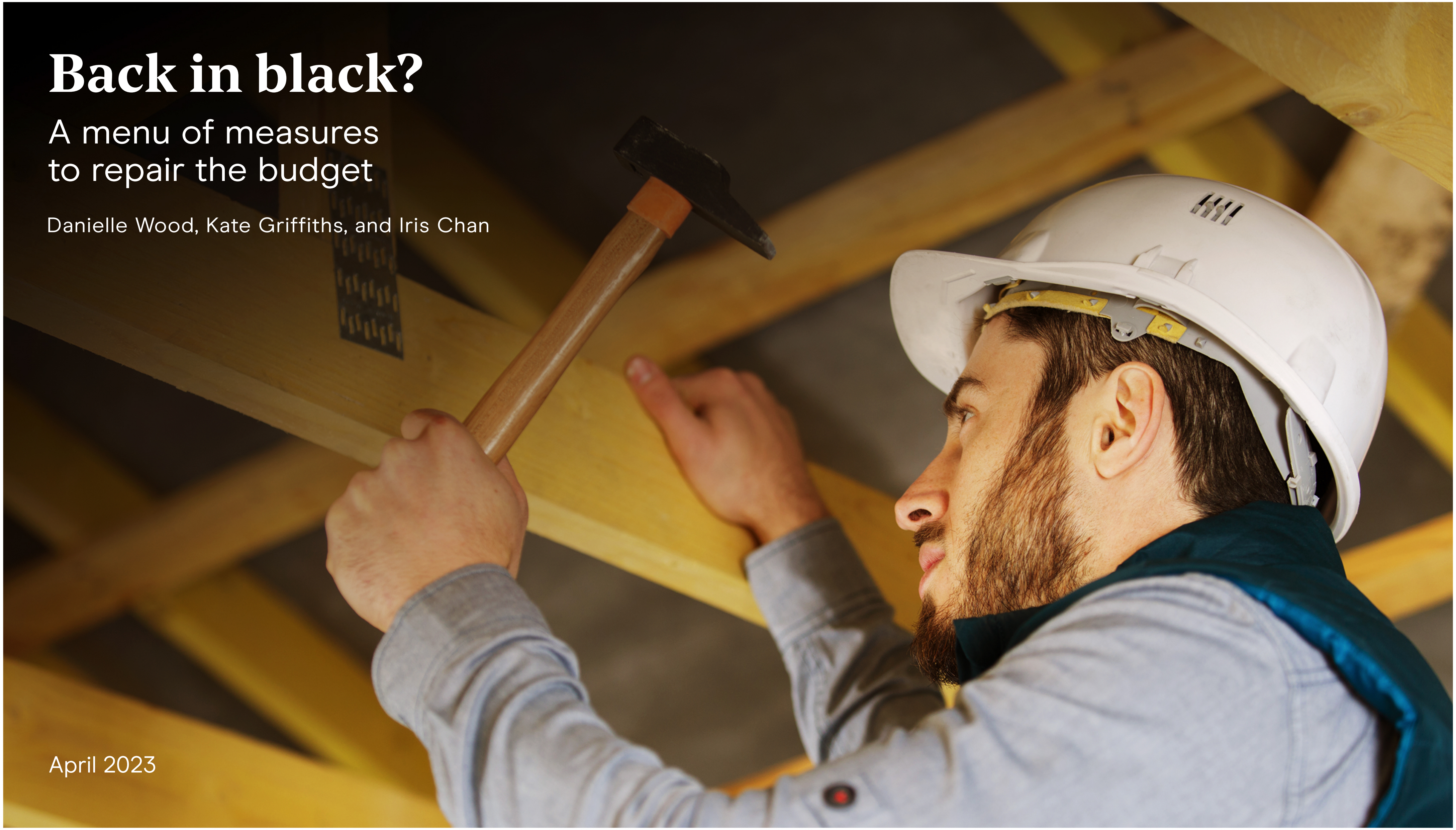
GRATTAN Institute

Back in black?

A menu of measures to repair the budget

Danielle Wood, Kate Griffiths, and Iris Chan

April 2023



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Overview

The Australian Government is on track for more than 25 years of deficits. Teenagers starting high school today have never seen a budget surplus and probably won't until they are well into adulthood.

The challenge is structural. Spending has grown because of rising community expectations, an ageing population, and the growing costs of providing labour-intensive services. But this increase in spending has not been matched by growth in the tax base. Indeed, the growing cost of income tax concessions and poor design of other taxes has eroded our revenue-raising capability.

The result is a persistent structural budget deficit. Official estimates suggest the structural deficit is about 2 per cent of GDP, or almost $50 billion each year in today's dollars. But using more realistic estimates of spending – including in defence, health, and support for the vulnerable – suggests a figure of more than $70 billion a year in today's dollars by the end of the decade.

Continually adding to national debt by running sizeable deficits asks future generations to foot part of the bill for today's spending and may reduce the government's room to respond to future shocks.

Now is the time to start the heavy lifting of budget repair.

Pursuing policies to boost growth is critical. Grattan Institute has previously published many recommendations on how we can 'grow the pie'. But higher growth will not alone close the gap. Given the scale of the challenge, governments will need to both cut spending and boost revenue.

There are no easy solutions, but this report puts forward a menu of 'least bad' options to reduce spending and boost revenue without hurting economic growth. Some of our options would even boost economic activity.

On spending, better procurement processes for infrastructure and defence could save several billion dollars a year. We put forward another $15 billion of savings measures, including undoing the WA GST deal, counting more of the family home in the aged pension asset test, and making health spending more efficient. Critically, the government will also need to make changes to ensure fast-growing programs such as the NDIS and aged care are sustainable.

On revenue, the menu includes winding back income tax concessions, redesigning the Stage 3 tax cuts, increasing the GST, and better taxation of fossil fuels. We would not expect the government to move on all these changes at once, but the menu includes choices worth about $50 billion a year once mature. Even if we did them all, we would still be below the OECD average in terms of tax collections as a share of our economy.

None of these policy options are easy. But if the government is serious about budget repair, it will need to embrace at least some of them. To those rushing to reject these policies out of hand, we say: what's your solution? We show that some of the perennials like cracking down on multinational tax avoidance and improving welfare compliance are unlikely to yield much for the budget.

If today's teenagers are going to see a meaningful reduction in the structural budget deficit before their middle age, now is the time for us to move on from head-in-sand optimism and 'easy' answers towards real solutions.

Recommendations

Options to reduce spending	Time horizon	Annual value
Improve infrastructure and defence procurement	5-to-10 years +	**Several billion**
Undo the WA GST deal	Immediate	**~$5b**
Include more of the family home in the Age Pension asset test • All equity over $750,000	5-to-10 years	**~$4b+**
Cut costs in hospitals, pathology, & pharmaceuticals	Immediate	**~$2b+**
Clean up grants and advertising	Immediate	**~$1b-$2b**
Abolish Family Tax Benefit part B for couples • Keep the payment for single parents	Immediate	**~$1.3b**
Abolish the Business Innovation and Investment Program visa	10 years +	**$1b+**
Other options • Mitigate aged care cost growth • Mitigate NDIS cost growth • Evaluator-General to identify and reduce ineffective spending	5-to-10 years +	Uncosted

Options to increase revenue	Time horizon	Annual value
Redesign the Stage 3 tax cuts • Retain the 37% tax bracket	Immediate	**$8b**
Reduce income tax breaks • Super tax concessions • Capital Gains Tax & negative gearing • Trusts	Immediate-to-5 years +	**~$21b** $11.5b+ $7b+ $2.3b
Raise the super preservation age • Gradually raise from 60 to 65 Plus freeze Super Guarantee rate	10 years +	**~$7b+** **$1.2b**
Raise the GST • 15% GST + low-income compensation • Cwth keeps half the extra revenue	Immediate-to-5 years +	**~$6b+**
Wind back fuel tax credits • Count the cost of roads and pollution	Immediate	**$4b**
Redesign the Petroleum Resource Rent Tax • Change method for pricing gas; and/or • Introduce a 10% Commonwealth royalty on offshore gas	 5-to-10 years Immediate	 **~$3b-$4b** **~$4b**
Bolder options • Realign company tax rates at 30% • Carbon tax • Inheritance tax	5-to-10 years	Uncosted

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1 Australia has a structural budget problem

Government support played a critical stabilisation role during the COVID economic shock. It provided vital support to Australian households and businesses at a time when the Reserve Bank had little room to move.

And while the associated ramp-up in government debt has understandably attracted much handwringing, Australia's debt-to-GDP ratio is still low among our economic peers, and repayments remain manageable.

Australia's real fiscal problem is a slow burn.

Long-term pressures on spending have been building for years as Australians demand more from government, the ageing of the population bites, and the costs of providing some labour-intensive services continue to grow. This growth in the size of government has not been matched by a commensurate increase in revenue.

The structural gap between government revenues and spending is officially expected to be almost $50 billion in today's dollars, or about 2 per cent of GDP, every year by the end of this decade. But these estimates understate the true size of the challenge. Our analysis suggests the annual structural deficit is likely to be closer to 3 per cent of GDP in 10 years' time.

Without action to substantially reduce the deficit, debt will continue to climb as a share of GDP, even without accounting for future economic shocks.

1.1 The size of government has grown

The size of government in Australia has grown. Government payments as a share of the economy have historically averaged about 25 per cent of GDP, but are projected to stabilise at more than 27 per cent of GDP over the coming decade (Figure 1.1).

Government spending has also grown as a share of the economy in other developed nations, particularly in recent decades (Appendix A).

While the most recent uptick was from the COVID shock, the longer-term increase reflects long-building spending pressures. There are three main sources of pressure.

First, as countries get richer, citizens' expectations of government services increase.[1]

Income supports and services that provide a social safety net – for example, good-quality aged care and disability care – can hugely improve quality of life and reduce the need for people to self-insure. For Australia, the National Disability Insurance Scheme (NDIS) and aged care are expected to be two of the fastest-growing areas of spending over the next decade (Figure 1.2).

Similarly in health, Australian governments have mirrored the global trend of spending more on healthcare as a share of the economy over time. Federal health spending in Australia has doubled from about 2.3 per cent of GDP in the early 1980s to 4.6 per cent of GDP today.[2] This

1. This is part of a longer-term trend across advanced economies, in which the size of government expanded significantly in the 20th Century. In France, Germany, the UK, and the US, for instance, the tax revenue share of national income increased from less than 10 per cent at the start of the 20th Century to between 30 per cent and 50 per cent by 1980, before stabilising: Saez (2022). The expansion in the size of government has been largely caused by the expansion of the state into providing social insurance – including healthcare, unemployment support, child support, the aged pension, and education: Saez (ibid); and Mulino (2022, pp. 55–70).
2. PBO (2022a, Table 7); and ABS (2022a, Table 1).

reflects mainly higher spending per person as Australians seek the benefits of more and better treatments that new technologies enable,[3] and population ageing.

Second, many of the services that governments provide are highly labour-intensive, inevitably costing more over time.

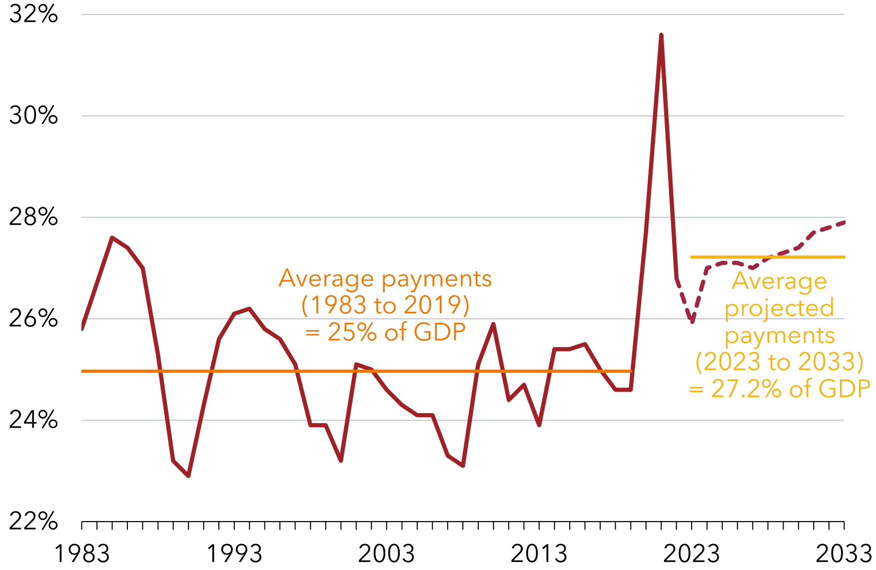
Care and education services – including early learning and care, school education, aged care, and disability care – have less scope for productivity improvements via new technologies than other sectors such as manufacturing and construction. As productivity in other sectors improves, so too do wages. Wage growth in care sectors has been slower but will need to speed up to attract workers, meaning that the relative cost of providing these services grows over time. Some of these cost pressures are not yet factored into the budget projections (Section 1.2).

Third, external forces are adding substantially to spending pressures.

Defence spending is growing quickly in response to a more uncertain geopolitical environment. In the 2016 Defence White Paper, the government committed to increase defence spending from 1.6 per cent of GDP at the time to 2 per cent of GDP by 2021.[4] Defence spending is expected to continue to grow over the next decade to 2.3 per cent of GDP by 2033 (Figure 1.2),[5] although this too understates the likely increase (Section 1.2).

Spending in response to natural disasters – including emergency support payments and infrastructure repairs – is relatively small

Figure 1.1: Government payments have stepped up since COVID
Federal government expenses as a proportion of GDP



Notes: Data are for the financial year. The dashed line represents Treasury's October 2022 Budget projections, which comprise forward estimates from 2023 to 2026 and medium-term projections from 2027 to 2033.

Sources: PBO (2022a, Table 1); Treasury (2022a, Chart 3.13).

3. Daley et al (2014).
4. Department of Defence (2016). ABS data show that defence spending was about 2 per cent of GDP in 2021, and the Parliamentary Budget Office (PBO) expects that defence spending will be 2 per cent of GDP this year: ABS (2022b), ABS (2022a), and PBO (2022b, Table 5-1).
5. Ibid (Table 5-1).

but growing fast, as the frequency and severity of natural disasters increase because of climate change.[6] These pressures are not going away.

And one of the fastest-growing categories of expenditure over the next decade is expected to be interest costs, reflecting the build-up of debt over the past decade and a half – supercharged by COVID – and growing borrowing costs. The federal government's interest payments are expected to grow from 0.9 per cent of GDP to 1.7 per cent over the next 10 years (Figure 1.2).[7]

1.2 The official figures understate the extent of the spending pressures

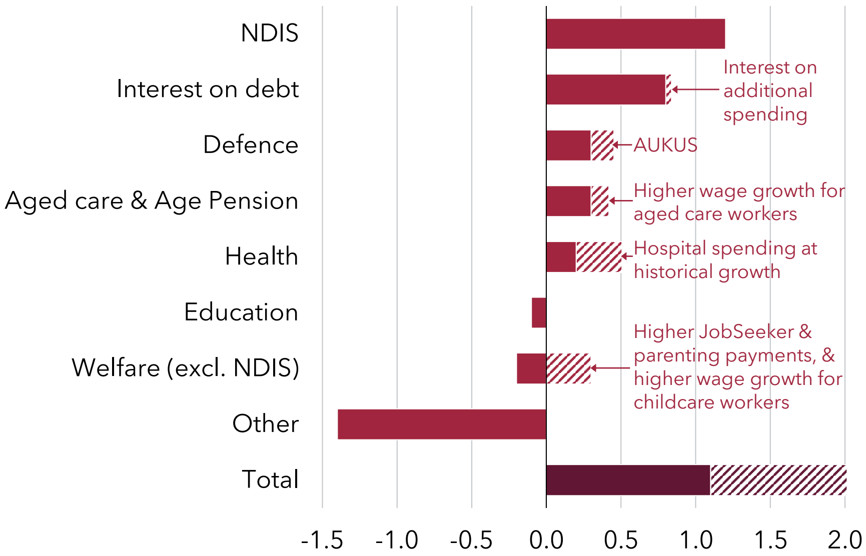
The official projections understate the likely trajectory of spending in three ways.

First, they do not yet include significant new spending announced since October. Key items are:

- A 15 per cent pay rise for aged care workers to take effect from 1 July 2023.[8] This amounts to about $2.3 billion in spending per year in today's dollars.[9]

6. Griffiths and Reeve (2022).
7. Net interest payments, which takes into account the interest that the government receives on its assets, are expected to triple from 0.5 per cent of GDP to 1.5 per cent over the next 10 years: Treasury (2022a, Table 3.1). These projections are based on the assumption that the 10-year bond yield will rise by about half a percentage point to 4.3 per cent by 2033.
8. Following the decisions by the Fair Work Commission in November 2022 and February 2023: Aged Care Work Value Case [2022] FWCFB 200 (4 November 2022) and [2023] FWCFB 40 (21 February 2023).
9. Calculated by multiplying the aged care workforce headcount with 15 per cent of aged care median wages, adding superannuation of 12 per cent, and adjusting for CPI inflation to December 2022: Grattan Institute analysis of Department of Health (2021), Mavromaras et al (2017, Tables 3.20 and 5.20), ABS (2023a), and ABS (2023b).

