



Source: IMF (International Monetary Fund), Fiscal Monitor Database (April 2012).

For now, Australia is fortunate in that it does not have to downsize its government sector to avoid a crisis, but it will need to cap new spending initiatives or displace existing programs to accommodate new ones if the effects of ageing on expenditure policies are also to be accommodated. Figures 1 and 2 show that many other developed countries are even more constrained than Australia because their public debt and/or tax burdens have become too big to be sustainable, especially in view of the future pressures from an ageing population. The only question left for them is how government will be downsized—by design or by crisis. Australia must avoid getting into that situation in the future.

Long-term growth of government spending

Historically, the size of government relative to the economy has grown in all countries as they developed. This has not been a smooth, continual process but one that has progressed in fits and starts. Australia, for example, entered World War II with public spending well below 20% of GDP. The wartime surge in this measure was never fully unwound, and by 1970, the public sector was controlling around 25% of GDP. The proportion has since increased, particularly in the 1970s and 1980s, to its recent level of around 36%. In many other countries, as we have seen above, the expansion has gone much further, taking the public sector share in some cases to above 50%.

The question for many developed countries is how to downsize government—by design or by crisis.

There is a vast theoretical literature canvassing the reasons for this growth, well surveyed by Stephen Kirchner.[4] Rather than exploring these theories, this report focuses on whether current and foreseeable policies in Australia are likely to further expand the public sector, thereby maintaining the long-term trend. Comparisons with other developed countries suggest that Australia's public sector could become significantly larger if our policies become more like theirs.

Schematically, the growth of public spending can be thought of as comprising increases in the cost of existing public policy programs, as currently designed ('existing policy'), and the costs of introducing new programs or redesigning existing programs ('new policy'). New policy does not necessarily increase public spending—it can also reduce public spending by eliminating or modifying the design of existing programs (historically, the expansionary dimension of new policy has dominated any shrinkage).

The age pension provides a good example of how the cost of a public policy program is driven by both existing and new policy. Existing policy in this case is defined as pension rates that are maintained in real terms through indexation and an eligible population of beneficiaries defined by age limits, and asset and income tests. New policy may involve variations in pension rates above or below those determined by the indexation arrangements, changes in the eligibility age, or changes in the asset or income tests. In 2009, for example, the government implemented large one-off real increases in pension rates, which increased the annual cost of the age pension program by some $3.6 billion. More recently, the government has announced an increase in the eligible age to 67 to be phased in over the next decade; this policy will save money.

I have analysed the growth of Commonwealth budget spending over 10 years to 2010–11 based on the distinction between existing and new policy.[5] One key finding was that while spending growth averaged 4% a year in real terms, three-quarters of that growth came not from the cost of existing policies but from new policies, or in other words, new programs and the expansion of existing programs. In the 10 years to 2010–11, if there had been no new programs or policy changes in existing programs, real Commonwealth spending growth would have averaged just 1% per year—a growth rate that would not even maintain the level of real spending per capita. It was the abundance of new programs and policy changes that boosted actual growth to 4% a year. That is a huge difference, cumulating to an ongoing annual cost of $85 billion after 10 years.

The relatively benign trend in the cost of existing programs in the last 10 years is an interesting result, but not one that policymakers can necessarily rely on to be repeated in the future. As will be explained in the next section, the forces for growth in the cost of existing programs are set to become stronger in the long term.

One conclusion from the analysis of past trends is that if the government sector is to be kept at its current size, let alone slimmed down, current and future governments will need to become less active in devising new ways to spend money, or become much more active in finding savings to offset new expenditure. Without a change in political behaviour or institutions, we can expect more of the same—more new spending initiatives, a timid approach to savings, and an upward pressure on taxes and borrowings. At this stage, nothing points to that change in political behaviour or institutions. As we shall see later, costly new programs and policy ideas are accumulating at a worrying rate. Indeed, some of them already have been adopted, with little regard to the long-term budgetary implications.

2050: A fiscal odyssey

The long-term outlook for Australia's public finances rarely gets the attention it deserves. Budgeting is no longer the narrow annual exercise it once was. Now the standard practice is to make four-year forward estimates with each annual budget based on the policies existing at the time. Nonetheless, budgets are too often prepared as though nothing matters beyond four years, and governments decide to defer expenditures and starting dates of new programs to make the fiscal outlook appear better than it really is. Separately from the budget process, since 2002, the Commonwealth Treasury and some states have produced occasional long-term *Intergenerational Reports* (IGRs). These reports peer 40 years into the future to project levels of government spending, revenue and deficits (or surpluses) as percentages of GDP.

