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# RETHINKING FISCAL SUSTAINABILITY IN A CHANGING AUSTRALIA: FISCAL SUSTAINABILITY REPORT

e61 Institute

## Fiscal Sustainability: Problem Definition

Fiscal sustainability can mean different things to different people. Concerns about sustainability reflect the **amount of debt** (both current and forecast), the **efficiency and equity implications** of tax and transfer changes, and the **intergenerational allocation of that debt**.

Government spending has risen as a share of the economy since the beginning of the 21st century and is expected to continue rising. Our tax and transfer system, federal financial relations, and overall productivity growth have not kept pace with the changing needs of the Australian economy, increasing the cost of these fiscal pressures. The cost of inaction will grow further over time.

In this context, sustainability concerns are not just about deficits or debt, but about how well our fiscal system can adapt to long-term economic, demographic, and environmental shifts. In this document, we outline policy areas where there are potential future sustainability concerns.

Overall, the **amount of debt** is not a concern at present – and although certain economic risks could worsen the fiscal position, this alone does not represent a concern.

Instead, the risk is how governments respond to a deteriorating fiscal position. Australia has a tax and expenditure system designed for a higher-growth economy. In a world where population and productivity growth are weaker, the fiscal habits and rules developed will lead to a growing government and increasingly inefficient tax revenue collection. Our fiscal habits thus generate **efficiency and equity** concerns, and reforms to these systems are needed.

However, these concerns are not just about the here and now. The same fiscal habits driving a larger government funded by a narrower tax base also generate **unfair intergenerational transfers** – where current workers are responsible for the liabilities of older generations.

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# 1. Government Budget Projections

### 1.1 The Current Budget Path

The pre-election Federal Budget showed that the government cash balance has again fallen back into deficit, amounting to 1.0% of GDP in FY24/25. However, due to recent surpluses and economic growth, gross debt has declined from 39% to 34% of GDP since the COVID-19 pandemic.

Deficits are forecast to continue over the next ten years, decreasing in size each year before becoming neutral in FY35/36. Estimates of the structural budget position highlight that the forecast deficits are not driven by cyclical factors. Gross debt is forecast to increase over the coming five years, before moderating and declining to below current levels. This forecast allows for certain economic risks (e.g., the Conservative Bias Allowance), the projected ageing of the population, and a historically conservative forecast path for export prices.

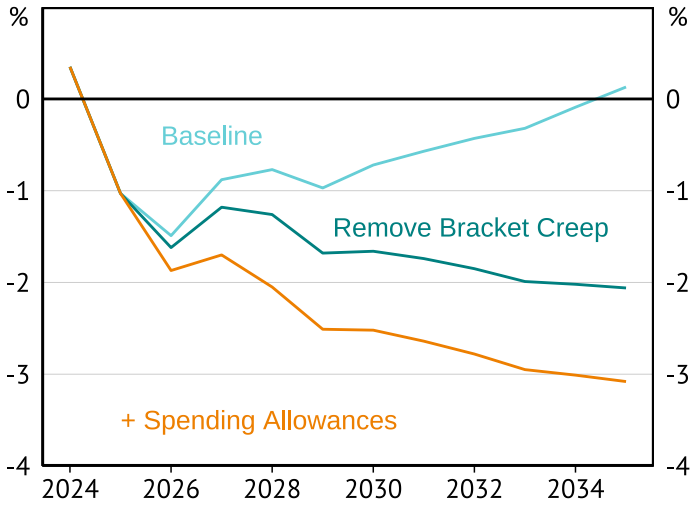
Parliamentary Budget Office (PBO) (2024) estimates indicate that gross debt will stabilise around 30% of GDP. Although this would be higher than at any time in Australia between 1972 and 2019, this is still low relative to the rest of the OECD and well below the 190% sustainability cap estimated in Warshawsky and Bokhua (2024) based on continuing low nominal interest rates. In this context, current fiscal concerns are **not about near-term solvency**.

Instead, concerns about fiscal sustainability reflect both **risks to future government income and expenditure** and how current policy settings, such as indexed spending and un-indexed revenue, incentivise **poor short-term policy responses in a changing economic environment**. These play out in potential costs in terms of **efficiency and equity** at a point in time, and unfair **intergenerational transfers**.

For example, bracket creep plays a vital role in restoring a balanced budget in current government projections. The PBO estimates that the deficit would increase to 2% of GDP if bracket creep was returned (Figure 1).

For the average full-time worker in FY24/25, bracket creep would **increase the average tax rate paid from 20.7% to 23% by FY35/36**. However, providing an allowance for bracket creep would see gross debt rise to 41.2% of GDP by FY35/36 under the status quo.

**Figure 1: Bracket creep restores balance**
Deficit % GDP, Financial Year




* Underlying Cash Balance as a % of Nominal GDP.
Source: PBO

Furthermore, if bracket creep was used to fund a larger government (e.g., 28% of GDP), then average tax rates on this individual would need to rise further to 24.1% by allowing fiscal drag to occur until FY39/40. This would push the average full-time worker into the second-highest tax bracket.

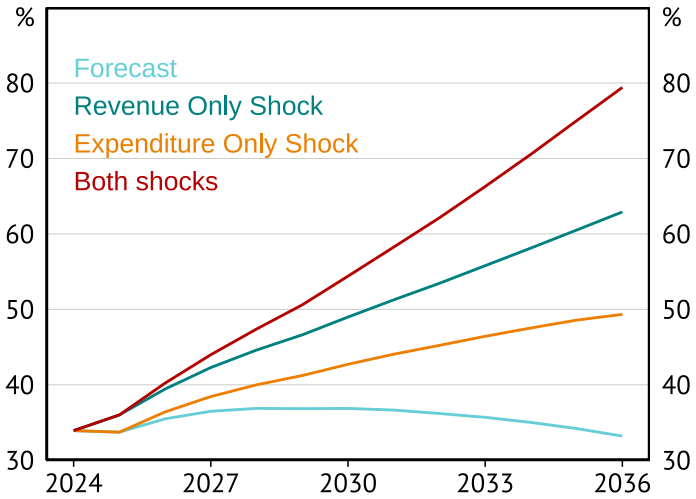
Over the past 25 years, surging export prices, a favourable demographic dividend, and rising labour force participation all boosted government revenue. But we can't rely on favourable luck forever. Without structural improvement, the government balance sheet will be in a precarious position when the luck runs out and may not be able to handle negative external shocks.

So, what are some key downside risks over the next two decades?

- **Revenue risks:** Lower net migration, continuing weak productivity growth, and a decline in export prices.
- **Expenditure risks:** Pressure to increase defence spending, cost over-runs in government programs (e.g. NDIS), and higher interest rates on government debt.