Figure 1.2: Many spending categories are projected to grow rapidly
Projected change in yearly spending as share of GDP from 2023 to 2033 (percentage points)



Notes: Data are for the financial year. Solid bars are projections from the Parliamentary Budget Office (PBO): health comprises Medicare, public hospitals, the Pharmaceutical Benefits Scheme, and the Private Health Insurance Rebate; education comprises schools, the Commonwealth Grants Scheme, and higher education research; and welfare (excl. NDIS) comprises the disability support pension, family tax benefit, carer income support, income support for the unemployed, childcare, parenting payments, student payments, the paid parental leave scheme, and veterans support. Patterned bars represents Grattan Institute analysis of potential spending that has not been factored into the PBO's projections: 15 per cent wage growth for aged care workers following the Fair Work Commission's November 2022 decision, and assuming 15 per cent wage growth for childcare workers; additional spending from the AUKUS submarine deal; a $75/week increase in today's dollars to JobSeeker and parenting payments; real public hospital spending growing at the 2009–2019 average assistance to the states for public hospitals; and interest payments on additional spending.

Sources: Grattan Institute analysis of PBO (2022b, Table 5-1), PBO (2022a, Table 7), Treasury (2022a, Charts 2.26 and 3.6), DSS (2023), Social Research Centre (2022), Department of Health (2021), Mavromaras et al (2017, Tables 3.20 and 5.20), ABS (2023a), ABS (2023b), and Wright (2023).

- The AUKUS submarine deal, which will cost up to $368 billion over three decades. This is estimated to add a net $31 billion in additional spending this decade and an annual average of about 0.15 per cent of GDP on defence spending over time.[10] Even this estimate may be conservative if the Defence Strategic Review persuades government that further spending is needed to prepare Australia for a more uncertain geopolitical environment.[11]

Second, some of the estimates of spending growth by category appear optimistic in their assumptions of the likely scope for cost control. In particular, the assumption that hospital spending will grow less quickly than it has historically, despite current system pressures emerging from COVID and the ageing of the population. This is consistent with a history of projections that overestimate capacity for cost constraint in key areas.[12]

Third, the official projections do not include areas where policy change is becoming inevitable because the impacts of extended periods of cost suppression are starting to cause significant hardship. The two most obvious examples are:

- Low wages for early childhood educators, which are contributing to acute staff shortages and are likely to be boosted by a Fair Work Commission determination in coming years.
- The extremely low level of income support available through JobSeeker and the Parenting Payment. Australia's unemployment benefits level is the second-lowest in the OECD and has drastically fallen behind broader community living standards over the past 25 years,[13] leaving many Australians in deep poverty.[14]

10. Wright (2023); and Hurst and Borger (2023).
11. Department of Defence (2023).
12. D. Wood (2022a); and D. Wood et al (2019a, pp. 9–11).
13. D. Wood et al (2022a, Section 2.2.8).
14. See D. Wood et al (ibid, Chapter 2), and ACOSS and UNSW (2022).

Overall, the official projections appear to understate the likely extent of government spending pressures over the decade. We estimate that the spending areas mentioned above might collectively add at least $23 billion in today's dollars – close to 1 per cent of GDP – a year to the medium-term spending outlook (Figure 1.2).[15]

Growing off-budget commitments also partly mask the true extent of increased spending. These commitments are off-budget because they are expected to deliver a positive rate of return over time. This means they don't hit the bottom line. But future taxpayers will be on the hook if the numbers ultimately don't stack up.[16]

1.3 Revenues have not kept pace with spending

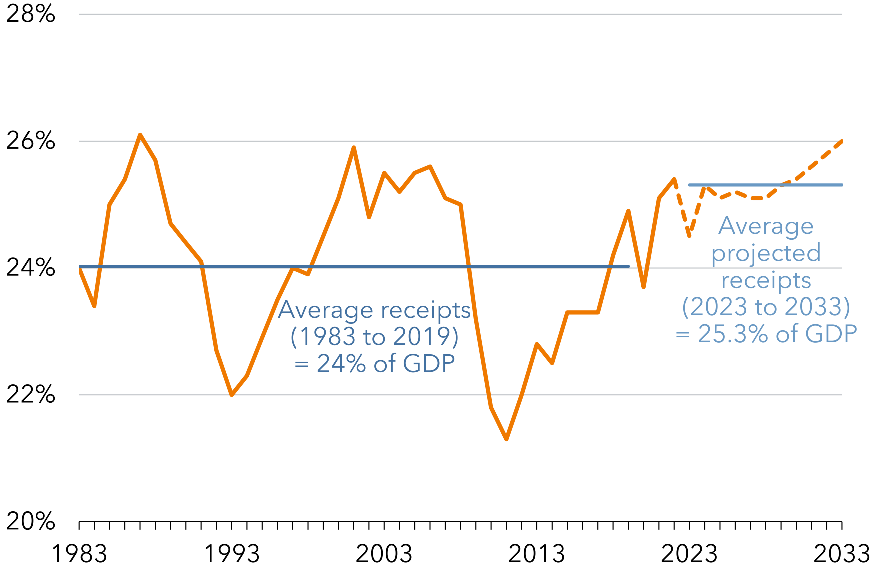
Australian government revenues have remained relatively stable as a share of the economy over the past 40 years, averaging about 24 per cent of GDP,[17] but have moved around considerably year to year depending on economic activity and commodity prices (Figure 1.3).

Even when state and territory taxes are added in, Australia is a low-tax country among our economic peers. Total tax collections across governments in Australia represented 28 per cent of GDP in 2019, about 5 percentage points lower than the OECD average of 33 per cent (Figure 1.4). Our overall tax collection was eighth-lowest in the OECD in 2019.[18]

15. The additional spending pressures sum to 0.9 per cent of GDP in 2033, which is about $23 billion today.
16. Terrill and D. Wood (2018).
17. This is mainly tax revenues, which accounted for an average of 22.2 per cent of GDP over this period.
18. OECD countries with lower tax receipts in 2019 were Mexico, Chile, Ireland, Türkiye, the US, South Korea, and Switzerland: OECD (2023).

Figure 1.3: Government receipts are expected to creep up over the next decade

Federal government revenue as a proportion of GDP

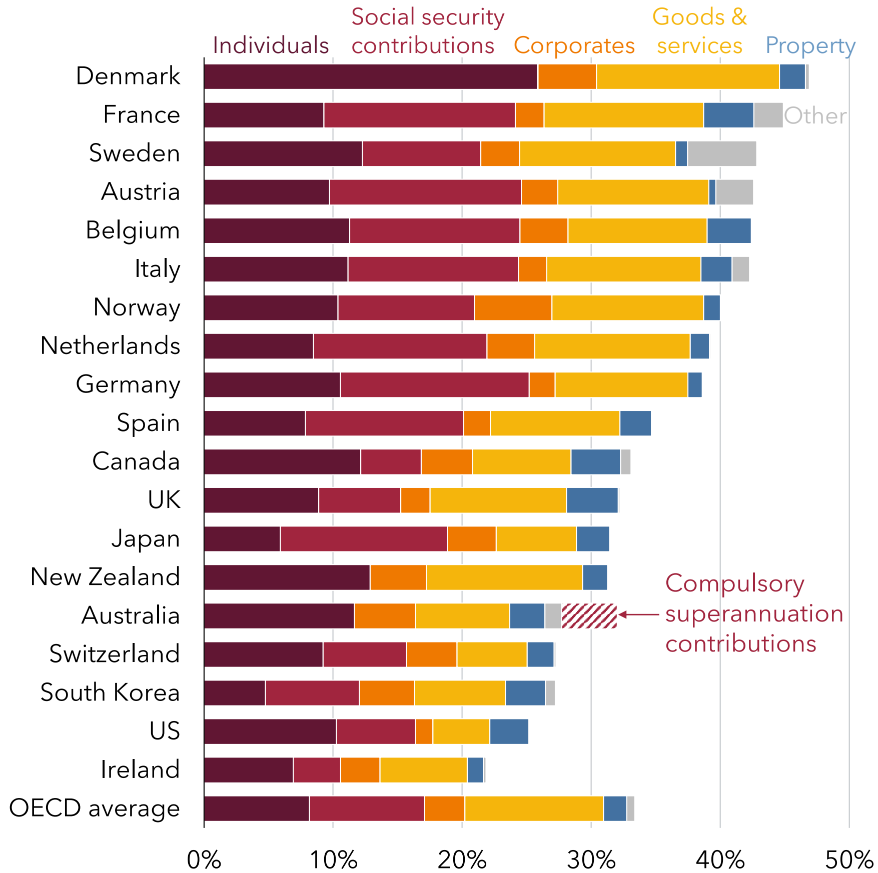


Notes: Data are for the financial year. The dashed line represents Treasury's October 2022 Budget projections, which comprise forward estimates from 2023 to 2026 and medium-term projections from 2027 to 2033.

Sources: PBO (2022a, Table 1); Treasury (2022a, Chart 3.12).

Figure 1.4: Australia's tax base is low and narrow by international standards

Source of tax revenue in selected OECD countries as a proportion of GDP, 2019



Notes: Taxes on individuals and corporates are taxes on income, profits, and capital gains; taxes on income, profits, and capital gains unable to be allocated across individuals and corporates are evenly split between the two categories. The superannuation bar for Australia comprises the sum of employers' defined benefit and Super Guarantee contributions.

Sources: OECD (2023); APRA (2023, Table 1a); ABS (2023c, Table 1).

Australia collects less taxes on income and goods and services compared to other countries, and more taxes on companies (Box 1).

Australia's income tax base is increasingly 'leaky'. The cost of concessions and tax minimisation opportunities is growing.[19] These leakages mean that ordinary wage-earners pay higher average rates, while the wealthier and well-advised can reduce their tax burdens.[20] That is why many of our revenue recommendations focus on broadening the income tax base (Chapter 4).

With no changes in policy, receipts are projected to grow over the next decade, although this is premised on the assumption that government will allow income tax collection to creep up over the decade without 'returning' bracket creep via income tax cuts.[21]

But even with the tailwinds of bracket creep, revenues are not keeping pace with spending increases, resulting in a persistent structural deficit (Section 1.4). Indeed, the growing gulf between our expectations of government and our tax base is like expecting BMW services on a Kia budget.

1.4 A generation of deficits

Australia has been running structural deficits almost every year since the Global Financial Crisis (GFC). A structural deficit of about 2 per cent of GDP, or about $50 billion per year in today's dollars, has opened up and official estimates suggest that it will remain over the next decade (Figure 1.5).[22] In other words, once we strip out cyclical effects from fluctuations in economic activity, commodity prices, and emergency economic measures, the Australian government spends more than it collects in revenues and is expected to continue doing so.

However, the official estimates are likely to understate the medium-term position, given the un-costed spending pressures discussed in Section 1.2. We estimate that the true structural deficit is probably more than $70 billion in today's dollars, or close to 3 per cent of GDP, a year.[23]

Longer-term budget pressures also loom large

Beyond the 10-year horizon that is the focus of this report, structural budget pressures will continue to mount.

The ageing population will further supercharge demand for services, particularly health and aged care, while also narrowing the tax base.[24]

Slower productivity growth, if it becomes entrenched, will also worsen the longer-term outlook. Lower productivity growth feeds through to lower economic growth, reducing the budget dividend from growth. The 2021 Intergenerational Report projected that if productivity growth remained at its 1.2 per cent average of the past 20 years, rather than

19. For example, Treasury estimates that capital gains discounts for individuals and trusts (which exempts half of capital gains for assets held for at least a year) cost $4.4 billion in 2014 and $17 billion in 2022; similarly, concessional taxation of employer super contributions (which are taxed at 15 per cent rather than 30 per cent for individuals whose contributions are below a specific threshold) cost $14.5 billion in 2014 and $21.7 billion in 2022: Treasury (2018, pp. 77, 105); Treasury (2023, pp. 127, 162).
20. See Stewart (2022, Chapters 9 and 11) for more on tax minimisation. Company tax receipts are subject to similar pressures because multinational companies use international tax minimisation practices: PBO (2018, p. 22).
21. PBO (2022b, Sections 4.2–4.3).
22. In a March 2023 speech, former Treasury Secretary Ken Henry also argued that the federal government will need to raise an extra $50 billion a year to cover spending pressures: Kehoe and Wootton (2023) and Grattan (2023).
23. Adding our estimate of 0.9 per cent of GDP (Figure 1.2) to Treasury's estimate of a 2 per cent structural deficit (Figure 1.5) gives us 2.9 per cent of GDP in 2033, which is the equivalent of $72 billion this year.
24. See Treasury (2021, Chapters 2 and 7). For example, in 2019-20 there were 4 people of traditional working age (15–64) for every person aged 65 and over, but by 2061 the ratio is expected to be only 2.7: Treasury (ibid, p. 31).

Box 1: Australia's tax mix is different to many advanced economies

Australia is a low-tax country among our economic peers, but our tax mix also looks different in several notable ways.

First, Australia appears to collect more in taxes on individuals – the bulk of which is income tax – than most OECD nations. However, we do not have a contributory social security program as most of these other countries do. Social security contributions, which are levied on income, are forms of income tax.[a] Once these are factored in, Australia's taxes on individuals are *lower* as a share of the economy and as a share of total collections than the OECD average (Figure 1.4).

Even if we include Australian compulsory super contributions, which are mandated from income but accrue to individuals rather than government (and are not generally regarded as taxes), Australia would still be below the OECD average.

Company tax collections are currently higher in Australia compared with our peer economies (4.7 per cent of GDP compared to an OECD average of 3.1 per cent). But this difference is not as large as it may initially appear because of our almost unique dividend imputation system. About one-third to half of corporate tax revenues in Australia are handed back to shareholders in credits against company tax already collected.[b]

Company tax collections are expected to shrink as a proportion of the economy over the next decade as elevated commodity prices return to long-term levels.[c]

There are genuine concerns that Australia's relatively high rate of company tax may be a barrier for international investors who do not enjoy the advantages of dividend imputation.[d] But cutting the headline tax rate would be a very expensive way to address this concern. Investment allowances deliver much better 'bang for buck' in terms of encouraging new investment.[e]

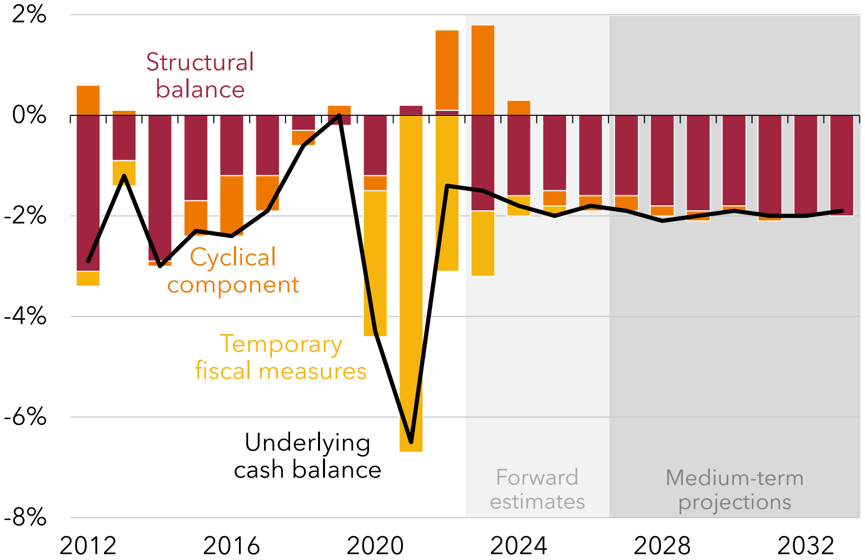
Australia also collects considerably less in revenue through its goods and services taxes than other OECD nations – 7.3 per cent of GDP compared with the OCED average of 10.7 per cent (Figure 1.4). This reflects the lower tax rate and narrower base in Australia than in most OECD nations (see Chapter 4). And GST-applicable items are shrinking as a share of household spending, because people are spending more on exempt goods and services, particularly in housing and health.[f]

a. Stewart (2022, pp. 23–24); and Whiteford (2022).
b. Stewart (2019).
c. Treasury (2022a, p. 150); and PBO (2022b, p. 18). The reduction in smaller businesses' tax rate in recent years can also be expected to put downward pressure on company tax receipts. See ATO (2022a) and PBO (2018, Section 3.1).
d. Rose et al (2021).
e. Minifie (2017).
f. PBO (2020).

returning to its 30-year average of 1.5 per cent, it would double the already sizeable deficits by 2061.[25]

Figure 1.5: A structural budget deficit is projected every year over the next decade

Budget components as a proportion of GDP



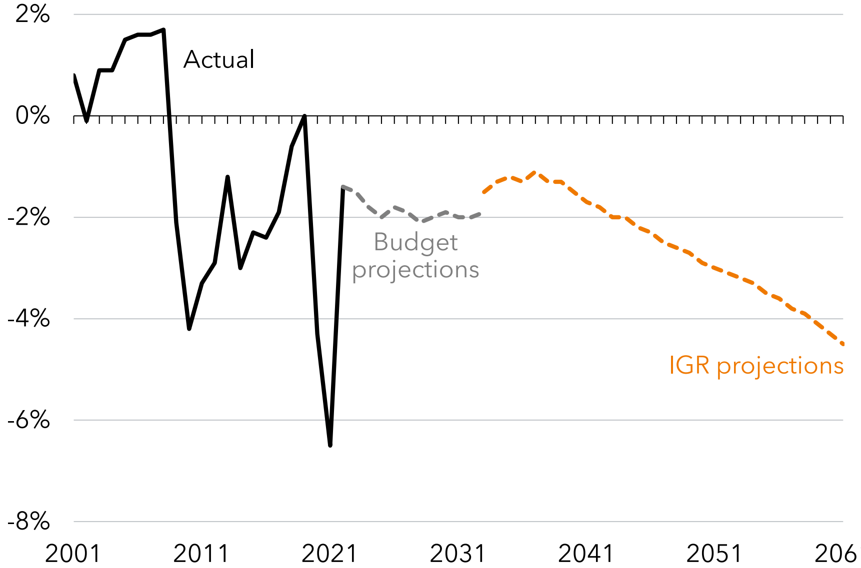
Notes: Data are for the financial year. The cyclical component includes automatic stabilisers and cyclical movements in commodity and asset prices. Other fiscal measures include COVID-related direct economic and health support measures.