Costly new programs and policy ideas are accumulating at a worrying rate.

The last Commonwealth IGR was released in February 2010.[6] It showed that the Commonwealth budget faced a significant expansion of expenditure as a percentage of GDP up to 2050, with a resultant fiscal gap (deficit) of 2.75% of GDP.

The most recent state government IGR was issued by the NSW government with its 2011/12 budget in June 2011.[7] It projected a fiscal gap of 2.8% of Gross State Product (GSP) by 2050, since revised to 1.8% of GSP (currently equivalent to 0.6% of Gross Domestic Product (GDP)). Other states have not recently produced IGRs. There is therefore no long-term fiscal gap estimate for the Commonwealth and states combined, though it would certainly be desirable to have one. All that can be said is that such an estimate would be larger than the Commonwealth figure, but it is not clear by how much.

On the basis of the Commonwealth IGR alone, it is possible to say that total general government spending as a percentage of GDP would rise from its current level of around 36% to slightly above 40%, and that the tax burden would have to rise commensurately if the fiscal gap is to be avoided and public debt is not to rise from current levels. However, as explained in Box 2, if early action is not taken to close the projected fiscal gaps, debt will rise and government spending, including the interest on public debt, would be higher still—in the low 40s as a percentage of GDP.

The time profile of the projected fiscal gaps is such that they will not become significant until well into the next decade, giving some breathing space for reforms to head off the problem. However, IGRs seriously understate the potential for future budget shock because they are based on existing policies and do not allow for the introduction of new programs or the expansion of existing ones. The spending growth reflected in IGRs only reflects changes in fiscal 'parameters' such as demographics.

This is not a criticism of the IGR methodology, which has a limited purpose, but it does draw attention to the methodology's limitations as a realistic guide to the long-term future. Given that new programs and policies have been very important in driving government spending growth in the past, the potential exists for the same to happen in the future. In fact, new policies have already been introduced since the Commonwealth's 2010 IGR, and many more are at various stages of proposal or development. The cost of these polices will occur over and above IGR projections, and will begin to accumulate as soon as the next few years.

Box 2: What the *Intergenerational Reports* tell us

The *Intergenerational Reports* project government expenditure and revenue many years into the future assuming that existing expenditure policies continue unchanged. Typically, revenue is assumed to remain unchanged as a proportion of GDP, while expenditure is projected on the basis of expected changes in demographic and other relevant variables.

Projected expenditure exceeding revenue is termed a 'fiscal gap.' This is different from a budget deficit because the intergenerational projections are made only for primary expenditure, which excludes interest expense on any borrowings. This methodology is valid if the purpose is to illustrate the size of the adjustment in primary expenditure or the revenue needed to avoid the gap projected 40 years ahead. But if the adjustment is not made, then deficits, borrowings and interest expenses will cumulate, and the budget deficit at the end of the projection period will be much larger than the primary fiscal gap.

The Commonwealth's 2010 IGR estimates that if action is not taken to close the projected fiscal gap, the accumulation of deficits and debt will result in an additional interest bill that will blow the budget deficit out to 3.75% of GDP in 2050. The extra interest burden represents the cost of delaying action. Under this scenario, Commonwealth net debt would rise to 20% of GDP by 2050, and gross debt would be more than 30% of GDP, and rising rapidly.

NSW's 2011 IGR states that if measures are not taken to close the state's fiscal gap, the net debt of the general government sector will rise from 2.3% of GSP to an unsustainable 119% of GSP by 2050.

New pressures for bigger government

Despite the warnings sounded by IGRs, little has been done in the way of pre-emptive policy action to close the projected fiscal gaps. The gap projected in the 2010 Commonwealth IGR was only slightly smaller than in the 2007 IGR. By drawing attention to the problem, the reports can probably be given credit for policy changes such as those to contain the projected cost of the Pharmaceutical Benefits Scheme (PBS) and increase in a phased manner the eligibility age for the age pension to 67. These are the kinds of policy changes needed to secure fiscal sustainability, but there have been far too few of them to date.