Many of these are discussed in more detail below, as well in the 2023 Intergenerational Report (Commonwealth Treasury, 2023) and e61-UNSW Policy Partnership report (e61-UNSW Policy Partnership, 2025). Following Vass and Wong (2025), we can use the PBO *Build your own Budget* (2025) tool to show how the combination of these risks could lead to a significantly worse fiscal trajectory (Figure 2).

**Figure 2: Gross debt scenarios show fiscal risks**
% of nominal GDP



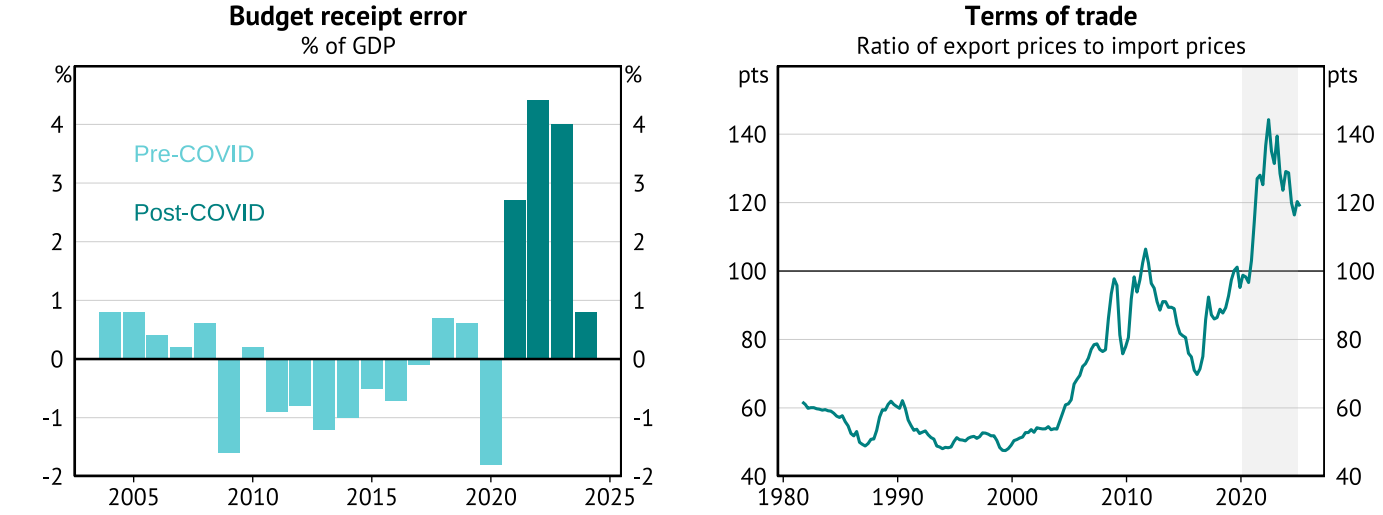

* Expenditure shock includes higher defence, NDIS, and interest spending. Revenue shock includes decline in net migration, lower productivity, and a decline in export prices.
Sources: e61; PBO

The government of the day will respond to these shocks to prevent an excessive deterioration in the budget position. However, without a framework and clear tools they are likely to use arbitrary tax increases (such as bracket creep) or ad hoc spending cuts to do so.

### 1.2 Revenue shocks and the Budget position

Since COVID there have been persistent large upside revenue surprises in the Federal Budget (Figure 3) – with strong labour market participation, high inflation, and a surge in commodity export prices all contributing factors.

**Figure 3: Post-COVID revenue surprise**




Sources: ABS; Budget 2025; e61; Treasury

The surprise lift in revenue has seen the ratio of government revenue to nominal GDP rise to 26.3%, the highest ratio since FY2000/01.

Compared to the Budget projections there are three main revenue risks that could credibly play out: lower net migration, continuing weak productivity growth, and a sharp decline in the terms of trade. Each of these risks could reduce growth in nominal GDP and drag down government revenue.

The drivers of **potentially weaker productivity growth** are outlined later in the document, however current government projections of 1.2% p.a. productivity growth are high relative to the recent experience of the Australian economy.

Reducing productivity growth to 0.6% p.a., which is in line with productivity growth in the five years prior to COVID, would lead to gross debt rising to 45% in FY35/36.

Australian Taxation Office (2024) figures indicate that commodity exporters (alongside utility companies) account for around 20% of corporate income and 45–55% of corporate tax revenue in a given year.

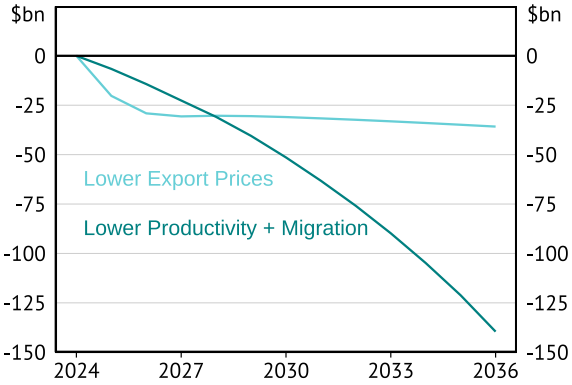
However, there is considerable uncertainty regarding how long commodity prices can remain this high, especially with the direct and indirect effects of tariffs reducing the price that Australian producers receive for these commodities.

A tariff induced interruption to trade could lead to a **sharp reduction in commodity prices**. A 41–44% reduction in hard commodity prices (i.e. coal, iron) back to their 2016 level would reduce tax revenue by 2.8% relative to projections.

Combining this export price drop with a plausible reduction in medium term net migration below 190,000 p.a. (from current projections of approximately 225,000 p.a.) and a decline in medium term productivity growth to 0.6% p.a. (from 1.2% p.a., and including a corresponding drop in wage growth) would significantly reduce revenue. Although the effect of commodity prices dominates in the short-term, the compounding effects of lower productivity and population growth become dominant through time (Figure 4).

**Figure 4: Productivity dominates long-term revenue deterioration**

Revenue decline attributed to a shock

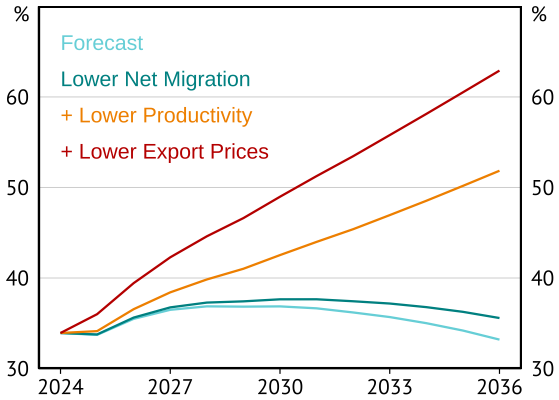



* Export price decline is a 45% drop from projections, to 2016 levels.
** Productivity decline reduces trend growth from 1.2% to 0.6%.
*** Annual net migration declines by 35,000.
Sources: e61; PBO

Overall, Figure 5 illustrates that these revenue changes would see gross debt rise above 60% of nominal GDP by FY35/36 under current spending and revenue raising settings.