Source: Treasury (2022a, Chart 3.20).

The 2021 Intergenerational Report also showed that, without corrective action, the impacts of ageing and slower productivity growth alone would result in deficits steadily growing over the next 40 years (Figure 1.6).

Figure 1.6: Ongoing low productivity growth will make the deficit worse

Underlying cash balance of the federal government as a proportion of GDP



Notes: IGR = Intergenerational Report. Data are for the financial year. Projections from the 2021 IGR are shown from 2033 only. Both sets of projections assume productivity growth of 1.2 per cent.

Sources: PBO (2022a, Table 1); Treasury (2022a, Chart 3.2); and Treasury (2021, Chart 4.6).

Finally, climate change, which is not factored into the above projections, will add to budget pressures through both the impacts of more extreme weather events and the costs of moving to a greener economy.[26]

25. Treasury (2021, Box 4.2 and Chart 6.7); and Treasury (2022a, Box 3.3).

26. In the short-term, the budget impacts will mainly be in additional health spending and disaster recovery payments (for example the Black Summer bushfires and 2022 floods cost the federal government about $3.2 billion combined). While this is relatively small in the scheme of the budget today, in the longer term costs will be much greater: for example, NSW Treasury (2021) predicts that by 2061, natural disasters alone will cost the NSW economy between $15.8 billion and $17.2 billion

1.5 Debt will continue to grow

Ongoing budget deficits have resulted in an increase in the federal government's net debt since the GFC, even before additional borrowing to fund COVID supports (Figure 1.7).[27] Indeed, most of the increase in debt occurred during an extended period of economic expansion.

Current official estimates have net debt increasing steadily, from 22.5 per cent of GDP in 2022 to 31.9 per cent of GDP by 2033.[28] Updated estimates in the May 2023 Budget will probably show a more favourable trajectory – because economic growth has been stronger than expected and commodity prices have stayed elevated for longer than expected – but the same structural pressures will remain.

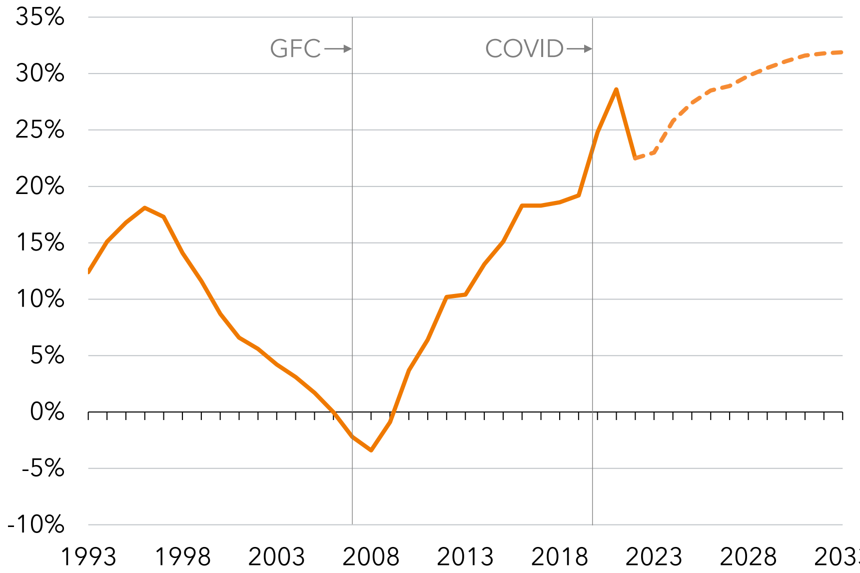
While Australia still has a low level of public debt by international standards, our net debt has grown faster in the past decade than many of our peers (Appendix A). Without a change in policy settings, our public indebtedness will only continue to grow.

If the government aims to at least stabilise net debt as a share of GDP over time during periods of economic expansion[29] – and there are important reasons to do so (Box 2) – the government will need to substantially reduce the size of Australia's structural budget deficit over time.

Our estimates suggest the government would need to shrink its projected deficits by an average of 1.2 per cent of GDP per year – that is, more than halving the structural deficit – for debt to remain the same

Figure 1.7: Federal government debt has grown rapidly since the GFC and is expected to continue growing

Federal government net debt as a proportion of GDP



Notes: Data are for the financial year. The dashed line represents Treasury's October 2022 Budget projections, which comprise forward estimates from 2023 to 2026 and medium-term projections from 2027 to 2033.

Sources: PBO (2022a, Table 2); and Treasury (2022a, Chart 3.15).

every year, or the equivalent of 2.5-to-2.8 per cent of NSW's economy. See also Griffiths and Reeve (2022).

27. Net debt is the sum of the government's financial liabilities (gross debt) less its financial assets.
28. Treasury (2022a, Chart 3.15).
29. A persistently growing debt-to-GDP ratio during the 'good times' is arguably an indication of unsustainable budget policies. See Blanchard (2022) for a discussion on when debt becomes 'unsafe'.

as today in 10 years' time.[30] Keeping debt stable would save taxpayers about $10 billion per year in interest payments alone by 2033[31] – almost the entire higher education budget.[32]

1.6 State governments have budget challenges too

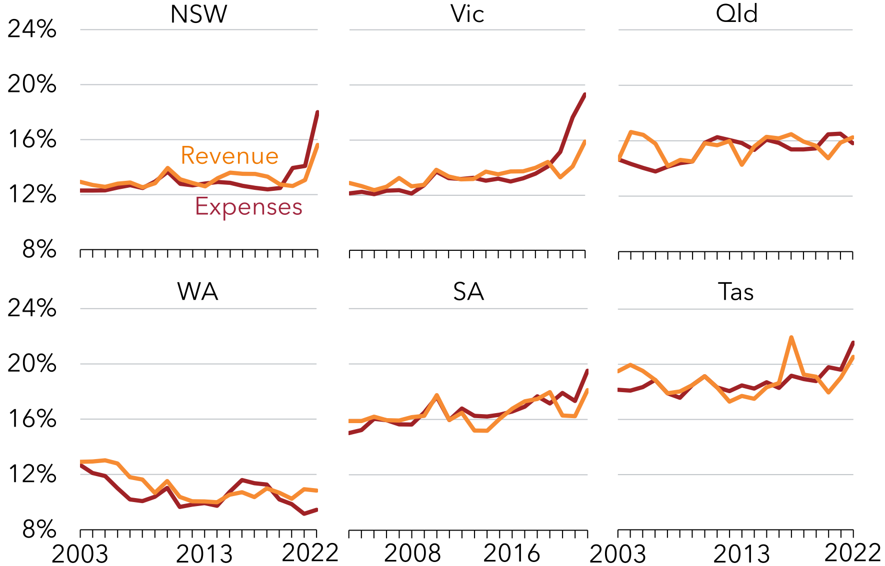
Most Australian state governments are facing long-term budget pressures too.

Budgets in Western Australia and Queensland have been temporarily boosted by growing mining and resource royalties. But the budget position of most state governments deteriorated substantially in the wake of the COVID recession (Figure 1.8).

Many states have also significantly ramped up capital spending, which will hit their future net operating balances.[33] In NSW and Victoria, yearly spending nearly tripled from an average of 0.6 per cent of

Figure 1.8: Budgets have also been under pressure in most states

Revenue and expenses as a proportion of gross state product



Notes: Data are for the financial year. Expenses excludes the net acquisition of non-financial assets.

Sources: PBO (2022c, Tab D11); and ABS (2022c, Table 1).

30. Grattan analysis comparing the difference between the October 2022 Budget projections for the next 10 years with a hypothetical scenario where debt-to-GDP remains at 2023 levels over the same period. We took Treasury's projected 2033 gross debt, added Grattan's estimate of additional spending required (as per Figure 1.2), and then took the difference between that and 2023 gross debt as the total 'correction' needed over 10 years for debt-to-GDP to be stable (excluding interest). We then added the savings from lower interest payments under our hypothetical scenario. We estimated the government's refinancing needs each year to keep debt-to-GDP at 2023 levels, based on the mix and maturity profile of Australian Government Securities on issue as at the Budget, using the interest rate assumptions from the Budget. Grattan Institute analysis of Treasury (2022a, Charts 2.26, 3.6, 3.8, 7.2 and Tables 1.2, 7.4, 7.5, 7.6, 11.5).
31. Interest payments in 2033 would amount to 1.4 per cent of GDP in our hypothetical scenario, compared with Treasury's projection of 1.8 per cent. Saving 0.4 per cent of GDP per year on interest payments from 2033 is equivalent to about $10 billion in today's dollars.
32. The total cost of higher education is expected to be $10.6 billion this year: Treasury (2022a, Table 6A.1).
33. The depreciation on this capital spending affects net operating balances in subsequent budget years.

Box 2: Why you should care about budget repair

Fiscal sustainability does not require governments to run balanced budgets or surpluses every year. Indeed, responsible fiscal policy will see deficits expand during downturns. But if budget deficits outside of economic downturns translate into persistently growing debt, then they can threaten sustainability.

Large and persistent deficits, higher interest rates on existing debt, and low economic growth all make a growing debt-to-GDP ratio more likely.

Containing growth in debt over time matters for three reasons.

1. Market access and the price of debt

Lenders have greater confidence in governments that have a credible commitment to fiscal sustainability.[a] When lenders are sceptical of a government's ability to soundly manage the economy and its debt obligations, the extra risk is priced in, even when default is perceived to be a remote possibility (Appendix B). This makes it more expensive to borrow and increases future drain on budgets from interest costs.

2. Economic firepower

The federal budget is one of the main defences Australia has in the event of an economic downturn, particularly when the Reserve Bank has little room to move. Having the funds and political capital to spend big when needed cushions the blow, which was crucial to Australia's relatively speedy economic recovery from both the GFC and COVID.

Being on a fiscally sustainable path – and being seen to be so – is an important pre-condition for a government to be able to ramp up spending and/or reduce taxes in response to shocks.[b]

3. Intergenerational equity

Budget deficits borrow from the future. They require future generations of taxpayers to pay for today's spending.

Ongoing deficits might be rationalised if borrowing is funding productive investments that benefit future generations, or if economic growth is greater than the real interest rate.[c] Yet in practice, much of current government spending – including the areas growing most quickly, such as aged care and the NDIS – is valuable but does not benefit future generations much.[d] Indeed, even where governments have spent big on 'investments' such as transport infrastructure, they have often picked and delivered poorly (Chapter 3), limiting the benefit to future generations relative to the extra repayments they will face.

Sizeable intergenerational transfers are particularly difficult to defend when future generations already face substantially greater fiscal headwinds from the ageing population and climate change (Section 1.4).

Sources: (a) IMF (2021, Chapter 2). (b) D. H. Romer and C. D. Romer (2019) found that countries with lower debt-to-GDP ratios responded to financial distress with more expansionary fiscal policy due largely to the choices of policymakers rather than problems with market access; these countries suffered much less severe aftermath as a result. This suggests lower debt is important to create the room for public appetite to respond as necessary to shocks. (c) An increase in debt can be sustainable if the borrowed funds are used to increase the size of the economy by more than it would cost to service the extra debt. But even when additional spending is justified in terms of intergenerational fairness, there would still be an inherent limit to additional borrowing because market access and pricing are tied to perceptions of fiscal sustainability. Deficits are also sustainable if the deficit plus interest remains less than nominal GDP growth. (d) The existence of a safety net has value for all generations, but the primary beneficiary is the individual.

the economy in the five years to 2016, to an average of 1.6 per cent and 1.9 per cent respectively in the five years to 2022.[34] Most of this increase has been on transport infrastructure. And it has been funded largely by borrowing, so net debt has increased rapidly (Figure 1.9). This means that depreciation and interest will be growing costs for state budgets over the next decade.[35]

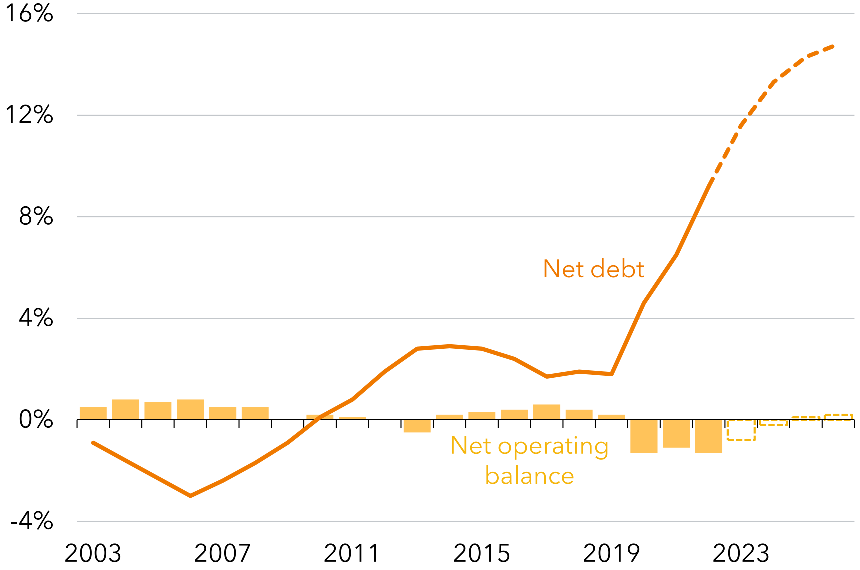
In the long-term, fast-growing areas of expenditure such as hospitals, and areas of significant need such as social housing, are likely to put further pressure on state budgets.

The size of government has already expanded substantially in NSW and Victoria over the past decade to meet these demands (Figure 1.8). The 2021 NSW Intergenerational Report shows that demographic change and climate change will supercharge these pressures, with state government spending projected to grow to 14.5 per cent of NSW gross state product by 2061, from 12.5 per cent in 2019.[36] With no other action, this would take NSW's net debt to 99.9 per cent of gross state product in 2061, from -1.7 per cent in 2019.[37]

34. Net capital investment excluding government businesses: PBO (2022c, Tab D11); and ABS (2022c, Table 1).
35. Interest payments on state debt, which accounted for 0.4 per cent of Australia's GDP nearly every year in the decade to 2022, are expected to reach 0.6 per cent of GDP by 2026: PBO (2022c, Tab C5). Four-fifths of these payments in 2026 are expected to be from the debts of three states: Victoria (38 per cent), NSW (26 per cent), and Queensland (17 per cent): PBO (ibid, Tab D11). The bulk of states' and territories' net capital investment in 2022 was from NSW (37 per cent) and Victoria (35 per cent): PBO (ibid, Tab D11). In NSW, depreciation expenses are already expected to account for 6.9 per cent of spending and are expected to grow by 4.9 per cent every year on average to 2026: NSW Treasury (2022, pp. 5–10). Depreciation expenses are expected to grow at an annual average of 2.3 per cent to 2026 for Victoria: Victorian Treasury (2022, p. 64).
36. The figures exclude net capital expenditure: NSW Treasury (2021, Appendix – Projections summary).
37. Ibid (Appendix – Projections summary).

