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Overview

A federal election is an opportunity to take stock of how Australia is doing, where it's going, and what governments can do about it. This report surveys policy recommendations from seven years of Grattan Institute reports and outlines what the Commonwealth Government should do to improve Australia.

The problems aren't hard to find. Per capita national income has fallen over the last four years as the mining boom subsided. Economic growth is slow, reflecting trends across the developed world. Unemployment stands at nearly six per cent, higher than in the United States and United Kingdom, countries hit much harder by the Global Financial Crisis than Australia. Underemployment also remains high.

Commonwealth budgets haven't come close to balancing for eight years. Interest on the accumulating debt now consumes 4 per cent of government income, or as much as the Commonwealth spends on public hospitals. Younger generations will be taxed more to pay for today's spending. Every $40 billion deficit, the norm for each of the last eight years, forces households aged 25 to 34 to pay an extra $10,000 in tax over their working lives. Our large capital cities have growing pains. House prices are very high relative to incomes. Home ownership is falling for all households aged under 55. Most new housing is far from the city centres where most new jobs are being created. More people spend longer in traffic getting to work. The physical divide between rich and poor is growing.

School education is not keeping up with the best in the world. Test results are well behind international benchmarks, and Australia is slipping down global rankings. Between Years Three and Nine, talented students from poorer backgrounds fall almost two years behind their peers from richer backgrounds.

Our political system is not dealing well with these challenges. Politicians are often creating great expectations that far exceed what government can ever do. Meanwhile, they are failing to act on the things that they can control. The result is an often barren debate that disappoints everyone and makes for a dull campaign. Yet there are many reforms that can contribute to economic growth, improve the quality and reduce the cost of government services, and bring budgets back into balance. A growing evidence base shows which reforms would work.

Progress on this agenda has been underwhelming for a decade, perhaps because the prosperity of the mining boom sapped the will for reform. The politics of reform is never easy. Vested interest groups, emboldened by success, are more vocal in protecting their interests. Meanwhile the public interest has few friends. Ironically, though, the public seems to be up for reform. Surveys suggest that people understand the need for budget repair, and are even prepared to contemplate slaying sacred cows such as negative gearing.

Our politics can implement this reform agenda by using the evidence that has been assembled, robustly articulating the public interest, and staring down interest groups. Australia has a proud history of enlightened public policy. Many countries would be delighted to swap our problems for theirs. Australia can continue to be the lucky country. But we must make our own luck.

1 Economic growth priorities

Box 1.1: Summary

Improving the efficiency of Australian taxes could provide a big kick to economic growth. In particular, the Commonwealth should encourage the States to replace stamp duties by general property taxes.

Lifting workforce participation rates for women and older workers could boost economic growth, and counter the ageing of the workforce. The Commonwealth should ask the Productivity Commission to assess combinations of tax, transfer, and childcare support that would reduce welfare traps and encourage higher female labour force participation for a given budgetary cost. The Commonwealth should also raise the age of access to the Age Pension and superannuation to 70 years.

Government should remove inappropriate impediments to flexibility in the economy, so that resources can be swiftly reallocated to their highest value uses as conditions change. Government should remove barriers to innovation, but should not waste money in its name. Removing barriers to the local spread of global innovations is likely to make more difference to economic growth than subsidies for Australian inventions.

With many of the economy-wide reforms already completed, industry-specific reforms – especially in sectors such as superannuation – may well comprise the bulk of the productivity increases that government reform can achieve.

1.1 Scope

This report aims to help the next Commonwealth Government to set priorities for reform. Drawing primarily on work published by Grattan Institute over the last seven years, it identifies policy changes that the Government should adopt to make the most difference to the lives of Australians.

The report considers reforms to increase economic growth and reduce budget deficits. It discusses reforms to policy for tax and budgets, cities, transport, energy, school education, higher education and health. Grattan Institute has focused on these because they make a big difference to the lives of Australians, because analysis can chart a path to better policy, and because outcomes are too often driven by vested interests rather than the public interest.

The report does not cover areas such as foreign affairs and trade, immigration, defence and security, law and order, industrial relations, communications, human services, indigenous affairs and the environment. These areas matter, but have not been part of Grattan Institute's work to date.

The report focuses on issues that the Commonwealth can influence directly rather than those that are essentially State responsibilities. It selectively identifies areas where there might be a clear rationale for the Commonwealth to make additional tied grants to the States.[1] These areas include situations where the Commonwealth budget would substantially benefit from State Government reforms.

[1] In this report, "States and Territories" are abbreviated to "States".