**Figure 5: Gross debt scenarios**

% of nominal GDP




* Scenario reduces net migration and productivity, alongside lower real wage growth to match. Terms of trade shock reflects a 45% decline in key export prices.
Sources: e61; PBO

Gross debt levels would continue to rise in later years in these scenarios – with population ageing and a rising interest burden putting increasing pressure on Federal government finances through the 2030s and 2040s.

### 1.3 International risks

Even without a drop in commodity prices, there is a separate risk regarding whether international tax settings will continue to allow the return on these commodities to be taxed in the source jurisdiction.

The Trump tariffs have made this risk apparent. As argued in Nolan (2025) the nature of US tax policy may be a shock that puts the global economy on a path to **destination-based taxes**. Such taxes would substantially reduce tax revenue in Australia – with IMF (2019) estimates indicating that Australia would lose 40% of its corporate tax revenue irrespective of whether the country replicates new rules overseas or continues to tax on an origin basis.

More generally, government support following economic and social shocks is becoming more prevalent. This gradual trend was exacerbated during COVID-19, with the various support provided totalling almost 17% of GDP.

Such an increase in government support could be due to either a greater frequency of external shocks (i.e. due to climate change) or a change in the nature of the policy process where governments are more likely to intervene during a crisis. Either way, the fiscal cost of crisis management in a small open economy is rising as highlighted in the consultation for the long-term

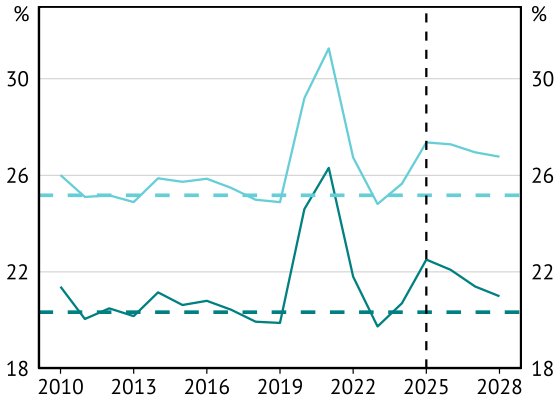
insights briefing by the New Zealand Treasury (2025) – these estimates suggest **an allowance of 1% of GDP** should be made for such crisis relief per year, combining both expenditure and revenue risks from such shocks.

### 1.4 Trends in Expenditure

Concerns about fiscal sustainability are not necessarily about debt – and may instead reflect **concerns that the size and scale of government spending** will increase beyond a level that is politically sustainable in Australia.

**Figure 6: Federal expenditures**

Spending as a % of GDP




* Core expenditure excludes interest and transfers to States and Local governments.
** Dashed lines reflect the pre-COVID average of the category.
Sources: e61; PBO

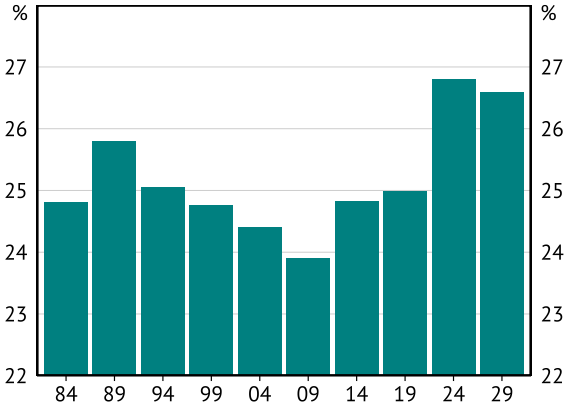
Over the past 20 years, growth in core Federal Government expenditure (excluding interest, contingencies, and transfers to States and Territories) has arguably been restrained, remaining near 20% of nominal GDP outside of the COVID period and the most recent Budget year. Projections show expenditure declining back to this level over the next five years as shown in Figure 6.

Including interest, contingencies, and transfers to local and state governments does lead to a more persistent increase in Federal government expenditure to GDP – with total expenditure approximately 2ppts of GDP higher than its pre-COVID average by FY28/29.

Taking a longer-term perspective, post-Global Financial Crisis expenditure had already been higher – as a share of national income – than Australians were previously accustomed to (Figure 7). We have stumbled into a situation where government spending is structurally higher.

**Figure 7: Expenditure 5 year average**

Five year expenditure % GDP, to FY



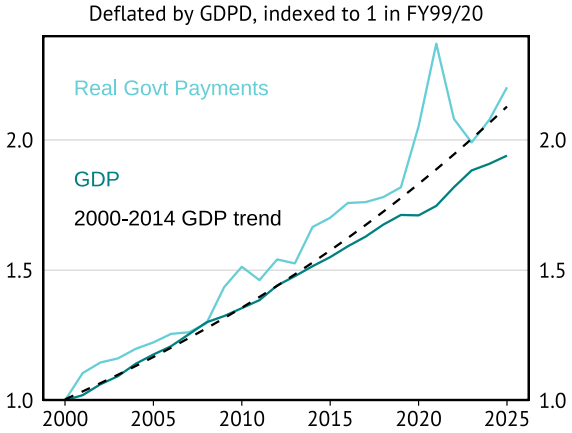

Sources: e61; PBO

These spending trends reflect underlying 'stickiness' in spending as the economy ebbs and flows – we refer to this stickiness as **fiscal habits**. In so far as such fiscal habits reflect automatic stabilisers over the economic cycle, this is a good thing. However,

when spending is sticky during a secular decline in economic growth, this can lead to an inadvertent increase in the size of government and therefore higher taxes.

There are two types of fiscal habits that are clear in the budget process. The first is a tendency to provide fixed increases in major areas of expenditure (i.e. health, education) as the primary means to improve service delivery. The second reflects the asymmetry in government spending responses to revenue surprises as opposed to revenue shortfalls when it comes to making new spending decisions.