Figure 1.9: State and territory net debt has increased rapidly

Total net debt of states and territories as a proportion of Australia's GDP



Source: PBO (2022c, Tabs C4, C5).

State revenues are also likely to come under renewed pressure. The two biggest revenue sources for states – the GST and property stamp duties – are vulnerable to broader economic changes.

GST revenues (which are transferred from the federal government to the states as untied grants) are vulnerable in the long term because of shifts in people's consumption patterns (Box 1). Until the GST is reformed, it is unlikely to be the 'growth tax' the states were promised (Section 4.4).

State governments have relied heavily on fast-growing property tax revenues for much of the past decade. Stamp duty has outpaced growth in economic activity in most states.[38] The downturn in the property market, and the potential for lower growth in house prices in future,[39] means these 'rivers of gold' may not run as freely as they have in the past.[40]

This report is focused on federal rather than state government budget pressures, but previous Grattan Institute reports include various recommendations that would improve state budget positions.[41]

Growing state government budget pressures inevitably squeeze the federal budget. State governments are very effective at bringing political pressures to bear on the federal government for more money to help fund critical services. State governments are already asking the federal government to continue COVID hospital funding arrangements to help relieve growing cost pressures.[42]

38. From 2013 to 2021, annual growth in stamp duty tax revenue exceeded growth in nominal gross state product for most of the time for NSW, Victoria, Queensland, and Tasmania: Grattan analysis of ABS (2022d, Tables 2-9) and ABS (2022c, Table 1).
39. The NSW Intergenerational Report says that 'if we are able to build enough new homes for our growing population, rising interest rates are expected to slow the growth in house prices'. The Report projects that stamp duty revenue will grow more slowly because population growth is projected to be slower, reducing pressure on house prices: NSW Treasury (2021, pp. 13, 93).
40. The volatility of stamp duty revenues has always been a significant challenge for state governments in running their budgets: for example, see NSW Treasury (ibid, p. 94); and Daley et al (2018c).
41. See, for example, Daley et al (ibid); Daley and Coates (2015); Terrill et al (2019a); and Terrill et al (2019b).
42. During the pandemic, the federal government increased its share of public hospital funding from 45 per cent to 50 per cent (with the remainder paid for by the states and territories), conditional on annual cost growth remaining below 6.5 per cent. The states and territories have been seeking an extension of this arrangement, along with funding that exceeds the growth cap: see Chrysanthos (2023).

2 There are no easy options

There are no easy options for budget repair, but now is the right time to begin the heavy lifting. The combination of low unemployment and high inflation makes this a good time to consolidate the budget. Delaying will only make the future challenge harder.

The size of the problem, and the politics of budget repair, mean that both spending and revenue measures need to be on the table. Boosting growth is important but alone is unlikely to put the nation's finances on a sustainable trajectory.

This report presents a menu of options that could make a real difference.

2.1 Genuine budget repair requires tackling spending and revenue

The federal government should act on both revenue and spending to put Australia's public finances back on a sustainable footing. The scale of the structural problem means it is unlikely to be solved on one side of the budget alone.

Tackling lower-value and inefficient spending is imperative for both the economics and politics of budget repair. If they are being asked to contribute more in taxes, taxpayers have a right to expect that services will be delivered as efficiently as possible and targeted to the people that most need the support. This is not always the case and there is capacity for governments to deliver significant budget savings through some of the proposals outlined in Chapter 3.

However, it is simply impossible to rely on spending cuts alone to do the heavy lifting in closing the structural deficit without seriously winding back the scope of what government delivers.

Indeed, given expansions in the scope of government spending in recent years – including greater dignity and support for older Australians in care and for Australians with a disability, and a greatly expanded defence program (Section 1.1) – keeping spending within the existing envelope would mean either winding back these changes or making deep cuts into core services such as health, education, or welfare.

For example, if we were to reduce spending by $50 billion a year to meaningfully close the structural deficit, it would entail annual spending cuts almost three times larger than those announced in the controversial 2014 Budget, much of which did not pass Parliament.[43] To put it another way, these cuts would be almost equivalent to total federal spending on schools and public hospitals combined this year.[44]

This is why – barring a fundamental shift in community expectations – revenue increases will need to do more of the heavy lifting of budget repair.

The good news is that Australia begins this process as a relatively low-tax country (Section 1.3). Indeed, even if we were to adopt *all* of the tax changes on our menu of options (Chapter 4), our tax collections would still be below the OECD average and that of countries such as the UK as a share of GDP.

The other good news is that on the tax side we can do the heavy lifting by expanding underutilised tax bases such as the GST and/or winding back concessions and planning opportunities rather than lifting base

43. The cut to spending for 2017-18, the final year of the forward estimates period in the 2014 Budget, was $17.9 billion (in December 2022 dollars): Treasury (2014, p. 3-23); ABS (2023b).
44. Treasury (2022a, Table 6A.1).

rates of income and company taxes that would have larger undesirable economic effects.[45]

Given budget repair is politically challenging, a sense of 'sharing the pain' is important to building public support. Some economists have argued that a single dedicated revenue-raising option may be more politically feasible than tackling the debt on multiple fronts.[46] But moving on both revenue and spending spreads the pain of budget repair. In the past, tax increases have often also been linked to better services and safety nets as a more palatable 'grand bargain'.[47]

2.2 Can't we grow our way out of debt?

Many seeking to avoid the type of difficult policy prescriptions in this report argue that we should aim to 'grow ourselves out of debt'.

It is true that higher rates of productivity and economic growth would help ease the enormity of the structural budget challenge.

Governments can and should aim to do what they can to boost economic activity and living standards. They should also avoid making bad economic choices that could further slow growth and make the budget repair task even harder.[48]

45. Two exceptions on our menu are winding back elements of the Stage 3 tax cuts (Section 4.1) and realigning the corporate tax rate (Section 4.7). In both cases our proposals affect only a subset of taxpayers and companies with a more limited economic impact.
46. Rose and Breunig (2020). See also: Grattan (2023).
47. For example, a 'Social Services Contribution' was introduced in 1945 to help pay for social security benefits, and the Medicare Levy was introduced in 1984 to help fund universal health care. See Reinhardt and Steel (2006).
48. For example, protectionism and much industry assistance can drag on productivity. Industry assistance has reached historic highs in recent years, even after excluding economy-wide COVID-related expenditure: Productivity Commission (2023, Volume 2, Box 2.1).

There are levers that governments have that can make a difference to growth in the short and long term. Grattan Institute has had much to say on these previously,[49] and the Productivity Commission's 2023 five-year productivity review makes lots of recommendations.[50]

Improving the composition of our skilled migration program is one example of a (non-budget) policy that could deliver a sizeable fiscal dividend as well as broader economic benefits.[51] The government should pursue this opportunity.

Improving the efficiency of Australia's tax collections is another way the government can boost productivity. The options outlined in Chapter 4 would raise revenue more efficiently than the current default reliance on bracket creep. They would therefore set Australia up for a more robust and pro-growth tax mix over time.

But relying on higher growth to save the day is not a prudent approach.

First, much of the impetus for longer-term economic growth is outside the direct control of governments. For instance, the pace and adoption of new technologies is a critical contributor to productivity[52] that governments only influence at the margins.

Second, governments have proved historically reluctant to adopt more difficult productivity-enhancing reforms. Grattan Institute's 2021 *Gridlock* report documented a declining appetite for governments to do hard things.[53] The Productivity Commission's previous five-year productivity review, published in 2017, famously sat on the shelf with almost none of its recommendations adopted.[54]

49. D. Wood et al (2022a); D. Wood (2022b); Coates et al (2022); and D. Wood et al (2020).
50. Productivity Commission (2023).
51. Coates et al (2022).
52. Dieppe et al (2021).
53. Daley (2021).
54. Productivity Commission (2017).

Indeed, even when governments have made ambitious growth pledges in the past – for example the G20's 2014 commitment to seek to lift global growth by 2 per cent of GDP through a range of in-country reform commitments[55] – they have fallen short of providing any real improvement.[56]

Third, even if the government is successful in embracing policies that do significantly increase productivity, that is still unlikely to be enough on its own to solve the budget problem. The 2021 Intergenerational Report showed that even if productivity growth lifted to its long-run average of 1.5 per cent, that would still be unlikely to be sufficient on its own to overcome the long-term budget challenges.[57]

Therefore, relying on a significant uptick in medium-term growth as a solution to Australia's budget problems would be a risky strategy. Instead, we should continue to push for pro-growth reforms, while also taking steps to consolidate the budget position. If growth surprises on the upside, there may be scope to relax the fiscal policy settings to tilt towards productivity-enhancing spending or tax reductions.

2.3 A menu of options

There are no silver bullets for solving Australia's structural budget problem. As well as being politically unpopular, cuts to spending and increases in taxes invariably cause some economic drag.

This report seeks to identify a menu of options with a good economic and/or social case that will make a meaningful difference to the structural budget problem (Figure 2.1).[58]

These are economically responsible, 'no regrets' proposals for increasing revenue and reducing spending. Indeed, even outside of budget repair, introducing these changes would free up room to cut less efficient taxes and/or deliver higher-value spending.

Our budget repair menu is not comprehensive, because it reflects mainly the areas where Grattan Institute or other credible sources have done detailed work – although this covers most of the more obvious choices.

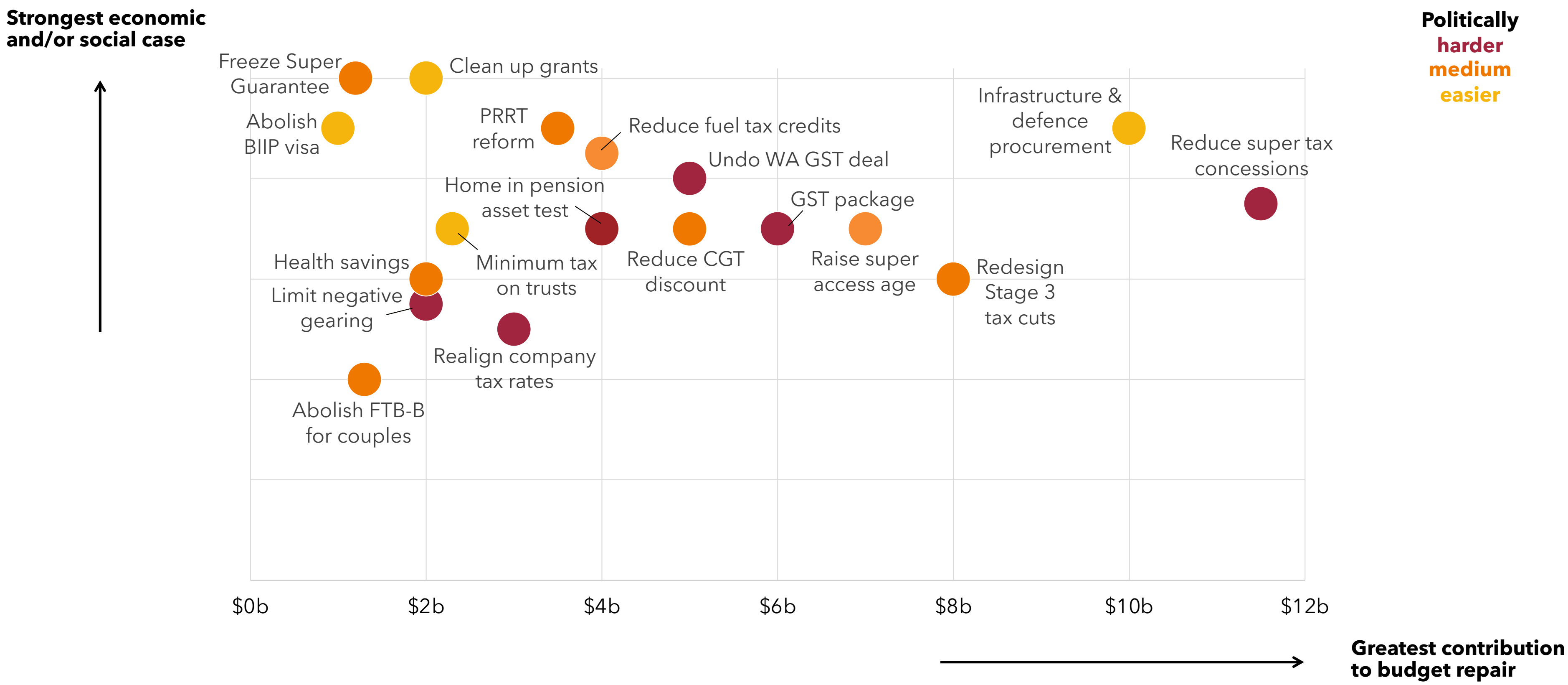
We hope that this report is useful in providing a sense of the best ideas for budget repair, but also their relative size. Understanding 'what's big' is important to improve the quality of budget discussions, which often focus disproportionately on suggestions that are politically easy but not that big in the scheme of the budget.[59]

We are not advocating that the government order the whole menu all at once. Pursuing so many major policy changes at once would be a mammoth task. But if the government has the appetite to choose several of them, we will be well on the way to tackling the structural budget deficit.[60]

The following two chapters detail a range of options to reduce the federal government's spending (Chapter 3) and increase its revenue (Chapter 4).

55. G20 (2014); see discussion in Hurst (2014).
56. See IMF (2018, Chapter 2) on persistently sluggish growth in the decade after the GFC for both advanced economies and emerging market economies.
57. Treasury (2021, Box 4.2).
58. Political feasibility is not an explicit criterion for good reform (and not simple to objectively assess). Budget repair is never politically easy, but we acknowledge the political landscape and present a practical range of options. Our menu of options is inspired by the US Congressional Budget Office's 'options for reducing the deficit' list: see CBO (2022) and CBO (2023).
59. See Box 3 on page 34 and Box 4 on page 45.
60. For example, if the government were to tackle income tax breaks, as recommended in Section 4.2, it would cut Australia's structural deficit by about 40 per cent.

Figure 2.1: All these reforms are worth doing, but some are much bigger than others



Notes: BIIP = Business Innovation and Investment Program; CGT = Capital Gains Tax; FTB-B = Family Tax Benefit part B; PRRT = Petroleum Resource Rent Tax. Labels are short-hand for the reforms detailed in Chapters 3 and 4. In ranking the tax measures, we focused on efficiency (whether the reform fixes or creates additional distortions in decision making), rather than the distributional consequences (factoring in the distributional consequences would provide additional impetus for some reforms). In ranking the spending measures, we focused on both efficiency and impacts on the vulnerable.

Source: Grattan Institute analysis.

3 Options to reduce spending

Spending discipline is an essential component of budget repair. Taxpayers have a right to expect that services will be delivered as efficiently as possible and targeted to the people who most need the support.

Over the past decade, the federal government has succeeded in constraining spending growth in many areas, and has arguably even gone too far in some, with the strong focus on suppressing supports for welfare recipients leaving some groups in deep poverty (Chapter 1).

A lot of the low-hanging fruit has already been picked. But there are still areas where governments have shown less discipline and where further savings can be found.

The single best discipline on government spending would be to adopt better processes for infrastructure and defence procurement. A practice of spending revenue windfalls rather than banking them to the bottom line has fuelled a culture of spending give-aways, particularly on infrastructure projects, when times are good. In the past decade, the savings could have amounted to tens of billions of dollars.

Further changes that would make a worthwhile dent in spending include winding back the WA GST deal, counting more of the family home in the Age Pension asset test, improving hospital efficiency and purchasing in health, cutting politicised grants, abolishing the Family Tax Benefit part B for couples, and abolishing business innovation visas. Together these changes could save $15 billion annually.

Over time, changes will also be needed to sustain fast-growing spending programs such as the NDIS and aged care.

Figure 3.1: Menu of options to reduce spending

Options to reduce spending	Time horizon	Annual value
Improve infrastructure and defence procurement	5-to-10 years +	**Several billion**
Undo the WA GST deal	Immediate	**~$5b**
Include more of the family home in the Age Pension asset test • All equity over $750,000	5-to-10 years	**~$4b+**
Cut costs in hospitals, pathology, & pharmaceuticals	Immediate	**~$2b+**
Clean up grants and advertising	Immediate	**~$1b-$2b**
Abolish Family Tax Benefit part B for couples • Keep the payment for single parents	Immediate	**~$1.3b**
Abolish the Business Innovation and Investment Program visa	10 years +	**$1b+**
Other options • Mitigate aged care cost growth • Mitigate NDIS cost growth • Evaluator-General to identify and reduce ineffective spending	5-to-10 years +	Uncosted

Source: Grattan Institute analysis.

