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The economic challenges ahead for government

The re-elected government faces a long list of economic challenges, some of them created or exacerbated in its first term. This CIS review discusses some of the major challenges: budget repair; fiscal reform; productivity growth; and housing.

BUDGET REPAIR – Robert Carling

The last time the federal budget was close to balance with expenditure and revenue matching was just before the pandemic, in financial year 2018-19.

Since then, the budget has fluctuated wildly: first into deficit during the pandemic, peaking at $134 billion; then into surplus for two years after the pandemic, peaking at $22 billion; and now back into deficit.

By the government's own latest reckoning (in its March budget), the budget has now settled into a pattern of entrenched deficits of $30–40 billion — (1 to 1.5% of GDP) for at least the next four years — that will be eliminated only slowly, and not completely until 2035-36. And this projection is based on heroic assumptions that make it a truly rosy scenario.

This is not budget repair. The two years of surplus helped, but they were a flash in the pan. Gross debt will exceed $1 trillion for the first time in 2025-26. It will keep increasing in dollar terms and only stabilise as a percentage of GDP (the government's benchmark of success) in three years' time; albeit at the highest level it has been — outside the pandemic years — since the 1950s, and then it was in a steep post-war decline. Treasury projects a gentle declining trend only from about 2030, but again this is a rosy scenario.

This does not position the federal government's finances to cope well with more economic or other shocks to the system — and there are even bigger debt problems in some states and territories.

The government's medium-term projections are meant to reassure, but there are three key problems with them:

- The 'underlying cash deficit' is the government's key metric but it understates the deficit because it omits off-budget spending, which has ballooned. The 'headline' cash deficit is $100 billion larger than the 'underlying' deficit cumulatively this year and the next four. This is feeding into debt.

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- In the current cyclical state of the Australian economy, with low unemployment, elevated inflation, healthy terms of trade and historically high tax revenue, the budget should not be in deficit at all — right now.
- 10 years is far too long to wait for a return to balance. In any case, the 10-year projection lacks credibility. It assumes no more big new spending initiatives, and it relies on income tax bracket creep eroding after-tax pay year after year and taking the overall income tax burden to a record level.

For all these reasons, budget repair must be one of the key performance indicators for the newly elected government, even though politicians brushed it aside in the election campaign.

FISCAL REFORM – Robert Carling

Good fortune has rescued the federal budget before and it could do so again. The budget is very sensitive to global and domestic economic conditions. But it would be irresponsible for the government to rely on good fortune; particularly in today's global economic and security circumstances. The current fiscal challenges call for fundamental reforms to the fiscal policy framework, expenditure policy and tax policy.

The problem with the fiscal framework is that the guardrails that used to keep the budget under control have gone. The Howard/Costello government's Charter of Budget Honesty is still in place but is seen as little more than a legislated nuisance to be met with the minimum of compliance.

The government needs to adopt clear and simple fiscal rules that will apply real discipline

The budget provides a waffling statement of fiscal strategy that goes nowhere near addressing the challenge at hand. The key stated objective — to get the debt/GDP ratio turning down at some point in the next several years — applies little discipline at all.

The government needs to adopt clear and simple fiscal rules that will apply real discipline; such as the old rule that the budget should be balanced (or in surplus) on average over the economic cycle.

For many years, taxation policy has too often been designed for short-term political objectives such as the need for a palliative for cost of living pressures. In other instances, it has opportunistically raised additional revenue from small groups considered to be politically-easy targets — such as the proposed new tax on larger superannuation balances that includes taxation of unrealised capital gains.

Tax reform

Tax reform is needed to lower the overall tax burden (which recent data show was near a record high in 2023-24) and shift the balance away from direct income taxation on households and business. Tax reform can promote productivity growth if the emphasis is on tax changes to improve incentives rather than to redistribute income.

Expenditure reform

We hear calls for expenditure reform much less often, but this is needed at least as much as tax reform. The chronic budget deficit does not reflect a shortage of tax revenue by historical benchmarks, but it does reflect levels of government expenditure that are historically inflated by at least $50 billion a year.

This is the case even with official projections taking a rosy view of future spending pressures and the policy responses we have come to expect from a spendthrift government.

Expenditure reform should have three strategic goals:

- Apply stronger discipline to the decision-making processes for new spending commitments;
- Reduce costs of government administration, which have grown apace in recent years; and
- Review the design of programs (such as eligibility for benefits) particularly in the fastest growing social programs of recent years — the NDIS, health, aged care, education and child care — which account for much of the increase in spending.

The criteria for success should be both a slow-down in the growth of expenditure below the growth of GDP and better effectiveness in achieving stated program goals.

PRODUCTIVITY – Gene Tunny

Treasurer Jim Chalmers has declared the Albanese government will prioritise productivity in its second term. This is necessary. The government's first term saw a significant decline in labour productivity and seven consecutive quarters of declining GDP per capita… a 'per capita recession'. Significant contributing factors were the further skewing of our economy toward low-productivity-growth sectors such as health care and social assistance, and a high immigration-led population growth, leading to 'capital shallowing'.

Nearly half the additional employed people over the Albanese government's first term were in sectors highly dependent on government spending: education, health care and social assistance (e.g. NDIS), or public administration and safety. These jobs can be valuable to the community. But, in many cases, the resources could have been employed more productively in other sectors.

