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RETHINKING FISCAL SUSTAINABILITY IN A CHANGING AUSTRALIA: SUMMARY DOCUMENT

e61 Institute

Summary

Australia's fiscal settings are not sustainable. The concern is not about excessive debt or the impending risk of a sovereign debt crisis. Instead, it reflects that the current spending and tax system is designed for an Australia with stronger productivity and population growth. This leads to two problems:

1. Government finances are vulnerable to economic shocks and structural trends, with politically feasible budget repair in response to these likely to be inefficient and unfair.
2. Weaker future income growth given current fiscal settings will create an inequitable transfer to current older Australians from future generations.

This document outlines these risks in both economic and administrative terms, and highlights areas for potential reform. Furthermore, we recommend that a reform agenda focuses on **substantive reforms** across a range of interrelated tax and spending policies – rather than attempting piecemeal reform.

Risks to Government Finances

Federal gross debt peaked at 39% of GDP during the COVID-19 pandemic and has since declined to 34%. Including State and Local Government debt (General Government debt), gross debt peaked at 62% during COVID-19, and has since declined to 54%. This level of gross debt to GDP is the highest on record in Australia (going back to FY70/71). And yet it is significantly below the OECD average, or debt levels in the UK or US. Furthermore, although General Government gross debt positions are similar between Australia and New Zealand, our neighbours across the Tasman are projected to have a much larger deterioration in their debt position over the next decade.

Unlike other countries experiencing a sharp increase in expenditures due to population ageing, Australia has partly offset this pressure through a combination of historic policy design, other demographic trends, and luck. These include means-testing of the Age Pension, user-pays elements in health and education systems, high working-age net migration, and the introduction of compulsory superannuation, as well as strong growth in both labour force participation and export prices.

However, fiscal sustainability goes beyond debt-to-GDP ratios. There remain structural challenges that threaten Australia's fiscal resilience, including:

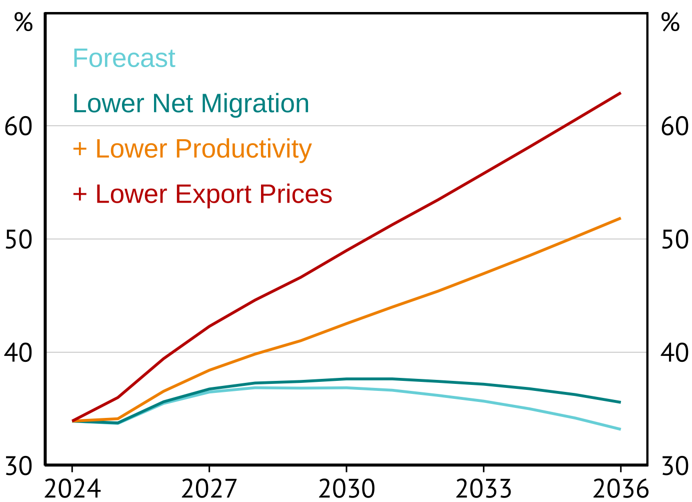
- **External risks:** Accelerated ageing of the Australian population due to declining fertility and lower migration, geopolitical risks regarding international trade and defence, and continued weak productivity growth pose a threat to the fiscal position.
- **Erosion of the income tax base:** Inconsistency in what is taxed and at what rate is limiting the ability of government to efficiently raise revenue from the income tax base. Different tax rates for different sources of income have a double cost – directly surrendering tax revenue from lower-taxed sources and indirectly reducing revenue and economic activity by encouraging the avoidance of higher-taxed alternatives.
- **Growing expenditure:** Rising universalism in government transfers such as child care, aged care and the NDIS – combined with an ageing population – is increasing government expenditure. Furthermore, due to its untargeted nature this higher expenditure is doing less to redistribute to those with low incomes.
- **The role of states:** When combining the fiscal position of the federal government with the states, consolidated expenditure is expected to reach 39% of GDP in FY24/25 – a historically large size of government as a share of the economy.

Current projections from fiscal authorities hide important costs under the surface. Budget balance is restored through the use of bracket creep and an increase in tax to GDP ratios from 24-25% pre-COVID to 27% in FY35. For the average full-time worker in 2025 this would be equivalent to an increase in their tax paid from 20.6% to 23% over a decade. This isn't just unfair but has efficiency costs, with the marginal excess burden (lost economic value from changes in behaviour) from raising this additional revenue from labour income tax instead of GST approximately $11.9bn.

Furthermore, these trends make Australia's fiscal position vulnerable to future economic weakness. For instance, under plausible assumptions — including reducing net migration to below 190,000 per year, a decline in medium-term productivity from 1.2% to 0.6%, and a drop in the price of Australia's major export commodities to their 2016 level — gross federal debt relative to GDP could almost double in the next decade (Figure 1).

Figure 1: Gross debt projections highlight Australia's fiscal vulnerabilities

% of nominal GDP



* Annual net migration declines by 35,000.
** Productivity decline reduces trend growth from 1.2% to 0.6%.
*** Export price decline is a 45% drop from projections, to 2016 levels.
Sources: e61; PBO

This increase in gross debt assumes that there is no economic crisis or external shock that government must respond to. Given the rising prevalence of such events for small open economies like Australia, government should be prepared to meet this greater cost now. Ultimately, assessments of fiscal sustainability should take into account Australia's ability to absorb and spread, through fiscal policy, the future idiosyncratic and systemic risks that will inevitably come along.

Australia's recent fiscal approach has relied on a positive demographic and economic trends – generating fiscal habits that rely on these trends continuing. Without reform, when Australia's luck inevitably runs out on export prices, demographic trends turn sour or the economy faces external shocks and other pressures, the government balance sheet will be in a precarious position.