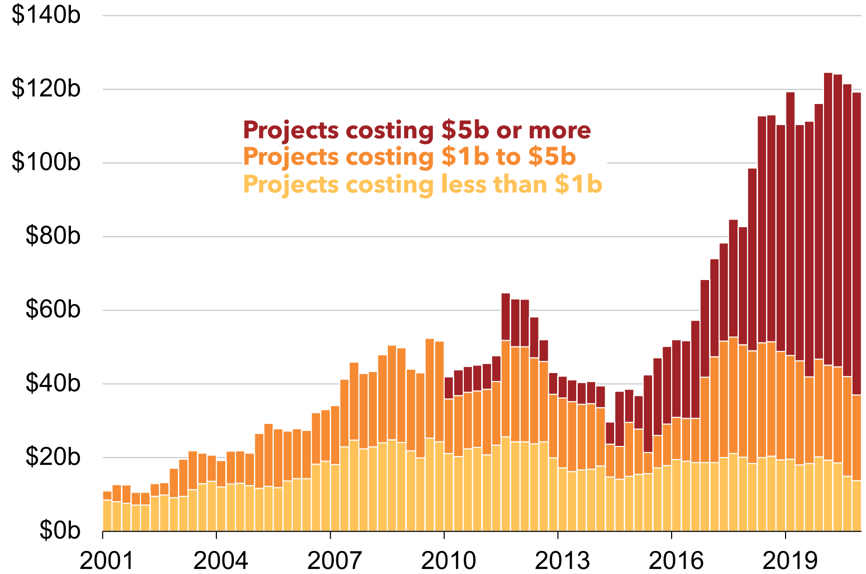
3.1 Improve infrastructure and defence procurement

The federal government spends about $50 billion a year on defence and transport infrastructure.[61] It is critical that this spending is cost-effective. Many individual projects run into the tens of billions of dollars and can run for more than a decade.[62]

One of the biggest cost savings available to governments is to stop making bad decisions – poorly conceived, often politically motivated decisions have proved very costly, especially as 'megaprojects' have become more common (Figure 3.2). Yet governments keep making the same mistakes, including:

- Premature announcement: announcements are often made before a business case and without considering all the options,[63] increasing costs and making it more difficult for governments to back out if the project doesn't stack up.
- Rushing to market: locking in contracts before the details have been fleshed out excludes competition right from the start.[64]

Figure 3.2: All the growth in transport infrastructure is in megaprojects
Expected cost of public road and rail projects under construction



Note: Includes all public road and rail projects costing more than $20 million.

Source: Terrill et al (2020).

61. $51.7 billion in 2022-23: Treasury (2022a, Tables 6.5 and 6.15).
62. For example, Submarines, Joint Strike Fighter, NBN, Suburban Rail Loop in Melbourne, WestConnex in Sydney, and North East Link in Melbourne. See Terrill et al (2020) and ANAO (2023).
63. For example, of 22 transport projects larger than $500 million to which the federal government has committed a contribution since 2016, only six had a business case published or assessed by Infrastructure Australia at the time of commitment: Terrill et al (2020).
64. For example, Defence selected an international partner for the $50 billion Future Submarine program before the design phase, 'remov[ing] competition in the design phase, and remov[ing] incentives for the international partner (DCNS) to produce a more economical and efficient build': ANAO (2017a). The expected cost of the Future Submarine program had grown to $90 billion when Australia walked away from the partnership. The government subsequently committed to an even costlier program without knowing the details, again excluding competition: Patrick (2022).

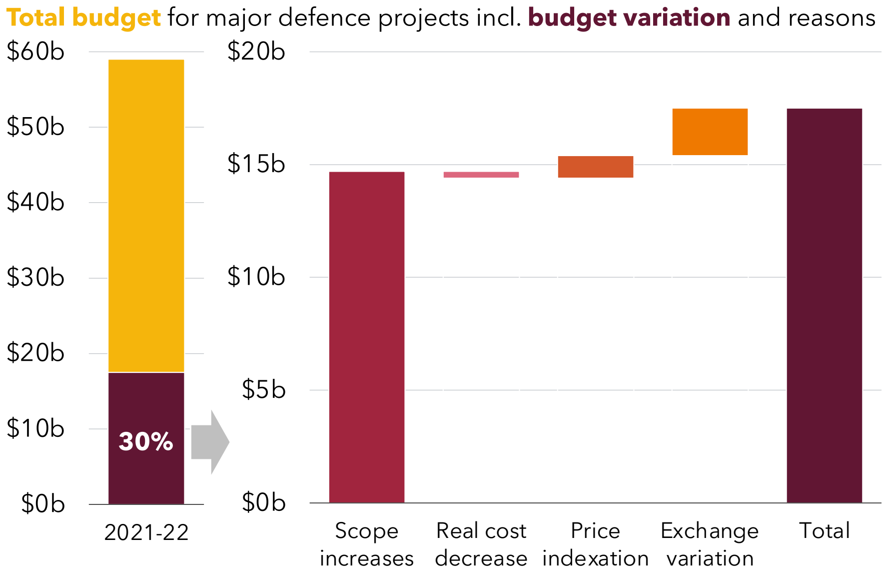
- Failing to properly estimate costs: massive cost-overruns are common among major transport and defence projects (see Figure 3.3), and the more premature the announcement, the larger the overrun.[65]
- Starting too big and getting bigger: bigger projects carry much bigger risks, and evolving scope is common given the time horizons involved in most major projects. Weak assessment of costs means these contingencies are not properly built in and planned for – and are exacerbated by poor processes and decisions along the way.[66]
- Introducing competing policy objectives: combining major projects with local industry assistance adds to cost and complexity.[67]
- Politicisation of decisions also adds to the cost, because decisions weigh electoral importance rather than just the public benefit.[68]

Getting major projects right is worth tens of billions.

In recent years Australia has wasted at least $8.5 billion on defence projects that have since been cancelled or did not meet capability requirements.[69]

65. Terrill et al (2020) and Terrill et al (2021). Across 21 major defence projects valued at $59 billion, $17.5 billion in cost increases was reported: ANAO (2023).
66. Patrick (2022); and McGregor (2023).
67. For example, defaulting to building new acquisitions domestically to support local manufacturing without considering other options (such as acquiring offshore and maintaining locally); or giving preference to bidders who pledge to use Australian-produced materials. These decisions may not offer value-for-money for Australians. The Productivity Commission has catalogued instances of large defence procurement projects that involve effective rates of assistance for domestic production of up to 300 per cent (an extraordinary rate in the context of other industry assistance of 0 and 5 per cent): Productivity Commission (2023, Volume 5, pp. 74–75).
68. Terrill and Scott (2022).
69. Patrick (2022).

Figure 3.3: Defence budget variations are huge, largely driven by scope increases



Note: The 2021-22 approved budget and variations do not include plans to acquire nuclear-powered submarines under the new AUKUS agreement.

Source: ANAO (2023).

The $368 billion AUKUS announcement came with very little scrutiny of value for money or evidence that the costs of key decisions – including local construction and bespoke design, rather than purchasing 'off the shelf' – were worth the benefits.[70]

In transport, federal money has supported infrastructure investments with highly questionable business cases, including the Inland Rail project – where costs have now blown-out to $31.4 billion (up from the $4.4 billion originally expected)[71] – and $2.2 billion for Victoria's Suburban Rail Loop.[72]

Backing the right horse is much more likely with clear objectives, stronger discipline in decision-making, and better procurement processes.

- **Start with clear objectives:** the biggest savings are in avoiding spending money on the things we don't need and the projects that won't be cost-effective. That will require much better upfront assessment of Australia's transport infrastructure[73] and defence capability needs.[74] Megaprojects should be a last resort, not a first.[75]
- **Strengthen discipline in decision-making:** do a rigorous cost-benefit analysis, including learning from experience,[76] and using the right discount rates.[77] Table the business case in parliament before committing public money.[78] And governments should be open to mothballing projects to give themselves more options on timing, for example in an overheated market.[79]
- **Improve procurement processes:** governments should avoid locking-in early, and signing contracts before the details have been fleshed out.[80] Buying smaller, more regularly, and 'off-the-shelf' reduces risks and cost. Keeping options open is especially important when capability requirements are likely to evolve, as can be the case for long-horizon defence and transport projects.

  Even with long-standing targets for growth,[81] defence spending should still be subject to the same public expectations around cost-effectiveness that apply to nearly every other area of government spending. Defence is one of only two major spending areas that is largely exempt from the annual efficiency dividend.[82]

The transport infrastructure pipeline is already crowded, so a 'pause' on new projects in the near term would be sensible and offers immediate savings (both in avoided spend and in helping to reduce cost growth on existing projects). But as Australia moves to a net-zero emissions economy, new investment in a wide range of infrastructure

70. Tillett (2023), see also Productivity Commission (2023, Volume 5, pp. 74-75).
71. Schott (2023); Terrill (2022a); Terrill (2019); and Terrill et al (2020).
72. Terrill (2022b).
73. Infrastructure Australia plays an important role here in identifying projects of national significance – governments should pay more attention to IA guidance.
74. For example, this should include assessing trade-offs between defence and diplomacy in identifying defence capability requirements, and optimal stockpile size.
75. Bigger projects carry much bigger risks: see Terrill et al (2020) and Terrill et al (2021).
76. For example, better data and evaluation of completed projects would help address the systematic underestimation of project costs. With a database of completed projects, cost estimators would be much better equipped to contextualise costs, by comparing estimated costs with actual experience: Terrill et al (2021).
77. Terrill and Batrouney (2018).
78. Terrill et al (2016).
79. As the NSW Government has recently done: O'Doherty and Leeming (2022).
80. Patrick (2022).
81. ASPI (2022); and Murphy (2023).
82. The current efficiency dividend of 1 per cent applies to only about 11 per cent of Defence appropriations relating to 'civilian and non-operational areas' of the department. The other main exemption is for the National Disability Insurance Agency: Parliamentary Joint Committee on Intelligence and Security (2017), Commonwealth of Australia (2019a) and Hamilton (2022).

will be needed, so it is critical that governments also lift their game and avoid the waste of the past.

3.2 Undo the WA GST deal

The federal government distributes GST revenue under an independent formula that seeks to give each state and territory a similar financial capacity to provide services, taking into account their different abilities to raise revenue.[83]

Western Australia has strong revenue-raising capability through its mining royalties, so during mining booms, WA receives a lower share of GST revenue.

In the lead-up to the 2019 federal election, the federal government struck a deal to ensure that WA received at least 70 cents in the dollar of GST revenue on a per-person basis.[84] In effect, this deal supports better services for WA residents than residents in other states and territories.

At the time, the federal government agreed to temporarily underwrite the cost of compensating other states, who would otherwise have gone backwards under the WA deal.

Economic circumstances have changed dramatically since the deal was done. Mining royalties in WA have shot up, so the GST deal is now costing the federal budget much more than was originally anticipated.[85]

The 'WA deal' now costs the federal budget $4.9 billion a year, and that figure is likely to rise if the deal steps up to 75 cents in the dollar from 2024-25 as proposed.[86] In effect, the federal government is spending almost $5 billion a year to support superior government services in the only state that is running a strong surplus.[87]

Winding back the deal will undoubtedly raise political challenges in WA, but not acting will be increasingly expensive and is likely to generate substantial heat anyway when the current 'no worse off' provisions for other states expire in June 2027, and the full cost of the WA deal lands on the eastern states.[88]

3.3 Count more of the family home in the Age Pension asset test

Many Age Pension payments are made to households that have substantial property assets: almost 40 per cent of the government's spending on the Age Pension goes to people with more than $750,000 in assets.[89]

83. Commonwealth Grants Commission (2023a).
84. Under the deal, all states and territories are guaranteed an arbitrary floor of at least 70 cents in the dollar of GST revenue on a per-person basis (rising to 75 cents in 2024-25), but WA is the main beneficiary of this arrangement: Eslake (2021).
85. Under the special deal, the federal government now needs to spend more to maintain the 70 cent rate for WA while ensuring that the other states don't lose revenue. This means paying much more to WA than is necessary to achieve a common service standard: Kehoe (2021).
86. Commonwealth Grants Commission (2023b) estimates the budget cost at $4.9 billion in 2023-24. This is a substantial increase even just since the October 2022 Budget estimate of $4.3 billion in 2023-24 and $4.7 billion in 2024-25 when the deal steps up to 75 cents in the dollar: Treasury (2022b, Table 3.1, p. 99). See also Kehoe (2022).
87. See Figure 1.8 and Eslake (2021). As the Commonwealth Grants Commission notes for 2022-23: 'Under the previous GST distribution arrangements, each state's GST share was calculated so that its assessed revenue (including GST) equalled its assessed expenditure. Western Australia is assessed to have revenue per person greater than assessed expenditure per person. All other states are assessed to have slightly less revenue than expenditure.'
88. Eastern state premiers are already calling for guarantees that their states will be no worse off when the current provisions expire: Gordon and Wright (2023) and Eslake (2021).
89. In 2019-20, 39 per cent of Age Pension payments went to households with net assets valued at more than $750,000: Grattan Institute analysis of ABS (2022e).

Under current rules only the first $224,500 of home equity is counted in the pension assets test;[90] the remainder is ignored. The average value of an Australian home is $880,000,[91] and the median is $705,000 nationally ($765,000 in the capital cities).[92]

The exclusion of most home equity means well-off households – provided their wealth is largely in the family home – can continue to qualify for the pension. This means taxpayers end up underwriting future inheritances.

Changing the test so that all the equity is counted above a generous threshold – for example $750,000 – would be fairer and would contribute about $4 billion a year to the budget, growing over time.[93]

Under this change, older Australians who are asset-rich but cash-poor would not need to sell their homes if they didn't want to. They could draw down against the equity in their home, via the Home Equity Access Scheme.[94] If their home equity dropped to the threshold, then they would qualify for the pension, so they would still be left with significant positive home equity.

90. This is the gap between the asset limit for homeowners vs. non-homeowners: Services Australia (2023a).
91. As at December quarter 2022: ABS (2023d).
92. Median dwelling price for Australia, as at 31 March 2023: CoreLogic (2023).
93. Grattan Institute analysis of ABS Survey of Income and Housing 2019-20. The savings would grow over time with house prices. The government should also allow other assets up to the same threshold so that non-homeowners are not disadvantaged.
94. Daley et al (2018a); and Daley et al (2018b).

3.4 Make savings in the Health portfolio

Health is one of the largest and fastest-growing areas of government expenditure, with spending on hospitals and medical benefits growing much faster than the economy (Chapter 1).[95]

The overall trend of growing health expenditure is likely to continue, particularly given new demand for care from the pandemic, population ageing, and demand for better treatments as they become available.[96]

Making hospitals more efficient can reduce this cost growth, and savings can be made by improving purchasing of pathology tests and medicines:

- Reducing hospital complications could save $1.1 billion a year, if all hospitals lifted their performance to match the best 25 per cent of hospitals.[97] Governments should give hospitals better comparative data on complications so that they can identify opportunities to improve unit by unit. And the focus of accreditation should shift from compliance to outcomes and improvement.[98]
- Greater use of nursing assistants, specialist nurses, and allied health assistants could save $430 million a year.[99]
- Changing the way the government pays for pathology testing, and negotiating the share of efficiency savings with industry, could save up to $175 million a year.[100]

95. Health currently represents 17 per cent of federal government expenditure and key areas of health spending – including hospitals and Medicare – are projected to grow by 5.4-to-6.5 per cent per year between 2022-23 and 2032-33: Treasury (2022a, p. 87).
96. Treasury (2021, pp. 94–102).
97. See Duckett et al (2018).
98. Ibid.
99. See Duckett and Breadon (2014a).
100. See Duckett and Romanes (2016).

- Encouraging the use of more cost-effective drugs through changes to the Therapeutic Group Premium program offers at least $150 million a year in savings.[101]

Together these changes could be worth more than $2 billion a year in today's dollars.[102]

And there are other avenues for savings, including: reducing the use of ineffective treatments,[103] driving down public hospital costs through a better pricing system,[104] and reducing avoidable hospital admissions of older people as part of improving aged care.[105]

The government should also consider reducing the Medicare rebate for in-hospital medical services for private patients,[106] and abolishing the private health insurance rebate for general insurance (known as 'ancillaries' or 'extras') and 'junk' products where there is no justification for a public subsidy.[107]

101. These potential savings are based on existing therapeutic groups, with at least 80 per cent of patients substituting to the cheapest, or second-cheapest, drug in each group. Therapeutic equivalence calculations are based on the Pharmaceutical Benefits Advisory Committee's therapeutic-equivalence ratios, with price estimates based on the Commonwealth Dispensed Price for Maximum Quantity of each drug. Expanding the share of drugs covered by the Therapeutic Group Premium policy would lead to additional savings.
102. Historical costings adjusted to 2022 dollars.
103. See Duckett and Breadon (2015).
104. See Duckett and Breadon (2014b).
105. Improving the quality of aged care should help reduce potentially preventable hospital admissions from nursing homes, and improving access to aged care should reduce hospital costs where people have been stuck in a hospital while waiting for a place in a nursing home: AMA (2021).
106. This would be a cost-shift to private health insurers, and therefore to private health insurance premiums.
107. 'Junk' hospital insurance products only cover care in public hospitals, which is covered under Medicare anyway: see Duckett et al (2019).