The short-termism of politics is crowding out long-term imperatives, leading to a widening, not narrowing, of the long-term fiscal gaps.

Meanwhile governments have been introducing new programs and enlarging the cost of existing ones, so the wish list of new ways to spend taxpayers' money keeps growing. The short-termism of politics is once again crowding out long-term imperatives, leading to a widening, not narrowing, of the long-term fiscal gaps. Examples of costly new initiatives in the 10 years before 2010 include indexation of pensions to average weekly earnings, large increases in family tax benefits, and a large one-off increase in pensions in 2009. A lot more has happened since the 2010 IGR. Although Commonwealth budgets are now more focused on eliminating the deficit, with net policy changes improving the future budget bottom line, this was only a recent change in emphasis and it remains to be seen how long it will last. Moreover, some of the recent savings measures have merely deferred spending, which is of no benefit to long-term fiscal sustainability. Beyond that concern, there are other known and potential future budget policy costs and risks that post-date the 2010 IGR projections, as detailed in Box 3.

Box 3: New spending since 2010

- The **National Disability Insurance Scheme** (NDIS) has been adopted as government policy and is to commence as a pilot program in 2013. The Productivity Commission estimated in 2010 that when the scheme is fully operational in 2018–19, it will cost $6.5 billion (at 2009 prices) a year over and above the existing $7 billion annual cost of disability support services. More recently, a report by the government actuary has raised the incremental cost to $10.5 billion at 2018–19 prices and put the gross annual cost of the scheme at $22 billion. The great bulk of this cost lies beyond the horizon of current government budgets. It is not known how it will be distributed between Commonwealth and state budgets, and nobody in government or opposition has explained how it will be financed, notwithstanding their in-principle support.
- The **National Injury Insurance Scheme** (NIIS) is a companion to the NDIS. The NIIS is estimated to cost about $1 billion a year above current arrangements. This cost will be spread unevenly across the states because some states already have schemes that do much of what the NIIS will do.
- The **Superannuation Guarantee Charge** (SGC) is being gradually increased from 9% to 12% over the next nine years, and the Gillard Labor government has introduced a low-income tax rebate for superannuation contributions. By 2020, these two measures will be costing almost $5 billion a year in foregone revenue. According to the government, this loss will be offset by the minerals resource rent tax (MRRT), but the revenue from that tax is subject to much uncertainty. The opposition has pledged to abolition the MRRT but retain the superannuation measures.
- Under the **community workers equal pay award** of 2012, large increases in community workers' pay are being phased in up to 2020. Although this award was not a government initiative, the Commonwealth and some state governments enthusiastically supported the union claim. There are no reliable estimates of the cost once the award is fully implemented, but it is likely to be billions of dollars a year, part of which is reflected in the cost of the NDIS (see above). Much of the cost of the award will fall on Commonwealth and state budgets in the form of increased grants to community organisations. Little of the cost has been reflected in government budgets to date. The Commonwealth has promised $3 billion spread across the entire eight-year phase-in period.
- The government is reportedly considering a subsidy of $1.4 billion a year **to the child care industry** to help cover the cost of a pay award.
- In April 2012, the government announced an **aged-care reform package**, including new spending and some offsetting savings from within aged-care programs. The net cost of the package when fully implemented in 2016–17 will be around $0.4 billion a year.
- The **Gonski report on funding of school education** in 2011 recommended a permanent addition to government spending of $6.5 billion a year (at 2012 prices). Although the Gonski funding model has been accepted by the government, the funding implications are not yet clear, but it appears certain that there will be an increase in education spending, if not the full $6.5 billion.
- In **higher education**, the federal government deregulated university student admissions in 2010 without increasing the grants to universities. This has created an unresolved tension between the Commonwealth and the universities, which are now admitting more students.
- The Gillard Labor government's 2011 **paid parental leave scheme** costs about $0.5 billion annually. Opposition leader Tony Abbott has promised a much more generous scheme that would cost some $4.5 billion a year and be funded partly by a 1.5% 'levy' on businesses earning profits of more than $5 million. Although described as a 'levy,' it is simply a targeted increase in company income tax.
- Social welfare organisations are asking for a large increase in the **Newstart Allowance and/or Youth Allowance**, both of which have been subject to lower indexation arrangements than other welfare payments for many years. The suggested $50 weekly increase could add around $1.5 billion a year to Commonwealth spending.