1.2 Spending projections

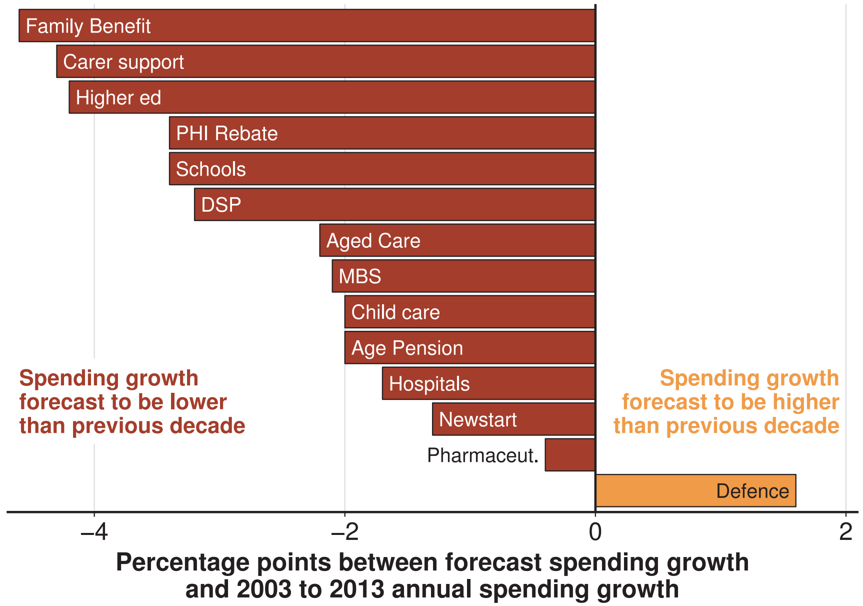
The Commonwealth's spending projections also seem optimistic. They assume tight spending restraint, with government spending falling as a share of the economy (**??**).[2] The projections forecast spending to grow at just 2.6 per cent a year on average between 2014-15 and 2025-26, far below the 3.6 per cent average growth rate of the last decade.[3] Consistent with this spending restraint, the Commonwealth Government forecasts that spending will decline to 24.2 per cent of GDP in 2024-25, below its long term average.[4]

Spending is forecast to be below the historical average in all program areas other than defence, as is shown in Figure 1.1, which compares the projected growth in the Commonwealth's largest spending programs over the next 10 years with the history of the last 10 years.

Some of these estimates seem improbable. For example, it seems unlikely that spending on demand-driven programs such as the **Medicare Benefits Schedule** will moderate without significant policy changes. The PBO attributes the strong historical growth in Medicare payments to policies (such as the Bulk Billing Incentive and the Extended Medicare Safety Net) that have made Medicare services more attractive or accessible. New policy measures such as the freeze in Medicare scheduled fees are forecast to produce lower growth. Yet for more than 20 years the ageing of the population, medical science and technology improvements and rising expectations of the health system have put relentless pressure on the health budget.[5] These pressures will not abate, and the forecasts almost certainly understate them.

The decline in spending growth for hospitals and schools may be credible given the decision in the 2014-15 Budget to limit spending increases

Figure 1.1: Spending forecasts rely on lower growth in almost all major programme areas



Notes: The defence estimates do not factor in the commitment to increase defence spending to 2 per cent of GDP by 2023-24. Rather they are based on the long-term funding commitments made in previous Defence White Papers and government announcements.

Source: PBO (2014)

[2] Treasury (2015, pp. 5–11).
[3] PBO (2015, p. 5).
[4] Treasury (2015, pp. 3–9).
[5] Daley (2014).

to inflation and population growth. This of course does not mean that spending growth will decline in these program areas – merely that the states will have to bear all of the cost of real per capita growth.

The 2015-16 budget assumes even tighter spending growth than have previous budgets. Except for welfare spending, mainly driven by the NDIS, no category is expected to grow materially faster than inflation.[6]

In other programs, lower forecast growth rates are tied to measures from the 2014-15 and 2015-16 Budgets that are unlikely to be passed by the Senate. Therefore spending on the Carers Payment, higher education and Newstart benefits is likely to be more than forecast. Even the forecast growth in defence spending – the only program area where spending is forecast to grow faster than in the last decade – does not put Australia on a path to spend 2 per cent of GDP on defence by 2023-24 as the Government has promised.[7]

Spending projections also assume there will be no new spending initiatives promised at elections or in response to natural disasters or community demands for more assistance to the disadvantaged. Experience over the last decade suggests that such spending restraint will be difficult (**??** on page ??).

Given all the number of things that need to go right, moderating spending growth to 24.2 per cent of GDP in 2024-25 seems extremely unlikely without further explicit budget measures to cut expenditure.

Table 1.1: Approaches to valuing properties for council rates vary
Property value bases that can be used to set council rates in each state

State	Basis for council rates
NSW	Unimproved
QLD	Unimproved
VIC	Either unimproved or capital improved
WA	Capital improved
SA	Either unimproved or capital improved
TAS	Either unimproved or capital improved
NT	Unimproved
ACT	Unimproved

Notes: 'Unimproved' refers to a set of land valuations that capture the value of the land only. 'Capital improved' refers to valuations that capture the value of the land and significant capital improvements made to that land, such as buildings.

Source: Productivity Commission (2008), Mangioni and Warren (2014), and NSW Treasury (2014).

[6] Treasury (2015, BP No. 1, pp. 5–11).
[7] See: Defence (2014, p. 1).