3.5 Clean up grants and advertising

Politicisation of taxpayer-funded grants and advertising is all too common and wastes public money.[108] Better processes and oversight would reduce the opportunity and incentive to politicise these funds and should reduce overall expenditure.

Many grant programs for infrastructure and services are used to 'reward' voters in government seats and 'buy' votes in marginal seats (rather than spending public money where it is most needed or most effective).[109] And some of the most politicised grant programs involve big dollars: for example, the $1 billion Community Development Grants program,[110] the $660 million Commuter Car Park scheme,[111] and the $100 million Community Sport Infrastructure Program (better known as 'sports rorts').[112]

Some of these programs could be abolished entirely, and many others substantially cut back, if grant processes were open, competitive, and merit-based. Ministers should be able to establish grant programs and define the selection criteria but should not be involved in choosing who receives grants. A multi-party standing parliamentary committee should

108. D. Wood et al (2022b); and D. Wood et al (2022c).
109. D. Wood et al (2022b).
110. The Community Development Grants program allocated more than four times as much on average to government seats compared to opposition seats: D. Wood et al (ibid). Ministers wrote to organisations confirming funding even before the department had assessed applications: ANAO (2018).
111. Under the previous federal government, the Prime Minister's department shut down a proposal from Treasury to run a competitive, merit-based scheme. Instead, the recipients were largely chosen by agreement between ministers and the Prime Minister, and the decisions appear to have been politically driven. Overall, 77 per cent of successful sites were in government-held electorates. See D. Wood et al (2022b) and ANAO (2021).
112. An Australian National Audit Office audit found that the minister disregarded departmental advice and program guidelines. The grants were disproportionately allocated to marginal electorates, and more than 40 per cent of funded projects were ineligible. See D. Wood et al (2022b) and ANAO (2020).

oversee compliance to provide a powerful and public deterrent to pork-barrelling.[113]

There would be much greater savings in reconsidering the need for a wider range of grants and special funds – particularly industry assistance funds – which may not offer sufficient community benefits to justify the costs and have the potential to crowd out private investment.[114]

Politicised government advertising also wastes public money. We estimate that politicised advertising costs the taxpayer about $50 million each year, so there are additional savings in tightening the rules around government advertising too.[115]

We recommend an independent panel assess all government advertising campaigns before they are launched. If the panel deems a campaign to be politicised, or otherwise not value for money, it should not run.[116]

3.6 Abolish the Family Tax Benefit part B for couples

Family Tax Benefits A and B support low- and middle-income families with the costs of raising a child. FTB-A is paid per child and is designed to assist with the *direct* costs of children. FTB-B is targeted to single-income families and is designed to help with the *indirect* costs of children – that is, to assist parents who are not in paid work because they are caring for children.

FTB-B plays an important role in supporting single parents,[117] but the case for supporting single-income couple families is weaker.

113. D. Wood et al (2022b).
114. Productivity Commission (2023, Volume 2, Box 2.1).
115. See D. Wood et al (2022c) for details on the costing and rule changes required.
116. Ibid.
117. The National Commission of Audit (2014) recommended continuing to pay the maximum rate of FTB-B to single parents with a child under 8.

FTB-B for couples increases barriers to workforce participation for the second earner in a couple.[118] It also raises equity questions, because it provides more to families where one parent works very little or not at all, than to families with the same income but with both parents working.[119]

The government could abolish FTB-B for couples, while maintaining the payment for single parents (or rolling it into the Parenting Payment for single parents). This would save the budget about $1.3 billion a year.[120] Some of the families affected would be very low income though, so given suppression of other payments (Chapter 1) and rising cost of living, this change may need to be packaged with overdue increases to other payments such as Commonwealth Rent Assistance and JobSeeker.

3.7 Abolish the Business Innovation and Investment Program visa

Australia's skilled migration program typically selects skilled migrants who earn above-average incomes in Australia. But some parts of the program do not give priority to younger, high-skilled migrants best placed to succeed in Australia.[121]

118. It creates a disincentive to commence work because the payment reduces as income increases and drops out entirely by the time a second earner's income reaches $29,985 a year (if the youngest child is younger than 5) or $23,360 a year (if the youngest child is 5 to 13). If the primary earner earns more than $104,432, the couple won't be eligible for FTB-B at all: Services Australia (2023b). See D. Wood et al (2020).
119. Henry et al (2009); and National Commission of Audit (2014).
120. FTB-B is worth about $4 billion a year: DSS (2022). One third of all FTB-B recipients have a partner, so if we assume similar payment levels on average between singles and couples then abolishing FTB-B for couples would be worth about $1.3 billion a year. DSS (2022) and DSS (2023).
121. Coates et al (2022, Chapter 3).

The Business Innovation and Investment Program (BIIP) visa is intended to attract high net-worth individuals to make substantial investments in Australia. But BIIP visa-holders are much less likely to work than other skilled migrants[122] and tend to earn very low incomes.[123] They also tend to be much older than other skilled migrants.[124] Few investors on BIIP visas are financing projects that would not otherwise occur.[125]

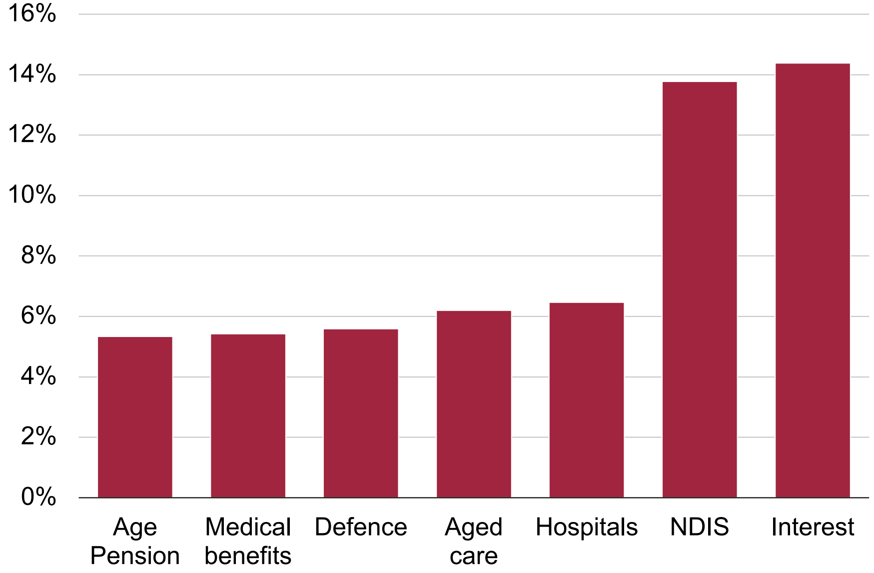
This reduces the fiscal dividend for Australia: each permanent visa allocated via the program costs Australian taxpayers $120,000 over the visa-holder's lifetime in Australia. By contrast, each primary permanent employer-sponsored visa-holder offers a lifetime fiscal dividend to the Australian community of $560,000.[126]

The government has already scaled back the BIIP allocation in 2022-23, but there are further savings to be had. The BIIP visa should be abolished entirely and skilled worker visa streams (allocated via employer sponsorship and the points test) should be expanded in its place. These changes offer long-term savings – by 2040, the federal government would be saving $1 billion a year, and $2 billion a year by 2050 (in today's dollars).[127]

122. Just half of all BIIP visa-holders were in paid work as of the 2016 Census. This is especially concerning given that the Innovation visa stream is supposed to promote innovation and skills transfer, but this seems unlikely when most applicants are not actively involved even in the businesses they own.
123. The average BIIP primary visa-holder reported an annual income of just $25,000 at the 2016 Census, compared to the average skilled worker who reported an annual income of $64,000.
124. Nearly half of BIIP visa-holders in the 2016 Census were older than 45, so would not qualify for other skilled visa categories.
125. Coates et al (2022, Section 3.3.2).
126. Net present value: Coates et al (ibid, p. 49).
127. Ibid (p. 54).

Figure 3.4: Major areas of spending cost growth

Average annual growth in major federal payments 2022-23 to 2032-33



Note: See also Figure 1.2 on page 8.

Source: Treasury (2022a, Chart 3.10).

3.8 Other options to reduce spending

There are other areas of government spending where cost growth will need to be tackled, notably the NDIS and aged care (Figure 3.4). But specific evidence-based proposals are currently lacking. This section points to a few options for savings that the government should explore further.

Mitigating cost growth in the NDIS

The National Disability Insurance Scheme will cost about $35 billion this year, to cover the 'reasonable and necessary' costs for Australians with a serious disability.[128] But this is expected to grow to about $100 billion a year by 2033.[129]

The scheme has improved the quality of life of many people with a disability.[130] It also provides longer-term benefits for the economy and governments by supporting employment[131] and reducing government spending on health, social security, and justice.[132]

But the rapidly growing cost of the scheme will put increasing pressure on the federal budget (Figure 3.4).

The federal government is currently reviewing the design, operations, and sustainability of the NDIS. The key goal of the review should be to improve the sustainability of the scheme without compromising core supports for people with a significant disability.

The review should consider:

- Better processes for identifying and reducing fraud.[133]
- Accreditation for professionals who help people access the scheme and support requests for items in NDIS plans.[134]
- Methods for determining price in 'thin markets' – many markets in regional areas and even capital cities are not sufficiently deep to rely on competitive pressures to deliver good price and quality outcomes.[135]
- Boosting supports through the states for people with a disability outside the NDIS (tier 2 supports), thereby reducing the 'oasis in the desert' effect which is driving more people to try to sign up to the NDIS.[136] The very high rates of young people accessing the NDIS – for example, 9 per cent of boys aged 5 to 7 are on the NDIS[137] – is evidence of many flocking to the scheme who may be more-cost effectively supported outside it.

128. This includes both federal and state contributions to the NDIS in 2022-23: Treasury (2022a). The federal contribution is $24.1 billion in 2022-23.
129. The federal contribution would be $88 billion with the remainder covered by state governments: Read (2022).
130. NDIS quarterly reports show improvement with life satisfaction, ability to do everyday tasks, and participation in community activities: NDIS (2023).
131. To date, overall employment effects have been much smaller than anticipated. Gains have been seen among younger participants (under 35s) but participation among older age groups has gone backwards. Overall, there has been only a small increase in employment: NDIS (ibid, Q2 of Y10, p. 30).
132. Productivity Commission (2011, pp. 948–950). D'Rosario and Lloyd-Cape (2021) estimated that the NDIS in 2020-21 produced economic activity in the region of $29 billion, in addition to that created by the $23.3 billion of NDIS spending.
133. Evans (2022).
134. As recommended by the Joint Standing Committee after the plan to remove independent assessments was dropped by the former federal government: Joint Standing Committee on the NDIS (2021).
135. More fundamentally the reliance on markets to deliver government-funded human services has generally not offered the cost and quality benefits that were claimed. See Considine (2022) and D. Wood (2019).
136. State and territory governments have largely vacated the field on supporting community disability services, leaving people not eligible for the NDIS with limited options. The 'all or nothing' nature of supports increases the incentive for those with a disability to get on the NDIS: Davy et al (2018, p. 24) and Topsfield (2021).
137. NDIA (2022).

Mitigating cost growth in aged care

Australia's population is ageing.[138] This increases pressure on pension, health, and aged care costs.[139] Some savings can be made on pension costs (Section 3.3) and in health care (Section 3.4). But aged care has historically been underfunded – as the 2018-to-2021 Royal Commission into Aged Care brought shockingly to light.[140]

Aged care expenditure is expected to grow from 1.2 per cent of GDP in 2021 to at least 2.1 per cent of GDP in 2061 (or $113 billion in 2021 dollars).[141] And if the Royal Commission recommendations are implemented in full alongside other policy commitments since it finished in 2021,[142] aged care expenditure is likely to grow to more than 2.5 per cent of GDP by 2061.[143]

In laying the foundations for a new rights-based model of aged care – as recommended by the Royal Commission – the federal government should be thinking about how best to mitigate this cost growth.

Perhaps the best opportunity to meet both goals lies in home care. Countries with fiscally sustainable rights-based models typically have a high proportion of at-home aged care.[144] Australians overwhelmingly prefer home care to residential aged care,[145] and home care is cheaper per person.[146]

But despite recent increases in the number of home care places, there are still 50,000 Australians waiting for a home care package.[147] And the long waiting lists for home care lead some people (about 16 per cent) to go into residential care unnecessarily or prematurely – at greater cost to taxpayers.[148]

Investing in home care will reduce time spent in residential care. Expanding home care won't necessarily deliver absolute savings[149] – unless people who are already in residential care are able to return home – but if people with less complex needs are cared for at home for longer, rather than in residential care, it will make aged care cheaper per person and provide better care to more people.

A greater portion of the family home should also be included in the means tests for residential aged care. The current means test for residential aged care support incorporates only the first $193,219 of the aged care resident's home,[150] and only when there are no remaining protected residents such as a spouse or dependent children still living in the family home. When assessing residents' capacity to contribute to their aged care costs, the means test could include the full value of

138. Australians are living longer, healthier lives, fertility rates remain below the replacement rate, and the Baby Boomer generation has begun to retire. The net result is an ageing population: Treasury (2021) and PBO (2019). The number of people aged 70 and older is expected to more than double over the next 40 years: Treasury (2021).
139. It also erodes the tax base, because older people are less likely to be working (although some have substantial investment income).
140. Aged Care Royal Commission (2021).
141. Treasury (2021, p. 104).
142. Other policy commitments include the Fair Work Commission wage rise for aged care workers.
143. Grattan Institute analysis of Treasury (2021, Chart 7.2.1) and Aged Care Royal Commission (2021). Drivers not included in the original Intergenerational Report projections were assumed to grow at the same rate as those in the IGR.
144. Dyer et al (2020).
145. Aged Care Royal Commission (2021).
146. As at 2018-19, the federal government spent $60,900 per person on residential care and $18,700 per person on home care: Duckett and Swerissen (2020, p. 8). Even when comparing the highest level of home care funding (Level 4) with the average cost of residential care, residential care costs the government about 25 per cent more: see Duckett and Swerissen (2021).
147. As at 30 June 2022: Department of Health and Aged Care (2022a).
148. Waiting list transfers to residential care were reportedly 19,000 in 2019, which was 16 per cent of the waiting list. See Duckett and Swerissen (2021, Appendix A).
149. Because of current unmet demand for care.
150. The is the current 'home exemption cap' as at 20 March 2023: Department of Health and Aged Care (2022b).

the home, or its value above a threshold.[151] Residents could draw down against the equity in their home to pay for extra aged care costs, via the Home Equity Access Scheme, if they didn't want to sell their home.

In the longer term, more substantial reforms – such as recouping the cost of aged care from people's estates (again while maintaining a generous buffer) – may be needed to ensure that funding for quality aged care services is sustainable.

The proposed Evaluator-General should help prevent poor spending in future

The federal government plans to establish an Evaluator-General to oversee high-quality evaluations of government programs in collaboration with other agencies.[152] Evaluation of government programs has historically been weak – or lacking entirely – so policy makers are rarely able to learn from their mistakes.[153] This new function will be a welcome addition, although with quite a small expected budget ($5 million a year) its scope will be limited.[154]

Additional funding for evaluation to enable all departments and agencies to evaluate their programs on a regular basis, and for the Australian National Audit Office to review major expenditure programs, may be important to identifying wasteful spending.

151. Daley et al (2018a). The National Commission of Audit (2014) recommended including the full value of the home in the aged care means test, with arrangements to allow older Australians to access equity in their home to pay part of the cost of their aged care services.
152. Leigh (2018); and Leigh (2023).
153. Siminski and Cobb-Clark (2019); and Leigh (2023).
154. Siminski and Cobb-Clark (2019).

Box 3: Some go-to spending cuts don't offer much in savings

Spending cuts have been the focus of budget repair efforts for most of the past decade, so a lot of the lower-hanging fruit has already been picked. And many common targets for cuts are just not that big in the scheme of government spending.