Some of the recent savings measures have merely deferred spending, which is of no benefit to long-term fiscal sustainability.

- There is also pressure to extend Medicare to include **dental care**. The government has recently announced new spending in this direction of some $4.7 billion (most of it after 2012–13) spread over a number of years and targeted at youth and low-income groups. The cost of a broad dental care scheme would be several billion dollars a year. Although the recently announced scheme is for a finite period, there will be strong pressure to extend it indefinitely or introduce an alternative.
- In the 2012–13 budget, the federal government introduced a package of measures labelled 'spreading the benefits of the boom'—including a **new 'schoolkids' bonus, a new income support supplement, and increases in family tax benefits**—costing $2.1 billion a year when fully implemented. The cost is partly offset by abolishing the education expenses tax rebate.
- **Compensation for the carbon tax** is intended to be budget neutral. Revenue from the carbon tax will be about $9 billion a year initially; households and industry will each receive compensation and assistance of around $4.5 billion. The risk to the budget is that carbon tax revenue may fall after 2015, when the current fixed price scheme is linked to the European carbon permits trading scheme. This will reduce revenue and add to the budget deficit in future years unless the existing compensation and assistance is reduced, which would require increases in income tax and cuts in social security benefits that the government is hardly likely to impose. The opposition has pledged to abolish the carbon tax, but it is not clear whether it would also abolish all the offsetting household and industry assistance. If elected to government, the opposition plans to intervene directly to mitigate carbon dioxide emissions in lieu of the carbon tax or carbon permits trading. These direct interventions and their administration will involve a cost of unknown magnitude to the budget.
- The federal government created the **Clean Energy Finance Corporation (CEFC)** in 2011, and will give it $2 billion every year for five years beginning in 2013–14. Under accounting rules, the measured cost to the budget is smaller. The financing activities of the CEFC will create a contingent liability on future budgets.
- The **National Broadband Network Corporation** (NBN) is classified as an off-budget government trading enterprise. While it enlarges the overall public sector, it does not enlarge the general government sector. The Commonwealth budget is providing more than $20 billion of equity to NBN and the government is borrowing this money to make the investment. These financing operations are classified 'below the line' in the budget and do not affect the recorded budget deficit or expenditure.
- **Border protection** is becoming increasingly costly. The recent report of the expert panel on asylum seekers included recommendations that, if accepted by government, would add $1 billion a year to recurrent costs as well as one-off capital costs.
- **Defence spending** has been cut back substantially below the path set in the defence white paper of 2009, partly by deferring equipment purchases. If the previously set path is to be restored, there need to be very large increases in defence spending beyond the current forward estimates. As the IGR had already assumed implementation of the white paper, there will be no additional strain on the long-term projections, but there will be severe consequences for budgets towards the end of the current decade. The government's revised plans will become clearer in the new white paper due in 2013. Just restoring defence spending to its level relative to GDP in 2009–10 (1.9% of GDP) would cost an extra $6.7 billion a year.

Not all these costs will necessarily materialise, and some of them will be shared between the Commonwealth and the states. If we set aside the question of how the sharing is resolved, the menu in Box 3 could easily add approximately $28 billion a year (at today's prices) to the total Commonwealth and state spending base of 2010 by the turn of the decade, as shown in the following table.

While the list of new commitments grows, some offsetting savings have been announced. However, permanent savings from expenditure programs—as distinct from deferrals and revenue increases—have not been large.[8]

The above tabulation concentrates on the risks of increased expenditure, but there are also risks on the revenue side. As well as the usual general risks from

It would be dangerous for the government to base spending commitments today on a return of windfall conditions in the next several years.

a weaker economy, there are specific risks in the areas of carbon and mining resource rent taxes, which would make it more difficult for revenue to be maintained at 23.5% of GDP, as assumed in the Commonwealth's 2010 IGR.

Table 1: Potential new costs in 2020

	$ billion
National Disability Insurance Scheme	10.5
National Injury Insurance Scheme	1
School education	6.5
Child care subsidy	1.4
Community workers equal pay award	1.5 (?)
Newstart and Youth Allowances	1.5
'Spreading the benefits of the boom' package	1.3
Aged care reform package	0.4
Dental care	2 (?)
Paid parental leave	0.5
Border protection	1
Total	27.6

Governments and oppositions should concentrate on extracting greater value and effectiveness from existing spending.