Box 1.2: Impact of limiting negative gearing and CGT tax concessions on house prices

We model the impact of our policy proposal detailed in chapter 5: quarantining rental loss deductions and reducing the CGT discount to 25 percent. Other reforms would have different effects, although they are likely to be similar order of magnitude.

Two different approaches yield similar results. Firstly we calculate the capitalised value of the revenue foregone from the tax changes as a percentage of total residential property value. Secondly, we calculate the change in return as a proportion of property value, and as a proportion of all property owners

The proposed changes to negative gearing would reduce tax write-offs for property investment by about $2 billion initially and $1.7 billion over time. Assuming a discount rate of 5 percent, the present value of these lost tax benefits would be approximately $34.3 billion.

The proposed reduction of the capital gains tax discount to 25 percent would reduce after tax returns by about $3.65 billion a year, or $73.1 billion in perpetuity. Assuming 40 percent of this relates to gains on real estate (in line with 2013-14 gains realisations) then the expected present value of the lost benefits for would be approximately $29.2 billion.

If these lost benefits ($29.2 billion + $34.3 billion) were fully capitalized into the value of residential property – currently worth $5.4 trillion – prices would fall in the order of 1.1 percent.

Table 1.2: Impact of policy changes on after-tax returns

Owner type	Share of property	Return		
		BAU	Proposed	Δ %
Negatively geared	18.0%	7.0%	6.5%	6.1%
Positively geared	7.0%	6.4%	6.0%	6.8%
Ungeared	5.0%	5.8%	5.3%	7.8%
Owner-occupied	70.0%	-	-	-

Notes: Negatively geared property had 80% of the value of the property borrowed; positively geared is 40%.

Alternatively, we can calculate the impact of tax changes on returns as a proportion of asset values for different classes of owners as shown in Table 1.2

Weighting these changes in returns by the share of residential property, suggests the average return (and therefore the price) would fall by about 2 percent. Yet this somewhat overstates the overall price effect because it is based on the change in returns for a representative investor in the top (47 per cent) tax bracket.

Of course, price changes would not be uniform. Prices would fall by more in the segments of the market with more investors (inner city apartments, for example). The change in returns for investors indicates the *maximum* rational price change (about 7.4 percent). However, this would only occur in locations where every prospective purchaser was an investor, and the fall in prices did not attract any owner occupiers. Tax changes would be unlikely to drag on property prices in any location by more than 3–4 per cent.

2 Capital gains tax and asset lock-in

One reason often provided for lower taxes on capital gains is to reduce "asset lock-in". If investors are less likely to realise gains when tax rates are higher than increasing taxes on gains could actually reduce tax collections in the short to medium term. But the empirical evidence of lock-in in not settled. In Australia, the primary driver of asset lock-in appears to be people waiting until retirement to sell their assets. This incentive is still strong even with a 50 per cent discount.

2.1 Why does asset lock-in occur?

Asset lock-in occurs because taxes are only paid when gains are realised. This provides an incentive for investors to hold on to assets with large accumulated gains.[1] In effect, the investor seeks to maintain the implicit interest free loan on accrued gains. Crystallising a capital gain is only worthwhile if an investor can achieve a materially higher return elsewhere, or if they want the resources for consumption (Box 2.1).[2]

Lock-in can discourage investors from moving their money to the investments with the highest pre-tax returns, so assets do not always go to their highest value use.[3] Lock-in effects are most significant from a whole of economy perspective, if they constrain financing of profitable investments.[4]

Australia's open capital markets and generous capital gains tax regime for non-residents, reduce the danger that worthwhile projects will not get access to capital because of lock-in.[5]

1 Burman (2009).
2 Ingles (2009, p. 12).
3 Lindsey (1987).
4 OECD (2006); and Johnson (2008).
5 Non-resident investors in Australian shares are generally not subject to Australian capital gains tax (see: *Income Tax Assessment Act 1936* (Cth), s 136-25).

Box 2.1: Capital gains tax and asset lock-in

The tax treatment of capital gains can deter investors from taking up otherwise profitable investment opportunities.

Suppose Hayley, an investor in the top tax bracket purchases a house for $700,000 and holds it for 10 years. During that time the market price of the house increases to $1,000,000. She makes a net rental return of 5 percent a year, so her final income is $50,000.

If she were to sell the house she would crystallise the $300,000 in gains, paying tax on 50 percent of the gains at her marginal tax rate of 49 percent ($73,500). This would leave her with around $926,500 from the sale: $226,500 in net gains and her initial investment of $700,000.

The sale will only be worthwhile if Hayley can find an alternative property that yields more than her current rental income of $50,000 with the same opportunity for capital gains. With her $926,500 sale proceeds she would need to find a property with net rental return of more than 5.4 percent a year.

Properties with rental yields below 5.4 percent but higher than her current 5 would not be attractive because realising the tax liability on her current property erodes her capital base for investment.

The higher the tax rate on capital gains the less willing she will be to realise gains to pursue new investment opportunities. If capital gains were taxed in full, rather than with a 50 per cent discount, her hurdle rate for the new investment would be 5.9 percent.