For example, over the past decade there have been substantial cuts to the public service. While there may still be further opportunities for efficiencies, the public service is already subject to efficiency dividends,[a] staffing caps were only recently lifted, and the government is already factoring in savings of about $1 billion a year from consultants, advertising, travel, and legal expenditure.[b] Large wage increases would place further pressure on spending though.[c]

'Slashing the ABC' is regularly canvassed as an option for savings, but again, the ABC has already sustained substantial cuts over the past decade[d] and, with a total budget of $1.2 billion,[e] further trimming won't offer much in savings.

Going after 'dole cheats' and 'welfare scammers' is another idea that regularly comes up. But this soil is already well-tilled: since 2012, there have been 14 different budget measures, expected to deliver combined savings of $3.2 billion.[f] Many welfare compliance schemes are also ineffective in hitting their savings targets,[g] and, when poorly designed, can have disastrous consequences, as the Robodebt Royal Commission has demonstrated.

Sources: (a) The efficiency dividend (ED) is currently 1 per cent, but EDs have averaged more than 2 per cent for the past decade, and reached as high as 4 per cent in 2013. (b) Treasury (2022c, p. 83). (c) Bajkowski (2023). (d) Karp (2022). (e) Treasury (2022d). (f) Grattan analysis of Budgets 2012 to 2022 (October). $3.2 billion is the combined total of the nominal net savings expected at the time each measure was announced. (g) Knaus (2017) and ANAO (2017b).

4 Options to increase revenue

Tackling Australia's fiscal challenge without compromising core services will require increasing government revenue.

Tax increases inevitably create some economic drag. We focus on options that minimise this fallout.

A redesign of the Stage 3 tax cuts, to reduce their generosity at the top end, could be a down payment on budget repair. But the government will also need to make structural changes.

It should start with plugging 'leakages' in the income tax system. Concessions and minimisation opportunities are a growing cost to the budget. Broadening the income tax base should reduce the temptation to rely solely on bracket creep for budget repair.

Increasing taxes on business would have high economic costs. But pricing carbon emissions – through reducing the fuel tax credit – and giving Australians a greater share of resource rents have much less economic downside.

Increasing the GST – in conjunction with targeted increases in welfare supports and reductions in income taxes – could increase revenue collections and broaden the tax base.

And finally, increasing the super preservation age would reflect the greater capacity many Australians now have to work for longer, and would deliver substantial benefits to the budget.

Figure 4.1: Menu of options to increase revenue

Options to increase revenue	Time horizon	Annual value
Redesign the Stage 3 tax cuts	Immediate	**$8b**
• Retain the 37% tax bracket		
Reduce income tax breaks	Immediate-to-5 years +	**~$21b**
• Super tax concessions		$11.5b+
• Capital Gains Tax & negative gearing		$7b+
• Trusts		$2.3b
Raise the super preservation age	10 years +	**~$7b+**
• Gradually raise from 60 to 65		
Plus freeze Super Guarantee rate		**$1.2b**
Raise the GST	Immediate-to-5 years +	**~$6b+**
• 15% GST + low-income compensation		
• Cwth keeps half the extra revenue		
Wind back fuel tax credits	Immediate	**$4b**
• Count the cost of roads and pollution		
Redesign the Petroleum Resource Rent Tax		
• Change method for pricing gas; and/or	5-to-10 years	**~$3b-$4b**
• Introduce a 10% Commonwealth royalty on offshore gas	Immediate	**~$4b**
Bolder options	5-to-10 years	Uncosted
• Realign company tax rates at 30%		
• Carbon tax		
• Inheritance tax		

Source: Grattan Institute analysis.

4.1 Redesign the Stage 3 tax cuts

In 2018, the federal government committed to a substantial package of personal income tax cuts, spread over three stages. In 2019, the government effectively doubled the package.[155] The first two stages have already been implemented, but the third and most generous stage is not due to commence until July 2024 (Figure 4.2).

The economic and fiscal environment has changed dramatically since the original plan was announced. Rather than a forecast of growing budget surpluses,[156] we now face another decade of deficits (Chapter 1). And in the current environment of high inflation, large tax cuts risk making the problem worse.

Stage 3 will cost the federal budget about $20 billion in its first year, with the annual cost growing to $31 billion by 2030.[157]

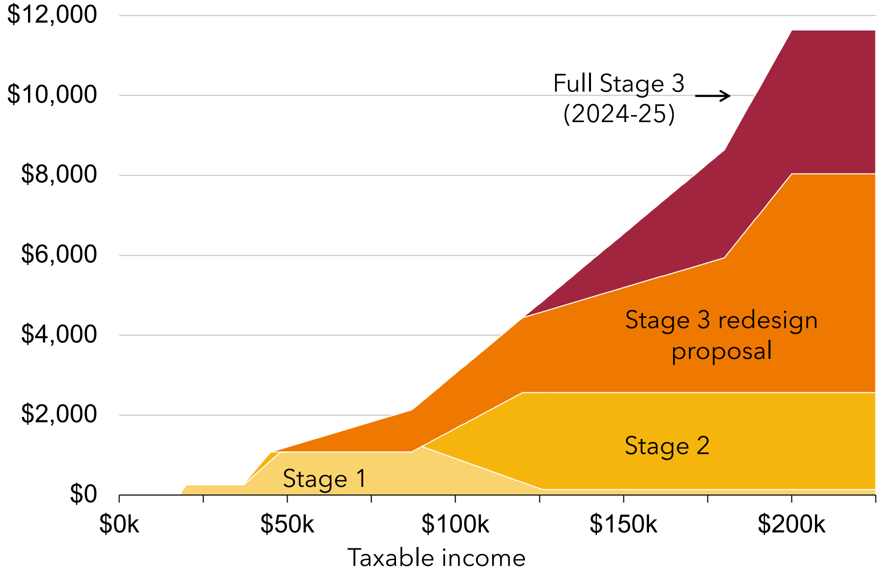
There is some justification for tax cuts given that bracket creep is pushing up average tax rates over time, particularly for middle-income earners.[158] But the Stage 3 tax cuts are too big – they overcompensate for the effects of bracket creep at the top end and give away crucial revenue that could be used to help smooth the path for difficult structural reforms.

A reasonable compromise would be to proceed with most of Stage 3 but retain the 37 per cent tax bracket.[159] This would mean reducing the 32.5 per cent tax rate to 30 per cent – benefiting everyone earning more than $45,000 – and raising the top tax threshold from $180,000 to $200,000 – recognising that incomes have grown substantially since the $180,000 threshold was introduced.[160]

155. D. Wood et al (2019a).
156. Commonwealth of Australia (2019b).
157. Grattan Institute analysis using the Build Your Own Budget tool: PBO (2022d).
158. D. Wood et al (2019a). Even if wage growth doesn't push a taxpayer into a new tax bracket, most taxpayers will still earn a bigger share of their income in their highest bracket, so end up paying more tax over time.
159. Under the full Stage 3 changes, the 37 per cent tax bracket is abolished.
160. The top tax threshold was raised from $150,000 to $180,000 on 1 July 2008: ATO (2023). Since 2008, incomes have grown substantially – for example, an income of $140,000 in 2008 (below the top tax threshold) is now worth about $200,000,

Figure 4.2: Stage 3 is coming soon and dwarfs the earlier changes

Size of annual tax cut



Notes: The full Stage 3 changes increase the threshold for the 45 per cent tax bracket from $180k to $200k, reduce the 32.5 per cent marginal tax rate to 30 per cent, and remove the 37 per cent bracket. Grattan's Stage 3 redesign proposal includes most of these changes but retains the 37 per cent tax bracket. The effect of these changes is shown on top of the permanent elements of Stages 1 and 2.

Source: Grattan Institute analysis of the federal government's personal income tax plan.

Retaining the 37 per cent tax bracket would save about $8 billion in the first year (growing to $12 billion by 2030),[161] and those taxpayers who would have benefitted – the top 10 per cent, with taxable income of more than $120,000[162] – will still gain a sizeable tax cut from the other changes (Figure 4.2).

This redesign of Stage 3 would provide a substantial down payment on budget repair. However, it is ultimately not a structural solution because further income tax cuts will eventually be needed to tackle bracket creep.

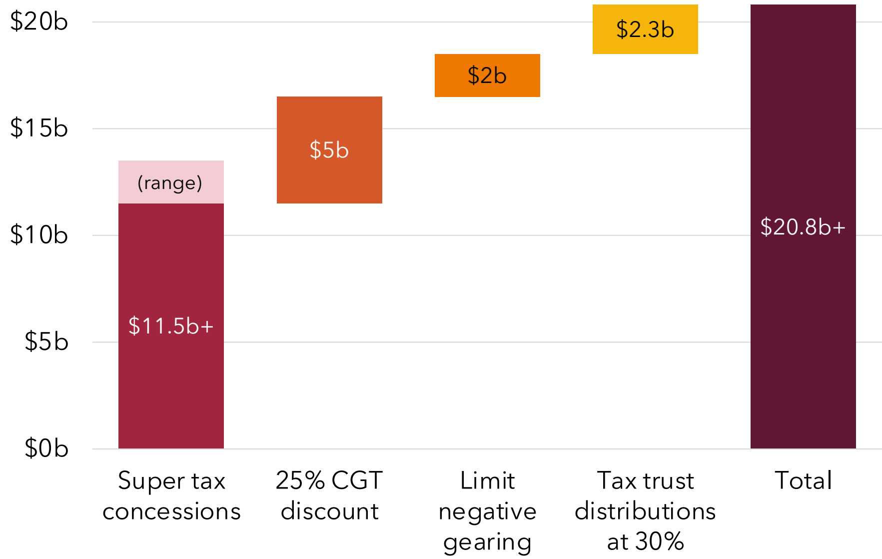
The sizeable tax cuts associated with Stage 3 (whether redesigned or not) could also be marshalled to 'buy' some of the reductions in income tax breaks recommended in the next section. History shows that difficult tax reforms are more likely to be successful where they are 'sweetened' with a tax cut.[163]

4.2 Reduce income tax breaks

There are many concessions and minimisation opportunities in Australia's personal income tax system. Curbing these 'leakages' would broaden the income tax base and, over time, reduce governments' temptation to rely on bracket creep to do the 'heavy lifting' on budget repair.

Broadening the income tax base offers a major opportunity for structural reform, would reduce distortion of economic behaviour, and has the potential to raise more than $20 billion a year (Figure 4.3).

Figure 4.3: The government could raise substantial revenue by reducing leakages in the income tax system
Annual value of reducing income tax leakages



Source: Grattan Institute analysis.

so is taxed at the top rate, even though in real terms (accounting for inflation), that income has barely grown.

161. Grattan Institute analysis using the Build Your Own Budget tool: PBO (2022d).
162. Grattan Institute analysis of ATO (2022b).
163. Daley and D. Wood (2015, pp. 13–14).

Wind back super tax concessions

Superannuation tax breaks cost the budget almost $45 billion a year and are projected to cost more than the Age Pension by 2036, while doing little to reduce Age Pension spending. These tax breaks predominantly benefit the top 20 per cent of income earners, who are unlikely to qualify for an Age Pension. Without change, superannuation risks becoming a taxpayer-funded inheritance scheme.[164]

A 2023 Grattan Institute report, *Super savings: Practical policies for fairer superannuation and a stronger budget*, recommended a package of changes, worth at least $11.5 billion,[165] including:

- Taxing super earnings in retirement at 15 per cent;
- Taxing the pre-tax contributions of high-income earners (>$220,000 a year) at 35 per cent;
- Capping pre-tax super contributions at $20,000 a year; and
- Taxing earnings on balances larger than $2 million at 30 per cent, to prevent super being used for tax minimisation and estate planning.

These changes would better target super tax concessions to their policy purpose, would not change savings behaviour, and would help make the system fairer.[166]

164. Coates and Moloney (2023).
165. $11.5 billion to $13.5 billion. These costings are detailed in Coates and Moloney (ibid) and assume that the Stage 3 tax cuts go ahead as currently legislated. If Stage 3 were wound back (as recommended in Section 4.1) then this would marginally increase the value of the super tax proposal (by about $60 million).
166. Ibid.

Reduce the Capital Gains Tax discount and limit negative gearing

Capital gains get special treatment under the current system to maintain incentives to save and invest.

If income taxes are applied to nominal capital gains, inflation can erode part of an investor's wealth. But given low inflation for most of the past decade, the 50 per cent CGT discount overcompensated many investors for inflation.[167]

The policy has also over-zealously protected savings at the expense of competing considerations. The economic benefits of tax neutrality for savings are small,[168] and the 50 per cent CGT discount encourages investors to focus too much on investments with capital growth rather than annual income. This is a major distortion which, together with negative gearing, encourages property speculation over more efficient investments. The current discount also compromises income tax integrity by encouraging artificial transactions,[169] and makes the tax system less progressive.[170]

The 50 per cent CGT discount for individuals and trusts should be reduced to 25 per cent, with a gradual phase-in (rather than grandfathering).[171] This measure alone would be worth about $5 billion

167. Daley et al (2016). While inflation is currently high, expectations are that it will ease back within the RBA's target band by mid-2025: RBA (2023, Table 5.1). Many of the longer-term dynamics that contributed to weak inflation – including the ageing population and rising income inequality – remain present: Summers (2020).
168. Those with high incomes save almost the same amount regardless of the tax rate. See Daley et al (2016).
169. Structuring transactions so that earnings are re-classified as capital gains to attract the lower tax rate.
170. Daley et al (2016).
171. For example, the government could phase in a 25 per cent discount over five years by reducing the value of the CGT discount by 5 percentage points each year.

a year,[172] and could be combined with changes to negative gearing to save at least a further $2 billion a year.[173]

Limiting negative gearing by not allowing losses on passive investments to be written off against unrelated labour income, in line with most developed nations, would further help reduce distortions in investment choices and support a modest improvement in housing affordability.[174]

Set a minimum tax on trust distributions

Trusts are a popular investment vehicle in Australia because maintaining assets in a trust offers a range of tax privileges for those on higher incomes.[175] Discretionary trusts (also known as family trusts) enable income-splitting and deferral of income to minimise income tax and capital gains tax.

Setting a minimum 30 per cent tax on all trust distributions,[176] would ensure that at least some tax is paid.[177] This measure would save at least $2.3 billion a year.[178] Loopholes for testamentary trusts should also be closed.[179]

Improving transparency around trusts – including who controls trust distributions and who the beneficiaries are – is also an important reform for tackling money laundering.[180]

4.3 Raise the superannuation preservation age and freeze the Super Guarantee rate

The age at which people can use their superannuation or get the Age Pension can anchor retirement decisions.[181]

Eligibility for the Age Pension will be 67 from 1 July 2023. The rationale for increasing the pension age was that as Australians live longer, healthier lives, many are well placed to support themselves longer by working. The same rationale should apply to accessing highly tax-advantaged superannuation.[182] Indeed, it is difficult to justify such a large gap between the age at which people can use their superannuation (60) and get the Age Pension (67).

In 2015 the Productivity Commission estimated that increasing the superannuation preservation age from 60 to 65 would raise about $7 billion a year when fully implemented and would boost workforce

172. Treasury estimates the 50 per cent Capital Gains Tax discount for individuals and trusts will be worth $10.5 billion in 2023-24: Treasury (2023, p. 162). This suggests that halving the CGT discount to 25 per cent would produce savings of $5.25 billion. The higher tax would probably reduce investor demand for property and therefore the revenue collected, although the annual savings would also grow with property values (see Daley et al (2016, p. 37)).
173. A 2019 PBO election commitment costing suggests the reform would be worth $2 billion in 2023-24, growing to $3.5 billion a year by 2030: PBO (2019, PER414). Interest rates have also grown since, substantially increasing the value of negative gearing reforms: see Janda (2022).
174. Daley et al (2016).
175. See Sainsbury and Breunig (2020) for examples. See also Glover (2007).
176. As recommended in 1999 by the Review of Business Taxation: Ralph et al (1999). See also ACOSS (2022, pp. 54–56). A 30 per cent tax rate also aligns with some of the income tax changes as part of the Stage 3 tax cuts (see Section 4.1).
177. Although high-income-earners could still use trusts and bucket companies to exploit the gap between the company tax rate and higher personal tax rates (see Sainsbury and Breunig (2020) for examples). ACOSS recommends taxing income retained in private companies at the top tax rate to close this gap (with a reinvestment allowance for active companies): see ACOSS (2022, pp. 54–56).
178. PBO costing of 2019 ALP election commitment 'Discretionary Trusts Reform': PBO (2019, Appendix B).
179. The child loophole for testamentary trusts was closed for other family trusts 40 years ago. See Boccabella (2020) and Stewart and Flynn (2022, Chapter 13).
180. OECD (2021); OECD (2019); and ACOSS (2022, pp. 54–56).
181. Treasury (2020, Section 3E).
182. The people who benefit most from a low preservation age are those with large superannuation balances at 60, who are more likely to be healthier, with fewer caring responsibilities, and are therefore more able to keep working than those needing the Age Pension.

participation among older Australians by 2 percentage points, helping ease pressures caused by the ageing of the population (Chapter 1).[183]

Another policy that would improve the welfare of Australians and the budget bottom line is freezing the Superannuation Guarantee rate. Stopping the planned increases in the Super Guarantee would avoid forcing people to over-save for retirement (boosting their incomes while they are working), and would save the budget $1.2 billion a year.[184]

Earlier access to superannuation could be allowed for people with a disability, people with caring responsibilities, First Nations people (who generally have a lower life expectancy), and people who are forced to retire early because of injury or impairment. The disability pension could also have less stringent work tests for people older than 60.[185]

4.4 Broaden and/or raise the GST

Australia collects less in consumption taxes than similar countries, and our GST tax base is narrow by international standards (Box 1). The GST base is also being eroded over time as a growing share of consumer spending goes on GST-free items.[186]

Increasing collections from the GST by broadening the base and/or raising the rate would diversify Australia's tax base. Raising more through the GST is relatively efficient. It is a hard tax to avoid and acts as a lump sum tax on accumulated wealth by collecting from households such as well-off retirees who are living off savings and otherwise pay little tax.[187]

But because it is a flat tax, it hits low-income-low-wealth households hardest, since they spend a larger share of their income on essentials. Some of the income from raising and/or broadening the GST would need to be used to cushion the impact on vulnerable households, for example by raising welfare payments.