Short-termism, principles, and the social contract

If these fiscal risks are realised the government will respond with lower spending and an increase in the tax take. However, the quality of those policy changes depend on the way decisions are planned and made.

In recent decades, short-termism and reactive ad-hoc policymaking have limited the ability for governments to undertake large-scale reform that involves long-term benefits. With government unable – or unwilling – to take decisive action to limit spending or reorient the tax system, these growing fiscal pressures will be met by ad-hoc spending cuts and implicit funding from ongoing bracket creep.

Such behaviour is driven by tendencies that pervade social choices:

- **Consumption**: Future taxpayers are under-represented among today's voters, leading to political outcomes that favour present over future consumption.
- **Electoral cycle and principal-agent problem**: Political representatives have shorter time horizons than the community they represent. This principal-agent problem can lead to decisions favouring near-term over long-term results, if information to the broader community is imperfect.

- **Time consistency problems**: Policymakers may favour certain long-term outcomes that their near-term incentives prevent them from achieving.

Beyond concerns about government responses to weak economic performance, decisions made in this way also threaten the intergenerational bargain that has held strong for the last 70 years. The fairness of Australian government finances is predicated on the assumption that because future generations being richer, such that government can always redistribute from them to current generations. If the assumption holds, then this improves the welfare of all generations as each new generation benefits from the next. But that may no longer be true.

In addition to slowing productivity and population growth, the inequity between generations has been exacerbated by other economic trends, including high house price growth and an increase in untargeted transfers to older Australians. These factors do not just redistribute from younger Australians to older Australians but generate greater inequity among cohorts of Australians when some inherit, and some do not.

Any fiscal reform needs to be mindful of the way tax, spending, and debt programs influence the opportunities and burdens of varying generations – and recognise that the structure of such policies was designed in a world where economic growth and future opportunities were expected to be higher than they are.

As a result, future-proofing tax and spending programs in Australia is necessary now to support the wellbeing of current and future Australians. Such reform needs to be based on clear principles for policy change. This will increase the consistency of reform and allow for transparent public discussion about the economic and social trade-offs that the public is willing to make.

Such principles reflect that there is a government budget constraint that depends on the overall size of government that people are willing to fund. In that environment, additional government expenditure always needs to be paired with recognition of the way it will be funded. An honest appraisal of the marginal value of public funds and targeting of the highest value expenditures is essential.

The underlying capacity for government to investment and transfer depends on the nature of the tax system. An efficient tax system is one that minimises distortions to household and firm decisions when raising revenue, and is cheap to administer and comply with. A more efficient tax system generates both the economic and social licence to spend. When paired with equity considerations – namely that those able to pay more contribute more, and those in similar situations are treated the same way – such a tax system will be seen as a fairer way of funding government expenditures.

On both the expenditure and revenue side, reform requires that policymakers step back and take a system view of the government fiscal position. The ad hoc nature of policy change, and status quo bias from the "no losers" rule of setting individual policies, has led to situations where spending and expenditure decisions have varied from best principles. This reduces economic output, generates unfair tax burdens and receipt of government support, and leads to an increased public perception that the government budget is about hand-outs rather than a social contract that also obligates some responsibilities.

Direction for a reform agenda

While more work is needed to understand the trade-offs (political and economic), the following tax and spending policy reforms should be considered to future-proof government tax and spending:

- **Tax policy reforms**:
  - Broaden, and increase the rate of, the Goods and Services Tax.
  - Make consistent the tax treatment of capital income (including capital gains and human capital), trust income, and earnings from and into superannuation.
  - Reform Australia's corporate tax regime given the high marginal excess burden of corporate taxation and disincentive effect on foreign direct investment.
  - Reform to the level and composition of capital taxation to reflect a changing economy.
- **Spending and structural reforms**:

- Introduce or improve means testing of a number of Australia's in-kind programmes (e.g. the NDIS, child care, aged care).
- Increase access to superannuation savings and reform Higher Education Loan Program (HELP) repayments to improve access to liquidity for early career Australians.

- **State-Commonwealth reforms**:
  - Adjust the equalisation of GST revenue transferred between States.
  - Establish State government administration of certain in-kind or income transfer programs.
  - Incentivise a switch in State funding from distortionary stamp duties to land taxes.

These are not recommendations. Instead, they reflect potential areas of reform that relate to existing trends in the Australian economy and warrant further investigation. More specific policy options are highlighted in the Twelve Fiscal Issues document.

These reforms have been highlighted in the past (to differing degrees) but have not been truly considered in the political debate. To practically achieve these kinds of principle-based reforms, changes to the machinery of government may be required to overcome short-termism and ad-hoc policy making. Potential avenues that should be explored are:

- Changing the time horizon of policy costings and benefit estimates.
- Moving responsibility for key forecasting roles and reports to an independent agency.
- Holistic reporting on key fiscal metrics and a regular independent assessment of fiscal performance against stated goals.

Incremental reforms to the machinery of government help to build the political will and public education necessary for reform. However, it should be seen as a mechanism rather than a replacement for principled policy reform itself.

Reforms are politically costly to introduce, irrespective of the size or scale of the reform. Given the existing web of interrelated and imperfect fiscal policies, we have come to the view that **substantive holistic reform to tax and expenditure settings** is more feasible than incremental shifts. Individual policy changes will have winners and losers – but a larger policy program increases the opportunities for policy change that balances the effects across groups while boosting efficiency and fairness.

Twelve Fiscal Issues

The need to future-proof government finances is highlighted through twelve key fiscal issues stemming from economic change and unprincipled policy settings in Australia. As technology, climate and geo-political risks continue to evolve, each of these issues reflect a unique set of risks to the Australian economy and society.

Below we summarise twelve fiscal issues in Australia that generate tangible risks to the fiscal position, and suggest potential directions for reform (remedies).

Twelve issues