Approximately $28 billion a year in additional costs represents around 2% of GDP. As these costs mostly lie well beyond the current budget forward estimates, it is difficult to assess their implications. In attempting to do so, one might consider two time horizons—the year 2020, when the cost would be fully incurred, and the year 2050, which is the 40-year horizon of the last IGR.

By 2020, according to the IGR, the adverse fiscal implications of demographic change will not have been felt. They will come later. If economic conditions are buoyant and the prices of Australia's commodity exports do not collapse, it is possible that enough tax revenue will be generated to make new spending appear sustainable without the need for increasing tax rates. This would be a recurrence of the 2000–10 scenario. For much of that decade, repeated positive revenue surprises for Commonwealth and state governments underpinned rapid growth of spending as well as some cuts to tax rates. However, it would be dangerous for the government to base spending commitments today on a return of such conditions in the next several years. To do so would be to gamble on economic and fiscal conditions eight years from now in a highly uncertain global economic environment. It would also be contrary to the need to use the next several years as a breathing space to lower the spending base in preparation for the longer term effects of ageing.

On the much longer view, by 2050, the increase in spending on items such as those listed in Box 3, on top of the growth projected in the IGR, could take the share of government in GDP to around 43%, and closer to 45% if it were to be debt-financed. Such an expansion would rate as one of the big leaps in the scale of Australia's public sector since World War II and would make Australia more like the bigger-government OECD countries of today. The fiscal gap would be larger than the 2.75% projected for the Commonwealth in its IGR. The deficit would increase if nothing is done to close the fiscal gap, leading to more government borrowing and thus incurring more public debt interest expense. Some of the risks listed in Box 3 represent threats to revenue, which, if they materialise, would make it more difficult to satisfy the IGR assumption that revenue will remain unchanged as a share of GDP.

This figuring is only illustrative as it is not possible to anticipate every government policy change. No doubt there will be much more new spending than the list in Box 3. Putting aside the foregoing 'bottom up' arithmetic, a simpler 'top down' way of viewing the long-term outlook is to note that if government spending grows as rapidly relative to GDP in the next 40 years as it has in the last 40 years, then the size of government would be 45% to 50% of GDP by 2050.

Implications and remedies

Any new spending proposals such as those listed in Box 3 should be assessed on their merits, but that is beyond the scope of this report, whose purpose is to elaborate upon the long-term fiscal projections of the IGR by exploring the financial implications of the new spending initiatives were all of them to be given the green light (some of them already have been). What are the implications for the total level of government spending and therefore the size of government? What do they imply for tax and debt burdens, and for fiscal sustainability?

These scenarios would put Australia on the path to much higher tax or debt burdens or both. There are various ways in which these outcomes can be avoided or ameliorated:

- There may be a surge in productivity growth and/or the terms of trade, which would generate the revenue to finance additional spending without increasing tax rates. However, it would be imprudent to make such large spending commitments that assume such good fortunes in such uncertain times ahead.
- Governments and oppositions could refrain from launching or promising as many new spending initiatives as they have in the past, and concentrate on extracting greater value and effectiveness from existing spending. This would be a welcome change, but one that requires a big change in political behaviour. The community also would need to accept less in the way of new programs and benefits, including ones that have intrinsic merit but are unaffordable at current tax rates and bases.
- There could be a rule that any new spending initiative must be matched by an offsetting saving from an existing program. Governments in the past have applied such rules in particular budgets, but they have invariably been unsuccessful and not sustained over time. In the past, new programs have tended to be loaded on top of existing ones. An enforced rule requiring offsetting savings would replace this incremental process with a sharpened competition for taxpayer funding and force closer scrutiny of the benefits of both new and existing programs. A rule that forces making choices would favour a more efficient allocation of public resources, provided the choices were not based on political criteria.
- The entire budget could be rebased to a lower level of spending through an audit of all existing spending programs. This would create greater fiscal headroom for tax cuts or new spending initiatives.
- Another option is to make greater use of user charges for government services to better reflect their true cost. Citizens could then decide whether they need them or not.

Standards of fiscal discipline would benefit from greater transparency surrounding the long-term fiscal outlook.