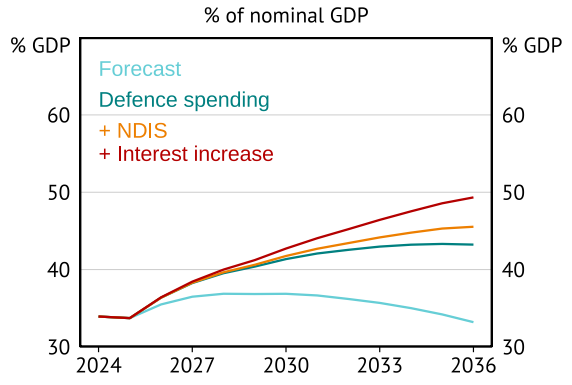
**Figure 8: Spending follows old GDP trends**




These two fiscal habits are based on rules and institutional arrangements that were built during a time of high growth. With national growth rates slowing, these same rules have pushed up government spending.

Furthermore, the expected stabilisation in spending pressures are contingent on cost control and limited additional spending by the Federal Government. If defence spending was increased to 3.2% of GDP (from forecast projections of 2.2%), NDIS spending grew at 10% p.a. (rather than the targeted 8% p.a. growth), and 10-year government bond rates were to rise to 5.5% (compared to current estimates of 4.5%) **expenditure would climb to 29% of GDP**, and gross debt would rise to 49% of GDP (Figure 9).

**Figure 9: Gross debt projects (expenditure shock)**




* Defence spending increased from 2.2% of GDP to 3.2%.
** NDIS spending grows at 10%pa rather than 8%pa.
*** Ten-year goverment bond rate rises to 5.5%pa from a 4.5%pa projection.
Sources: e61; PBO

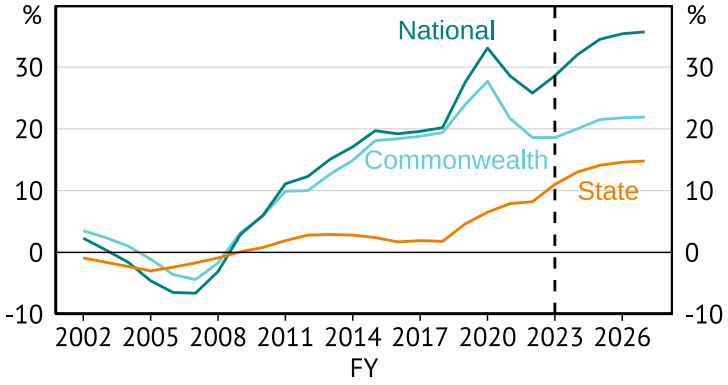
The size of the increase in expenditures in the highest spending scenario is approximately $103bn in the 2035/36 year, three times the size of the Conservative Bias Allowance in that year.

### 1.5 General Government debt trends

Even if the Federal Budget were to stabilise, and despite the fact that the NDIS has shifted significant expenditures away from the states, State budget balances have continued to decline.

Although Federal net debt declined from 27.8% to 22.3% of GDP between FY20/21 and FY23/24, the consolidated net debt including states has stubbornly remained at around 33% of GDP. State debt is expected to increase further over the coming years placing upward pressure on the consolidated fiscal position (Figure 10).

**Figure 10: Government debt as a % of GDP/GSP**
24-25 Budget Actuals and Forward Estimates




* The vertical dashed line represents the beginning of the forward budget estimates.
Sources: e61; PBO

Assuming that State finances continue on their projected trajectory, while only the revenue shocks negatively influence the Federal Budget, consolidated Government net debt would rise to 62% by the mid-2030s.

At this level of government debt, the Australian government's ability to mitigate a future crisis would be constrained, and interest expenditure on debt would rise to 3.6% of GDP (from 1.4% of GDP in FY23/24).

At the Federal level an additional expenditure risk comes from **off-budget investment items**. These items include both expenditure and revenue from a range of government investments. Such items tend to be capital in nature and are expected to generate non-tax revenue that will self-finance the item of expenditure.

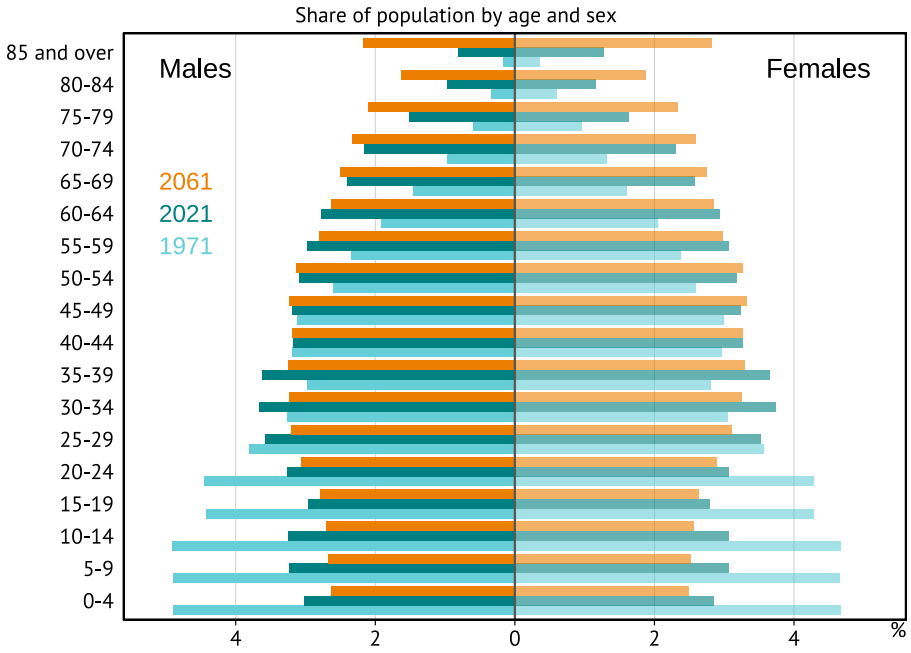
However, these investments have been growing in scale without a clear link to whether the investment is self-financing (e.g. the cost of writing off a portion of student debt). These choices increase the true risk around the government balance sheet, especially if there are cost over-runs or poor performance for current infrastructure investments.

# 2. Key economic drivers

### 2.1 The ageing economy and migration

A key driver of fiscal sustainability concerns is the reversal of the demographic dividend of the 1990s and 2000s. The retirement of the baby boomers began in 2010 and, even with rising labour force participation among older workers, this has begun to push up dependency ratios.

**Figure 11: Population pyramid**




Sources: ABS Historical Population 2024; IGR 2023

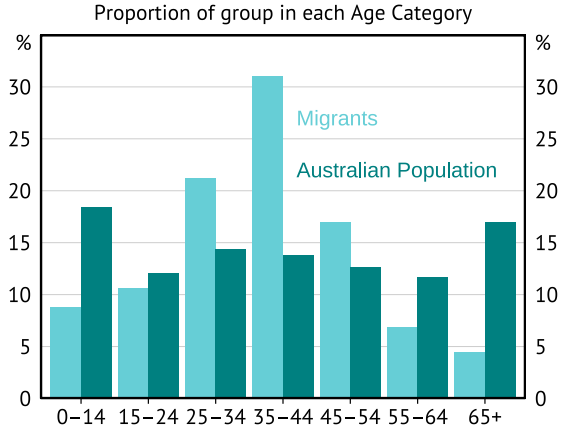
There has been a sharp increase in the share of the population aged over 75 in recent years – from 6.4% in 2014 to 8.0% in 2024. This trend will continue, with the share of those over the age of 75 expected to rise further, reaching 11.7% in 2045 and 12.8% in 2060 (Centre for Population, 2025).