The government's first productivity pillar is "creating a more dynamic and resilient economy". Alas, the government is pursuing this objective in some dubious ways. In its second term, there is a risk it will double down on policies that harm productivity; particularly regarding industrial policy and industrial relations (IR).

The ALP's industrial policy has been marked by significant intervention, aiming to transform Australia into a renewable energy leader and manufacturing hub. This includes targeted support for key industries

> **There is a risk it will double down on policies that harm productivity**

and notable interventions like assistance for the Whyalla steelworks. Despite these measures, manufacturing employment growth remained modest during the government's first term, indicating limited effectiveness. The strategy ignores the advantages of allowing market forces to guide resources towards their most productive uses.

The government's IR policies have harmed productivity by imposing rigidities and reducing flexibility in Australia's labour market (Tunny, 2023). Its reforms targeting the gig economy, casual employment, and labour hire arrangements have introduced prescriptive regulations undermining business efficiency and adaptability. By constraining flexible working arrangements and increasing compliance burdens, these changes discourage firms from optimally matching labour inputs to their production needs, ultimately hampering productivity growth. The best ways for the government to improve productivity include:

- Desisting from actions adverse to productivity in the first place, including the rapid expansion of government-subsidised services and interventionist industrial, IR, and energy policies (e.g. see Hilton, Morrison and Wu 2024);
- Use the savings from lower government spending to support tax reductions or reforms such as indexation of tax brackets to end bracket creep (Humphreys 2019 and Taylor and Carling 2024);
- Improving our education and training system through various strategies identified by CIS researchers over the years, including early screening for numeracy and improving teacher training, among other measures (Norris 2024; Fahey and Joseph 2023); and
- Reviewing and rationalising the myriad regulations that impose costs on businesses and reduce productivity and overall economic activity (Tunny and Scott 2020).

HOUSING POLICY – Dr Peter Tulip

A large body of research finds that planning restrictions limit housing supply and drive up prices and rents. Economists agree the way to make housing more affordable is to allow more building. This is largely a state government responsibility. However, there is a lot the federal government can and should do.

Canberra needs to publicly support state reforms, especially in NSW and Victoria; the states with the most ambitious agendas. There is widespread community misunderstanding of housing policy. Many voters do not understand the laws of supply and demand, so public education is needed. The federal government should use its large megaphone.

National Cabinet has set a target of 1.2 million new homes by 2029, reflecting a balance between ambition and feasibility. However, having announced a good housing target, the federal government has done very little to back it up with action.

The government's housing policy in its first term was preoccupied with symbolic gestures: the Housing Affordability Future Fund; Help to Buy; Build to Rent and so on. These demonstrated empathy but boosted construction by only a few tens of thousands of dwellings each — barely making a dent on the national target.

A more effective policy would be to redirect infrastructure funding to remove supply bottlenecks. The government does not need to build new housing — the private sector is eager to do that. The government just needs to get obstacles out of the way. Relatively modest expenditure on sewerage, roads and other infrastructure has the potential to unlock hundreds of thousands of new homes.

Canberra should also do more to enhance state government incentives. The $3 billion New Homes Bonus (which will pay states $15,000 for each dwelling completed within certain thresholds) is a good idea, except it is not payable until 2029. It would increase incentives more if payment was made as soon as homes are completed. Incentives could be further improved, in a revenue-neutral manner, if the Grants Commission allocated a larger GST distribution to states that build more.

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The measures above would boost housing supply. Unfortunately, the government also promised in the election campaign to guarantee loans to first home buyers. This policy will encourage reckless borrowing. It will also boost demand, putting upward pressure on prices. That will simply further increase the need for measures that boost supply.

About the Authors

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Gene Tunny is an Adjunct Fellow at the Centre for Independent Studies, Director of Adept Economics and a 1997 CIS Liberty and Society alumnus. He is a former Australian Treasury official who has managed teams in Treasury's Industry and Budget Policy divisions. In addition to a wide range of domestic and international consulting projects, Gene has led several courses for foreign officials as part of University of Queensland International Development teams.

Dr Peter Tulip is the Chief Economist at the Centre for Independent Studies. He came to CIS from the Reserve Bank of Australia (RBA) and was formerly at the Unites States Federal Reserve. His focus is on housing affordability and monetary policy. He is also a contributor to the ANU's 'Shadow RBA Board' and a sought-after media commentator on housing and Reserve Bank reform.

Related Works

Robert Carling, *'The Truth About the Tax Burden'*, CIS Policy Paper 56, April 2024.

Robert Carling, *'The National Conversation on Budgets, Spending and Tax',* CIS Policy Paper 49, March 2023.

Robert Carling and Gene Tunny, 'Budget Fails Important Policy Tests', CIS Issue Analysis 150, May 2024.

Gene Tunny, 'Gorillas In The Mist. How government obscures its spending', CIS Policy Paper 59, November 2024.

Gene Tunny, 'Riches from Royalties: How Australia's states and territories depend on mining', CIS Policy Paper 61, May 2025.

Peter Tulip, 'Housing Affordability and Supply Restrictions', CIS Policy Paper 55, February 2024.

Peter Tulip, 'Where should we build new housing? Better targets for local councils', CIS Analysis Paper 45, March 2023.

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