The above approaches involve various ways of managing the growth of spending to fit available funding. If these fail, then tax increases will be needed to pay for the projected growth in spending and new initiatives while avoiding an increase in public debt. The increase in the tax burden spread over the next several decades would need to be very large. Tax revenue is currently around 27% of GDP. A rebound from the revenue compression resulting from the global financial crisis will, in time, see this recover to the 30% level that prevailed before the crisis.[9]

However, a tax burden closer to 40% of GDP would be required in the long term to finance the expenditure outlook outlined above.[10] This would require an across-the-board increase in the tax burden of around one-third through increases in tax rates, broadening of tax bases, and cuts to concessions, which would expand the deadweight economic costs of taxation by a large order of magnitude.

Transparency and Credibility

Transparency is conducive to better policy, and public financial management would benefit from greater transparency concerning the long-term prospects for the public finances and the long-term impact of expenditure and tax policy decisions. Four-year forward estimates are of limited benefit in this regard. The risks to fiscal sustainability often lie beyond a four-year horizon and need to be anticipated by current policy. Moreover, governments have learned to 'game' the forward estimates by making policy decisions whose full impact they know to be beyond the four-year horizon.

IGR projections overcome some of these problems but need to be improved if they are to make their full potential contribution to transparency. One problem with the IGRs is that they are prepared infrequently—once every three or four years. Parameters usually do not change enough from year to year to justify more frequent, full-blown revisions of IGRs, but governments are constantly making policy decisions that widen or shrink long-term fiscal gaps. There is no reason why there could not be annual reporting of the net impact on the long-term fiscal gaps of all expenditure and tax policy decisions taken over the preceding year. This should be done early each calendar year to inform annual budget preparation. It would also tell governments and the public whether the government's policy decisions over the preceding 12 months have made the long-term outlook better or worse. This reporting is a requirement of the NSW fiscal responsibility legislation but not of the Commonwealth's. However, the NSW reporting is buried in the budget papers and gets little attention. Reporting separately from the budget (in a Fiscal Sustainability Update) would attract more attention.

Governments have learned to 'game' the forward estimates by making policy decisions whose full impact they know to be beyond the four-year horizon.

Another problem with IGR arrangements is that there is no coordination between the Commonwealth and the states and no picture of the national public sector. Not all states produce IGRs, and those that do produce them have done so at different times from the Commonwealth. The Commonwealth makes its own assumptions and uses its own methodologies, which may well be different from those of a state IGR. There is therefore no information on the long-term outlook for the government sector as a whole, including the Commonwealth and all state governments. The Commonwealth's IGR includes grants to the states on the expense side, but this still leaves it incomplete as a snapshot of the whole public sector. While the Commonwealth and state governments will always have disputes about which level of government should fund particular costs, this allocation issue is secondary to the outlook for the total public sector. To remedy this gap in current IGR arrangements, there needs to be an IGR for the whole government sector.[11]

The third issue concerns which agencies of government should be responsible for producing the IGR. The most obvious answer is that it should be produced by treasuries and finance departments as is the case now, but with the additional dimension of collaboration between the Commonwealth and the states to produce a joint IGR based on common assumptions and methodologies. However, given the closeness of departments to government, there is much to be said for a more independent agency doing the job. One possibility is the Productivity Commission using input from treasuries and finance departments following a similar process to the commission's current annual reports on standards of government service delivery. Another possibility would be to create a new independent fiscal authority to carry out the IGR function and others, as Stephen Kirchner and I have advocated elsewhere.[12]

Calls have recently been made for budget forward estimates to be extended from four years to 10 years. This proposal has merit and is consistent with the proposals detailed above to improve the current IGR process. The IGR does not only provide estimates of the fiscal gap 40 years ahead, but also at annual intervals over the entire period. Ten-year forward estimates (albeit at a high level of aggregation) are therefore imbedded in the IGR process. They would, however, need to be produced more frequently than the current IGR, perhaps as part of the annual Fiscal Sustainability Update suggested above.

Summary and conclusion

The current and much publicised financial and economic problems of the United States, Japan and Europe can be traced in part to their mismanagement of public finances over many years. Government spending has grown to more than 40% of GDP, and in many cases, more than 50%. Although tax burdens have also risen, governments have been unable or unwilling to raise sufficient tax revenue to avoid accumulating large deficits and crippling public debt burdens.

Current IGR practice should be improved by instituting a single, periodic IGR for the Commonwealth and states combined.