Individuals entering the twilight years of their life have both revenue and expenditure consequences – with lower employment and investment reducing tax revenues, while old age pension, health, and aged care expenses rise.

Australia has been more responsive to the fiscal risks around these trends than many peer countries. Three key policy choices that have limited the fiscal implications of population ageing are:

1. The **introduction of compulsory superannuation** which has led to individuals more actively saving for retirement, rather than relying on government support that is funded from the working age population.
2. Means and **asset testing** of the aged pension.
3. Significant **inbound migration** of younger individuals (Figure 12).

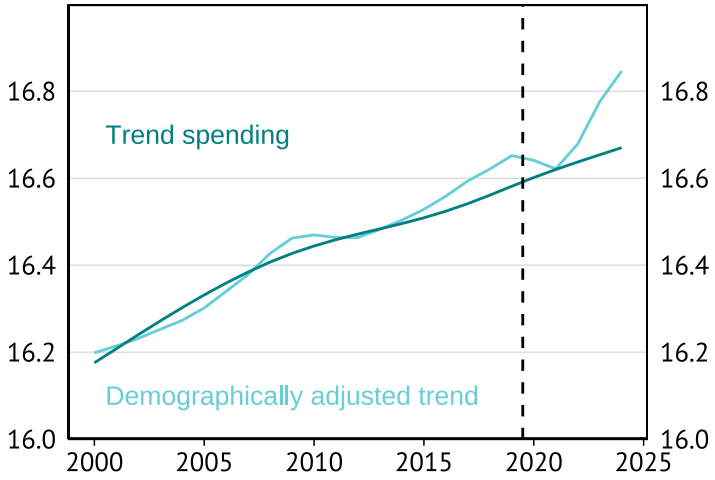
**Figure 12: Migrant flows support prime age workforce**




* Population reflects both citizens and non-citizens in 2024. Migrants reflect new arrivals in 2024.
Sources: ABS; e61

These policy adjustments have helped to restrain the lift in government spending even as these demographic pressures have intensified as discussed in Nolan and Vass (2025) (Figure 13).

**Figure 13: Demographic trend restrained**
Real value, 2012 prices (in logs)




* Model estimates trend government spending on subcategory as function of time and demographic structure. Model estimated on data before 2014
** Trend estimate based on an HP filter.
Sources: ABS; e61

These changes have partly mitigated the expenses associated with an ageing population, but the 2023 IGR indicates that these spending pressures will continue to rise through 2060.

And some of these policy choices have started to unravel due to other demands. Means and asset testing has become more limited, especially for the **growing share of in-kind transfers** provided by government. Furthermore, the political consensus about inward migration appears to be under strain in Australia, increasing the risk that more limited migrant inflows will be enforced and dependency ratios will rise more sharply than currently forecast. These trends will further exacerbate net spending pressures.

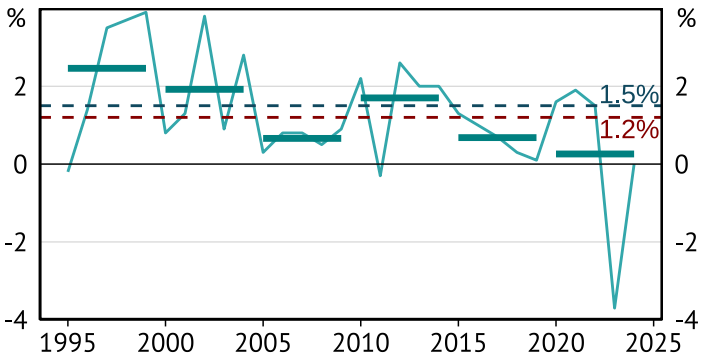
As expenditure pressures will remain elevated, higher taxation, or stronger economic growth, will be necessary to maintain fiscal balance – indicating the importance of robust productivity growth to generate the income needed.

### 2.2 The role of productivity

With an ageing economy pushing up government expenditure, productivity growth has become even more essential. But labour productivity growth in Australia has slowed markedly over recent decades, from an average of 2.1% annually in the early 2000s to 1.2% in the 2010s. Since the COVID-19 pandemic, growth has been effectively zero if not slightly negative.

This matters: productivity is the main driver of real wages, living standards, and a major driver of long-run fiscal sustainability under current settings.

**Figure 14: Labour productivity growth has stagnated**




* Labour productivity measured as GDP per hour worked growth.
Horizontal Lines are 5 year averages.
Sources: ABS; e61

Several structural factors underpin this declining productivity:

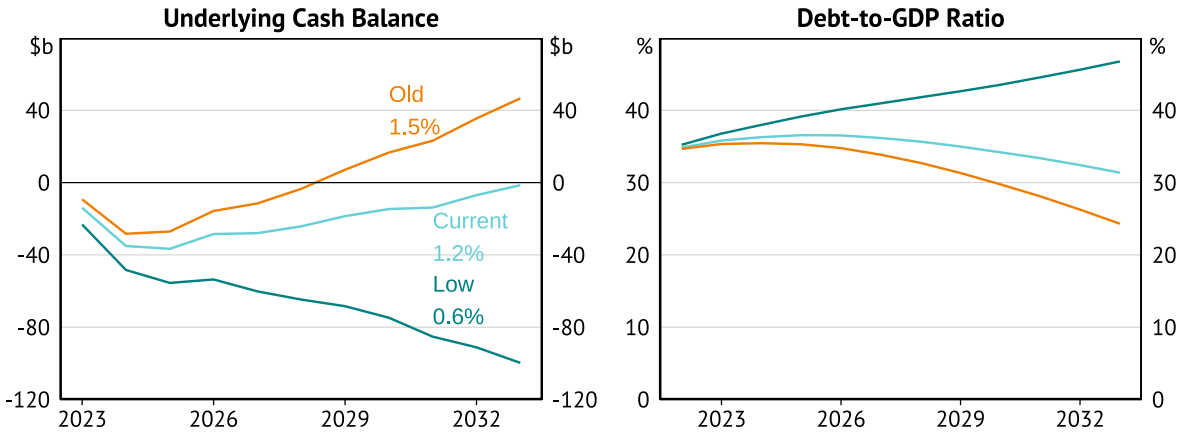
- An **expansion of low-productivity growth sectors**, particularly in care and other non-market industries, partially driven by increased government spending.[1]
- **Declining market dynamism**: Job-to-job transition rates have been trending down over time, as have new firm entries and exits. Market concentration has been rising in several sectors.
- **Reduced ambition on microeconomic reform**: Major productivity-enhancing reforms were enacted in the 1980s and 1990s – such as the floating of the dollar, abolishing tariffs, and introducing a national consumption tax. These were relatively clear-cut policy choices for brave governments to adopt. Although much of the "low hanging fruit" has been picked, **regulatory burdens** and an **elevated cost of capital** remain areas where fiscal reform could help to boost productivity.
- **Population ageing**: The effect of an ageing population on productivity is ambiguous. It may reduce productivity by increasing demand for low productivity non-tradable services, or through the loss of high human capital workers due to retirement. However, it could also boost productivity by making it easier for young workers to climb the job ladder supporting human capital accumulation (Bianchi & Paradisi, 2024).

Productivity is one of the three "Ps" (along with population and participation) that drive long-run economic growth. Higher economic growth both boosts government revenue and increases the overall capacity for the economy to bear debt. This "double dividend" means governments could afford to run more sustained deficits if underpinned by higher productivity growth. But when productivity falters, so too does the fiscal outlook.

The below figure shows how sensitive the forward estimates are to productivity growth. If productivity growth returned to 1.5% p.a. – faster than assumed in the Budget projections – this would lead to a sharp decline in the debt-to-GDP ratio and stabilise the budget. But, if it remained around where it has been for the past decade, the fiscal outlook would deteriorate and even with the help of bracket creep the Budget would not return to surplus.

1 Although, in a counterfactual world in which the government did not fund these activities as aggressively, undoubtably some portion of them would have been picked up by the market sector.

**Figure 15: Federal budget balance under productivity growth scenarios**




Sources: e61; PBO

### 2.3 Tension in the inter-generational compact

Australia's current spending and tax system is designed for a country with strong productivity and population growth. It assumes that because future generations will be larger and richer, society can redistribute some of those gains back to current generations through transfers to support their retirement. If each generation continues to be much better off than the last, this pay-as-you-go (PAYGO) system improves the welfare of every generation as each can benefit from the wealthier generations that will follow.

This inter-generational compact has held strong for the last 70 years, but it is now under threat. The slowdown in productivity growth has cast doubt on whether future generations will still enjoy much higher lifetime incomes. Combined with an ageing population, this calls into question the extent to which we can still place the burden on future generations to support current spending (Commonwealth Treasury, 2023).

There is also the fact that older generations today have benefited from large, lightly taxed gains in housing wealth over the past 30 years. As these gains were driven in large part by a secular decline in interest rates and immigration driven population growth that is forecast to slow,[2] current generations are highly unlikely to experience similar increases in housing wealth over their lifetimes.

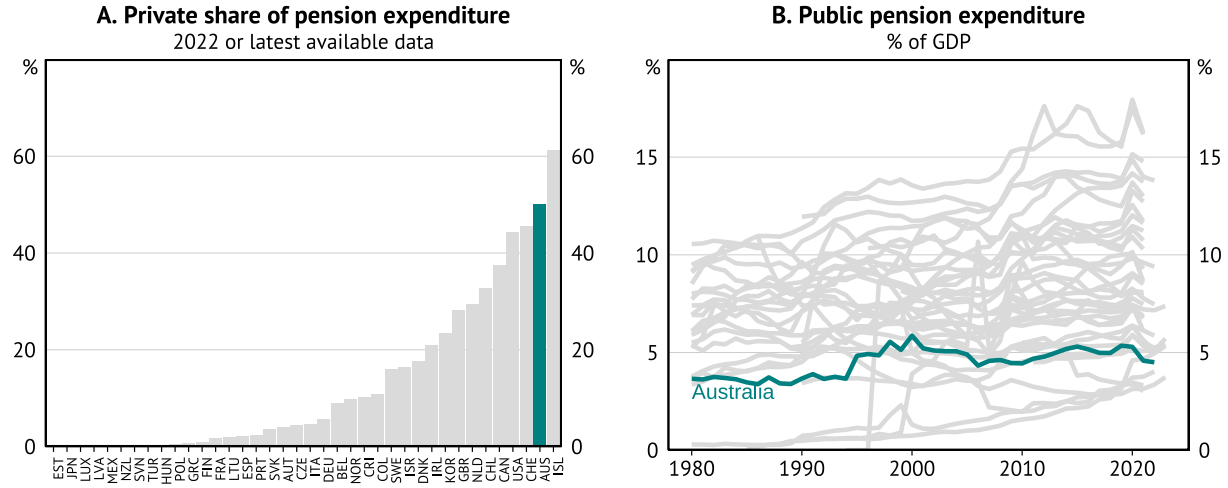
This raises questions over whether it is still equitable to fund the retirement costs of wealthier older Australians through a system of taxes that largely fall on working age Australians and borrowing that must eventually be repaid.

The good news is that Australia has already made some progress to move away from a PAYGO system towards a more user pays, save-as-you-go (SAYGO) style system where each generation bears more of the costs of their own retirement. The introduction of superannuation in the 1990s, along with increased means testing of the age pension mean that Australia now has the second highest private pension expenditure (relative to public) in the OECD, and one of the lowest and slowest growing levels of expenditure on public pensions as a share of GDP.

2 Accompanied by a failure of housing supply to keep up with this increase in housing demand.

**Figure 16: Trends in pension expenditure by country**

OECD countries

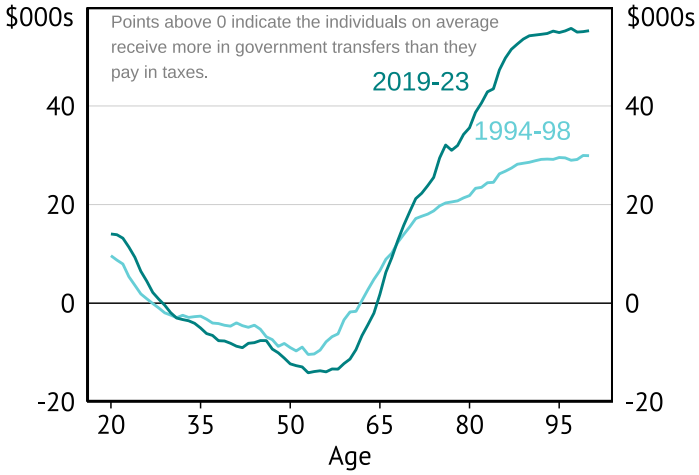



* Data is sourced from the OECD public and private social expenditure dataset. Pension spending is cash expenditure (including lump-sum payments) on old-age and survivors' pensions. Private pension spending includes payments made to private pension plan members, or dependants after retirement and covers persons working in both the public and private sectors.
Source: OECD

However, in other areas the size of transfers to older Australians has continued to grow. Transfers net of taxes to Australians over the age of 60 have grown by more than 41% per person in real terms since the 1990s (Varela et al., 2025). This growth has been driven by an increase in in-kind transfers, such as health and aged care, which are generally untargeted and thus have grown even as the income and wealth of older Australians has risen.