Australia is credited with a better record of public financial management, but our public sector is actually not much smaller than 40% of GDP. In light of the experiences abroad, it is a good time to ask whether Australia is headed for the same kinds of problems in the long term that have already beset many other advanced countries. Current budgets, although not heavily in deficit, are of little comfort because it is the long term that matters.

If the trends of the last 40 years are maintained, then Australia is on track for a government sector well above 40% of GDP. Two considerations lend substance to this claim. One is the long-term outlook as painted by the Commonwealth and state government IGRs, which show that even if budgets return to balance or surplus as planned in the short term, a deficit will reappear in the long term under pressure of demographic and other societal changes. The other consideration is that promises and proposals for new government spending are accumulating at an alarming rate. For example, the NDIS will add more than $10 billion a year to government spending before the end of the decade.

Expanding government on the scale projected will add substantially to the tax burden and/or the public debt burden. Either way, there would be a heavy economic price to pay. It would be better to plan to avoid expanding the size of government before these costs arise, for example, by adopting a fiscal rule that requires any new spending initiative to be fully offset by an equivalent saving in existing programs. This will require a much more disciplined approach than in the past.

Standards of fiscal discipline would also benefit from greater transparency surrounding the long-term fiscal outlook. Four-year forward estimates are now heavily 'gamed' by governments, and are no longer good enough as a guide to the longer term. There needs to be more emphasis on the longer term projections contained in the IGRs. Current IGR practice should be improved, however, by instituting a single, periodic IGR for the Commonwealth and states combined, and by each government reporting annually on the long-term impact of its policy changes.

Endnotes

1 See for example Vito Tanzi and Ludger Schuknecht, *Public Spending in the Twentieth Century* (Cambridge University Press, 2000).
2 Carmen Reinhart and Kenneth Rogoff, 'Growth in a Time of Debt,' *American Economic Review* 100:2 (May 2010).
3 Although Spain's public sector is large at around 45% of GDP, the main initial cause of its crisis was the bursting of a housing bubble and associated weaknesses in its banking system.
4 Stephen Kirchner, *Why Does Government Grow?* Policy Monograph 117 (Sydney: The Centre for Independent Studies, 2011).
5 Robert Carling, 'How to Double Government Spending in 10 Years,' *Policy* 27:3 (Sydney: The Centre for Independent Studies, 2011).
6 *Intergenerational Report 2010* (Australian Treasury, February 2010).
7 Budget 2011–12, Budget Paper No. 6, *Long Term Fiscal Pressures Report* (Sydney: Government of New South Wales, 2011).
8 For example, following the 2012/13 Commonwealth budget, I pointed out that of the $33 billion in savings over four years claimed by Treasurer Wayne Swan, more than half came from revenue increases. The expenditure savings of $16 billion summed over four years not only relied heavily on deferrals, but were exceeded by new spending initiatives announced in the 2012/13 budget alone, including the new 'schoolkids' bonus. See Robert Carling, 'Another boost for the welfare state,' *Incise* blog (9 May 2012).
9 Recent statements by the Secretary to the Treasury have questioned this assumption. However, the 2010 IGR assumes that Commonwealth tax revenue will gradually recover to its post-GST average of 23.5% of GDP by 2019–20. The balance of the 30% would be made up by state and local government tax revenue.
10 Spending is also financed by non-tax revenue, which is currently around 6% of GDP.
11 This IGR could show the results for the Commonwealth and the states separately, as well as for both levels of government combined. Local government probably does not need to be included because its expenditure is not subject to the same demographic influences as the other levels of government.
12 Robert Carling and Stephen Kirchner, *Fiscal Rules for Limited Government: Reforming Australia's Fiscal Responsibility Legislation,* Policy Monograph 98 (Sydney: The Centre for Independent Studies, 2009).

THE CENTRE FOR INDEPENDENT STUDIES

Issue Analysis (ISSN:1440 6306) is a regular series published by The Centre for Independent Studies, evaluating public issues and Government policies and offering proposals for reform. Views expressed are those of the authors and do not necessarily reflect the views of the Centre's staff, advisors, directors or officers. Issue Analysis papers (including back issues) can be purchased from CIS or can be downloaded free from **www.cis.org.au**.

The Centre for Independent Studies | PO Box 92, St Leonards, NSW 1590 Australia | p: +61 2 9438 4377 | f: +61 2 9439 7310 | cis@cis.org.au