**Figure 17: Transfers minus taxes by age**

Average per adult aged 20-100; $2023




* Transfers include cash transfers, such as the aged pension, and in-kind transfers, such as education, aged care and health care. All items are calculated on a per adult basis. Transfers made to children, such as public education, are assigned as a transfer to their parents.
Source: Varela, Breunig and Smith (2025)

Of course, older Australians will eventually pass down most of their wealth to younger Australians in the form of inheritances. But relying on inheritances to address inter-generational inequity leads to additional issues:

1. It will generate greater inequality within cohorts of Australians when some inherit, and some do not.
2. It inserts the government into intra-family bargaining by transferring income from working age Australians to their wealthier parents, who then will choose whether to eventually give the money back to their kids.
3. It may worsen the distribution of consumption across an individual's life because most inheritances are received towards the end of an individual's working years, while most tax is paid prior to that point (Wood et al., 2019).

Addressing the growing pressures on the intergenerational compact will not be easy. For one, it will require policymakers to look beyond short-term political considerations that incentivise the maintenance of generous support for current retirees, while deferring the costs to future Australians. With productivity growth slowing and the population ageing, this model is no longer sustainable.

# 3. Reform considerations

### 3.1 Principles for tax-expenditure policy change

Given the problem definition for fiscal sustainability, reform to fiscal settings appears necessary. However, any policy change needs to be made under a consistent set of principles – in order to ensure consistency and social buy-in.

The common economic framework that allows us to clearly define reform principles is the marginal value of public funds (MVPF). This approach to evaluating policy change measures the welfare benefit from spending on a given policy or programme relative to its cost, providing a standardised way to compare the value of different uses of government funds.

The advantage of this framework is that it reflects both the benefit for those directly affected by the policy or programme, as well as any spillover benefits (excluding pecuniary cost savings on the government balance sheet).

The cost of a policy is not just the headline amount the government spends. It also includes how costly it is to raise that money in the first place, and whether doing so affects other parts of the budget. One way we compare different options for raising revenue is by looking at something called the **marginal excess burden** – which refers to the broader economic cost of raising an extra dollar of tax revenue. This captures things like how taxes may change people's behaviour. For example, working less, saving less, or shifting money around to avoid tax. The most efficient policies are those that raise revenue while causing the least distortion to the economy — in other words, the lowest marginal excess burden.

If the tax required to raise funds distorts the behaviour of individuals generating an excess burden, or has large administrative or compliance costs, we call it inefficient. The cost of any spending is then considerably higher due to the cost associated with raising this required tax revenue.

### Types of efficiency costs

An example where the efficiency cost is due to administration and compliance comes from a comparison of GST and income tax treatment of labour market earnings.

Jill earns $100 cutting her parents' lawn and spends this money on a seat cover for her car. If both sums are reported to the tax authority and taxed at equivalent rates, then their tax treatment is equivalent – an income tax or consumption tax does not affect Jill's decision to work.

However, the income tax treatment has higher administrative and compliance costs:

1. Filling income taxes and providing evidence has significant compliance costs. For a GST, filing is undertaken by the business that can group everyone's transactions in information they already report for accounting purposes.
2. As Jill is paid by her parents she may try to hide the payment or treat it as a gift – even though it is substantively labour income. To prevent avoidance the ATO has to investigate and audit Jill's tax affairs, which has an administrative cost in time and resources used.

Another solution would be to allow Jill to claim the payment as a gift from her parents. However, this then distorts behaviour by incentivising Jill to mow her parents' lawns instead of spending her time undertaking taxable activities.

If she would not have mowed her parents' lawn in the absence of this favourable tax treatment, then this change in behaviour is an efficiency cost of the tax system.

Furthermore, if the policy leads individuals to transition to (away from) another government policy this will increase (decrease) the cost.

Spending decisions should then be made on this broad-based benefit-cost assessment of the policy, which is determined by both the spending item and the structure of the underlying tax system.

In addition to the MVPF approach above, typically frameworks for the design of a tax system highlight equity considerations (for a given amount of spending). These equity considerations are:

1. **Vertical equity** – the system should require proportionally more from those with a greater ability to pay; and
2. **Horizontal equity** – those with the same ability to pay should be treated equally.

### Policy equity concepts

Three people, Franklin, Sebastian, and Maria, want to split their dinner bill using equity principles.

The total cost of dinner was $30. Franklin and Sebastian both earned $100 last week, while Maria earned $400. If each paid proportionally to their income Maria would pay $20 while Franklin and Sebastian both pay $5.

A progressive payment schedule would require Maria to pay more than $20 of the bill. Maria goes up first and pays $22 to meet this progressive payment to achieve vertical equity.

However, Franklin did not get the memo and went up and paid $5 after Maria. This meant that Sebastian only pays $3 for the meal.

Given Franklin and Sebastian had the same ability to pay for the meal, the fact that they end up contributing a different amount is horizontally inequitable.

Nothing in this framework tells us that there is a correct size of government. Instead, it tells us that we need to clearly evaluate the value of additional spending and the cost of raising additional revenue.

Rising spending pressures due to population ageing and weak productivity growth are forcing Australia to increase the amount of revenue raised. Doing so thoughtlessly is the fundamental concern around fiscal sustainability.

In our analysis below we will discuss potential ways to either improve the revenue raising capacity or determine appropriate spending restraint, rather than relying on fiscal drag, ad-hoc spending cuts, or luck.

Furthermore, the decision of how much to borrow now reflects a choice about the intergenerational burden of spending decisions. Borrowing now to fund public investment is a consistent way to spread the financing of that investment over the lifecycle of those who would benefit from it.

But persistent borrowing to fund the consumption of certain groups can only be sustained if the income and number of future Australians continues to rise by enough. Low population growth and stalling productivity suggest that we need to be more

mindful about this spending. This is exacerbated by rising capital income shares, and hence a growing distinction between those who can rely on inheriting wealth and those who will not.

Finally, with the increasing prevalence of macroeconomic risks (i.e. natural disasters, tariffs, global conflicts, and health crises) the overall stance of net debt influences the government's ability to support the society through crises.

In terms of policy change a decision about the structure and size of debt now matters for such support. But so does the structure of tax and expenditure policies in terms of their ability to raise and return revenue where needed.

### 3.2 Short-termism and ad-hoc policy making

Given the overall social benefits of raising revenue efficiently and fairly, why do real world outcomes depart from this ideal?

The short answer is that elected governments operate under their own set of incentives. Political outcomes are heavily influenced by institutional settings and the 'rules of the game'. Understanding and improving those settings is a reform priority in its own right.

Two features stand out. One is *reactiveness*: the tendency to make ad hoc, piecemeal change to address individual issues. This will always be a feature of policy making, but is ideally complemented by periodic reform that is holistic and broad based. Otherwise a series of ad hoc interventions leaves the system increasingly complex and undermines its logical coherence.

The second is *short termism*: the tendency to privilege current consumption over the future, to deal with problems reactively (once they have already manifest, rather than in anticipation) and to eschew hard reforms if they involve near term costs and longer term benefits.

In economic terms, the political process can at times discount the future more heavily than is optimal from the perspective of the broader community. There are distinct reasons why this can be the case:

1. **Under-representation of future voters:** One weakness of political systems is that future taxpayers are not fully represented among the present voting electorate. Current voters have some incentive to extract benefits and shift costs onto future voter/taxpayers. This effect operates over very long-term horizons, and is less relevant to most decisions, of which present day voters will experience the effects. But it can be relevant to issues of long term inter-generational equity.
2. **Electoral cycles and the principal-agent problem:** Where reform involves short term costs, political actors may discount future benefits that accrue beyond the electoral term. There is some chance that they will not reap the political rewards, which could even accrue to their opponents. This can drive a principal-agent problem in which the interests of political actors diverge from those of the community, not dissimilar to the way a corporate CEO might have a different time horizon to the shareholders. At least for a listed company, the share price reflects market views about future profits – bringing future benefits into the present. There is no equivalent in the political process, and the community could lack good information through which to accurately judge true long-term performance.
3. **Time inconsistency:** Related to the principal-agent problem, political actors sometimes support long term policies but face near term temptation to oppose them for immediate gain. One response to this is to develop commitment mechanisms, or institute independent processes (e.g. for the setting of monetary policy).

In principle, government (on behalf of the community, including future generations) should have relatively low discount rates, in accordance with the Arrow-Lind principle. This states that the social cost of risk declines as the size of the population rises, hence by pooling individual risks government can motivate investment at a lower discount rate. The ability to pool liquidity and diversifiable investment risk has been used to motivate a reduction in the social discount rate overseas (i.e. Grimes (2024)). By contrast, the political process can impose higher discount rates (i.e. more short-term bias), particularly for policies that – like capital investments – involve up front political costs for longer term economic gains.

These higher discount rates also serve a political economy purpose if there is a tendency for agencies to understate the cost of schemes. However, the use of higher discount rates is an imperfect solution to this issue – as it will bias project selection towards investments and spending with short-term pay-off horizons.

There is no simple solution to short-termism. In many ways, the problem is an inevitable feature of democratic systems (which are nonetheless preferable to the alternatives).

Some institutional nudges could help support longer term thinking. For the most part, they involve:

- Better information by which to judge long term fiscal implications of present decisions
- Adjusting the incentives of public sector managers to take account of long term fiscal implications
- Building up the institutional architecture that supports these other changes

Better information could be achieved by:

1. **Reorienting the Inter-Generational Report:** The IGR currently focuses on long term fiscal aggregates. It has served a useful purpose in bringing to light the long term impacts of demographic change. An enhancement would be to focus more explicitly on inter-generational issues. Specifically, the IGR could shed light on the likely living standards of future generations compared to present and past generations, given macroeconomic trends and fiscal settings. This would help address the under-representation of future generations in the current political debate.
2. **Each jurisdiction publishing 10-year fiscal projections:** Many states and territories do not. But a projection methodology over a 10-year period forces Treasuries (or Parliamentary Budget Offices) to lay down realistic estimates of the drivers of spending – recurrent and capital – across different portfolios, and likely growth in revenue. For states, it would force a conversation about the sustainable level of capital investment to maintain a desired relationship between physical assets and debt.
3. **Publishing consolidated General Government 10-year projections:** Possibly under the auspices of Parliamentary Budget Offices or the Heads of Treasuries. This provides an aggregate picture of the combined Federal and State government sectors, netting out the effect of transfers between tiers of government. The Federal Budget Paper 3 currently produces these numbers for the forward estimates period.
4. **Using a projection methodology for fiscal aggregates for the last two years of the forward estimates:** At present, most jurisdictions use a hybrid approach for these two years. Economic parameters use a projection methodology (a simple return to trend rather than a forecast) but fiscal numbers are based on current policy. This leads to consistently unrealistic spending growth rates factored into the forward estimates and an inevitably rosy picture of the trajectory for the operating/cash balance and debt. A projection methodology – based on a reasonable steady state spending growth assumption – would provide a more realistic assessment of the sustainability of the budget position.

Incentives for public sector managers could be sharpened if, in response to published 10-year projections by spending area, managers were required to report to Parliament on strategies to maintain spending within the projected envelope. Managers could also be required to identify near term investments that will help take pressure off these long term costs. Active Parliamentary accountability (akin to Estimates processes) could be a complement to this reporting.

Efforts to bolster the independence of departmental secretaries would materially enhance the effectiveness of this reporting.

In effect, this approach would make portfolio secretaries more accountable for estimates variations in their programs. These are often treated as exogenous effects for the purposes of portfolio budget management. The forecast error is often taken more seriously than the variation itself.

Finally, the institutional architecture could be bolstered by:

- Establishing Parliamentary Budget Offices in each jurisdiction. Ideally these would have a mandate beyond costing election commitments and extending to research into fiscal topics relevant to the state/territory.
- Using the Heads of Treasuries as a body to oversee some reporting and analytical work. This could include:
  - Oversight of 10-year consolidated government sector fiscal projections
  - Advice on appropriate discount rates for cost benefit analysis in project assessment and regulation impact analysis
  - Baseline actuarial data on the total fiscal costs (state and federal) of specific high-cost cohorts, such as those with chronic disease or at risk of incarceration. These could provide an agreed counterfactual by which to evaluate the cost effectiveness of interventions.

# 4. Twelve Fiscal Issues

To provide practical guidance of the fiscal challenges faced, and their relationship with varying policy levers, we have produced a separate document reflecting twelve key revenue, expenditure, and state level fiscal issues that arguably require reform.

These twelve fiscal issues provide an opportunity to highlight the nature of the aggregate fiscal challenges described in this document, and provide examples about how to interpret and operationalise the policy reform principles.

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