The federal government would be largely responsible for paying out compensation, but GST revenue is passed through to the states and territories. These complexities tend to make GST reform unappealing to federal governments – who bear the political and compensation costs without the revenue benefits.

But if the GST raised more revenue, then the federal government wouldn't need to provide as much support to states through other payments, so GST reform still offers an opportunity to structurally improve both federal and state budgets. Most state budgets are in the red, with limited options for raising revenue directly themselves.[188]

In 2015, Grattan Institute analysis showed that a 15 per cent GST with a compensation package that on average compensated the bottom 40 per cent of households could raise about $11 billion after compensation.[189] If federal and state governments shared the extra

183. Productivity Commission (2015, pp. 11–13). The net fiscal impact includes additional income tax from older working households (~$2.5 billion), Age Pension savings from additional accumulation of super (~$2.5 billion, partly offset by access to other welfare payments), and a longer period of taxing super investment returns (~$2 billion). If this reform was introduced in conjunction with the super tax reforms recommended in Section 4.2, it would be expected to yield a bit less.
184. The Superannuation Guarantee (SG) rate is currently 10.5 per cent and is scheduled to increase a further 0.5 percentage points each financial year until it reaches 12 per cent in 2025. An SG rate of 12 per cent, instead of 9.5 per cent, was estimated to cost $2 billion a year: Coates and Nolan (2020). $1.2 billion is a pro-rata estimate based on freezing the SG rate at the current level of 10.5 per cent.
185. Coates and Nolan (2020, pp. 71–72); and Daley (2013, pp. 29–32).
186. PBO (2020).
187. Daley and D. Wood (2015). The other efficiency benefit is that it creates less distortion in incentives to save and invest, although this is overstated given the relatively low responsiveness of total savings to tax rates. See Henry et al (2009) and Coates and Moloney (2023).
188. See Section 1.6.
189. See Daley and D. Wood (2015) for the full costing details.

revenue 50:50, this would raise $6 billion (in today's dollars) for the federal budget. The government could broaden the GST base at the same time to raise more.

4.5 Wind back fuel tax credits

Fuel tax credits are worth $8 billion a year to the businesses that receive them, but only about half that outlay is justified in economic or social terms. If the costs of carbon emissions, air pollution, and road damage were factored into the price of fuel, fuel tax credits would be halved.

Fuel tax credits are gnawing away an ever-growing share of fuel tax revenue: a decade ago, credits reduced gross fuel tax revenue by 30 per cent; today, it's almost 40 per cent.

At present, heavy on-road vehicles, such as semi-trailers and passenger buses, pay a reduced rate of fuel tax. But there is no business reason why larger vehicles should pay less than smaller vehicles – in fact quite the reverse, since heavy vehicles impose greater costs on the community.[190] Fuel tax credits should be removed for heavy on-road vehicles (Figure 4.4).

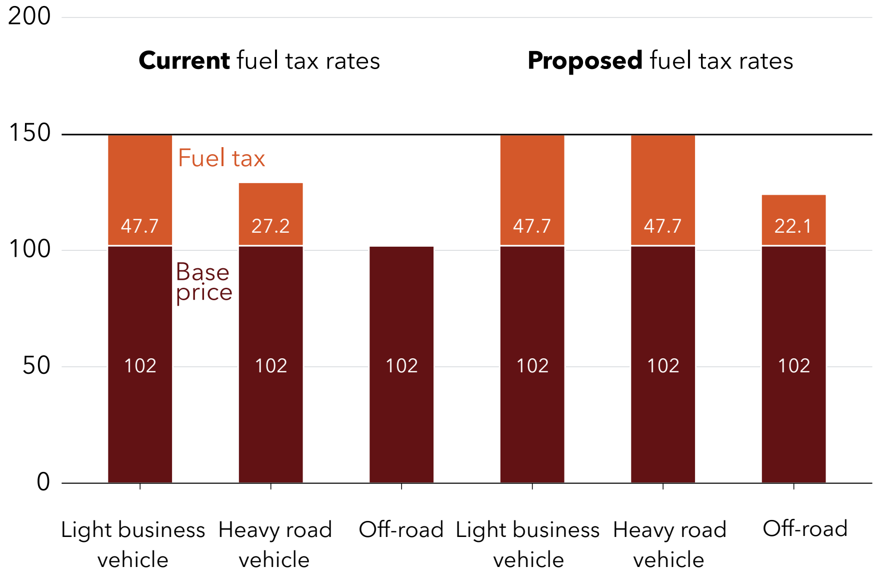
Off-road vehicles and machinery should not contribute to road construction and maintenance cost, but should still pay more than they currently do to cover the cost of their carbon emissions and air pollution (Figure 4.4).[191]

Winding back the credits in this way could reduce the structural budget deficit by about $4 billion a year.[192]

190. Terrill et al (2023, Figure 2.4).
191. Ibid.
192. Detailed in Terrill et al (ibid). Note that if an economy-wide carbon tax was implemented (Section 4.7), then there would be no need to include the cost of carbon emissions in the price of fuel as well, so the additional revenue raised by this measure would be smaller.

Figure 4.4: Fuel tax credits should be wound back for heavy and off-road vehicles

Effective diesel price, cents per litre



Notes: Prices as at December quarter 2021. Heavy vehicle defined as weighing more than 4.5 tonnes.

Source: Terrill et al (2023, Figure 2.5).

4.6 Redesign the Petroleum Resource Rent Tax

Australia is a major producer and exporter of fossil fuels, yet despite the extraordinary profitability of fossil fuel extractors,[193] government revenues from fossil fuels are relatively small.[194] The Petroleum Resource Rent Tax (PRRT) should be redesigned to raise more revenue and support the energy transition.

The Callaghan Review of the PRRT in 2017 identified several problems, including the gas transfer pricing arrangements,[195] and exorbitant uplift rates that compound deductible expenditure.[196] Following the review, uplift rates were reduced,[197] and the government directed Treasury to consult on the gas transfer pricing system. However, Treasury's inquiry stalled during the COVID pandemic, and was only recently recommenced.[198]

193. Oil and gas companies are making record profits: Evershed (2022) and Halper (2023).
194. Burke (2023). Revenue from the PRRT peaked at $2.4 billion in 2001 but was just $800 million in 2020: Kraal and Heffron (2022, p. 598).
195. Callaghan recommended 'examining the gas transfer pricing arrangements', particularly focusing on 'the way profits are split between upstream and downstream, and the rate of capital allowance in the RPM (residual pricing method)': Callaghan (2017, pp. 12–14).
196. In the 2019-20 financial year these uplift rates resulted in deductible expenditure reaching $282 billion (and the figure would be higher today). Industry has to produce this much profit before it is required to pay any PRRT: Kraal (2022).
197. The exploration expenditure uplift rate was reduced from the long-term bond rate (LTBR) + 15 percentage points to LTBR + 5 percentage points, but all exploration expenditure declared and incurred before 1 July 2019 is still subject to the old rate.
198. Treasury recommenced this inquiry late last year: Greber (2022).

Changing the gas transfer price from the current residual pricing method to a netback only method would raise substantial revenue over the medium-to-longer-term (Figure 4.5).[199]

The current gas pricing method undervalues gas,[200] reducing the profits used to calculate how much tax companies should pay. Using netback pricing instead would improve transparency and align with OECD best practice. It would also align with the method the ACCC already uses for east-coast onshore gas projects.[201]

The main criticism of the netback only pricing method is that the PRRT is supposed to only tax the raw resources. But arguably liquefaction of gas is a necessary component in exporting the 'raw' resource, so its inclusion in the netback price is appropriate. The PRRT is still a 'rent tax' so should tax all the rent.[202]

An even simpler measure would be to introduce a Commonwealth royalty on offshore projects of at least 10 per cent.[203] This could be done as well as, or instead of, changing the gas pricing method. This would ensure that the Australian community received an upfront share from the extraction of our finite resources. And it would be less likely

199. Callaghan (2017) found the netback only method would raise $89 billion in PRRT between 2023 and 2050, $68 billion of this between 2027 and 2039. This averages out at $3.3 billion a year.
200. Under the current residual pricing method, exploration costs are excluded from the upstream price, capital costs are subject to a generous allowance, and then the subsequent estimate of 'profit' is arbitrarily halved between upstream and downstream, further lowering the upstream profits that are liable for PRRT.
201. ACCC (2021); see also Kraal (2021).
202. Only taxing upstream activities means the PRRT arbitrarily taxes only half the rent from integrated projects.
203. Royalties of between 10 per cent and 12.5 per cent are already in place for onshore projects in Australian states, and royalties are common overseas. For example, Texas has a state royalty of 25 per cent, and Qatar has a complicated royalty system but received $51 billion in revenue in 2018 while producing almost the same amount of gas as Australia. See D'Cruz and Holden (2017, p. 37) and Kraal (2021, p. 163).

to be subject to companies 'gaming' the complex uplift rates and gas transfer pricing mechanisms.

A 10 per cent royalty on the wellhead value of existing PRRT projects could be expected to raise more than $4 billion a year, mostly bringing forward revenue that would otherwise be expected to accrue in later years under the PRRT.[204]

In the long run, a royalty that is creditable for PRRT purposes may not raise as much as the PRRT alone.[205] But requiring companies to pay some tax up-front would ensure that at least some tax is paid, and would reduce the risks of future tax minimisation and avoidance.[206]

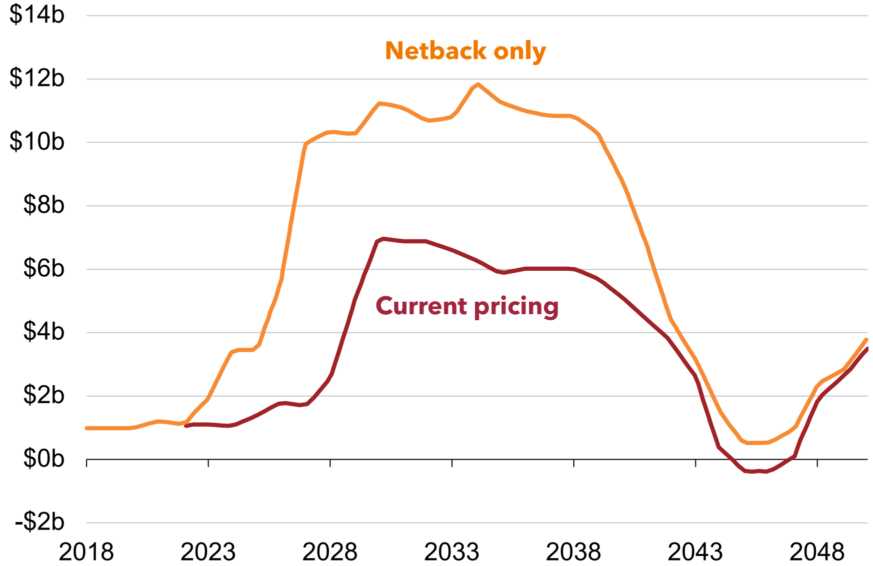
One of the criticisms of a royalty, over the current PRRT arrangements, is that it might prevent marginal projects from going ahead, reducing overall economic output.[207] But in the context of climate change, and in the absence of a carbon tax, discouraging marginal oil and gas projects would have broader environmental and social benefits.[208]

4.7 Other revenue-raising options

Governments with an appetite for bold economic reform might be willing to consider realigning the company tax rates, introducing a carbon tax, and/or introducing an inheritance tax.

Figure 4.5: Netback only pricing would raise a lot more revenue

Revenue raised under the PRRT over time



Source: Callaghan (2017, p. 91).

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204. PBO election commitment costing ECR503: PBO (2022e).
205. Callaghan (2017) modelled combined royalty and PRRT revenue to 2050 and found they would be about $19 billion lower than PRRT revenue alone. This assumes royalty payments would be creditable for PRRT purposes and uplifted at LTBR plus 5 percentage points. Under this scenario, the uplifted royalty credits outweigh royalty collections in the long run.
206. For example: Mather (2017).
207. Garnaut and Clunies-Ross (1979).
208. See Heffron and Sheehan (2020), Kraal (2021) and Kraal and Heffron (2022). New gas projects are not needed to meet net zero by 2050: IEA (2021, p. 102).

Return the small business tax rate to 30 per cent

Company income is taxed in Australia at 30 per cent,[209] but a lower rate of 25 per cent was introduced a few years ago for small and medium enterprises.[210]

The rationale at the time was that tax 'relief' for small businesses would drive investment, reduce unemployment, and help 'transition [the economy] from resource-led growth toward new and emerging markets'.[211] But economic times have changed, with unemployment now at historic lows,[212] and most of the businesses benefitting from the tax break don't appear to be employing many people or investing much.[213]

Under the original proposal, differential company tax rates were intended to be temporary. But they became permanent when the government abandoned the same tax cut for large companies.[214]

Differential rates can distort company decisions[215] and can push resources towards smaller, less efficient firms rather than larger, more efficient ones.[216] The lower rate for small businesses is also an additional incentive for trusts to leverage arbitrage opportunities and divert income through small businesses operated by trusts to avoid higher income tax rates.[217] When a lower tax rate for small business has been considered in the past, it has not been supported.[218]

Returning the rate to 30 per cent would be likely to raise about $3 billion a year,[219] and would re-align company tax rates, reducing distortions in the company tax system.[220]

A carbon tax

A carbon tax could raise substantial revenue while encouraging a much more efficient transition to a net-zero emissions economy. Indeed, it could replace many of the complex shadow taxes that have been enacted to encourage decarbonisation in certain sectors in the absence of an economy-wide carbon tax. Over the past two decades this policy has proved to be politically more difficult than perhaps any other.[221] Some of the revenue raised would probably need to go back out the door to cushion vulnerable households. But it remains a good economic, social, and environmental reform.

209. See Box 1 on page 12 for an international comparison.
210. ATO (2022a). A lower tax rate for small businesses was announced in the 2015 Budget. This proposal was expanded and accelerated in the 2016 Budget and 2018-19 MYEFO. The rate reached 25 per cent in 2021-22.
211. Treasury (2015, Budget Paper 1, pp. 1-9).
212. ABS (2023e).
213. About 83 per cent of the companies that benefit have an annual company turnover of less than $2 million. The main beneficiaries appear to be sole-traders in professional and financial services: Treasury (2023, pp. 23–24).
214. In the 2018-19 MYEFO. See Nielson (2016).
215. For example, in how business organisations are structured, and in commercial decisions about forms of expenditure.
216. Freedman (2009).
217. Sobeck et al (2022).
218. Neither the Asprey Tax Review (1975) nor the Henry Tax Review (2009) supported a lower tax rate for small businesses. Henry et al (2009) argued that a lower company tax rate targeted at small companies was unlikely to attract much additional investment or otherwise improve productivity, and could be used for non-business accumulation, such as rents and profit retention. Henry did however recommend reducing the overall company tax rate to 25 per cent to encourage international investment. The Ralph Review of Business Taxation (1999) recommended reducing the company tax rate (to 30 per cent) but did not discuss a lower rate for smaller companies.
219. Treasury (2023, p. 23) estimates revenue forgone at $3.6 billion in 2022-23, $2.5 billion in 2023-24, $3.5 billion in 2024-25, and $3.7 billion in 2025-26.
220. Realigning the corporate tax rate would also remove the complexity of determining when companies earn 'active' versus 'passive' income, which is required for eligibility for the lower tax rate.
221. T. Wood and Blowers (2016); and T. Wood et al (2021).

An inheritance tax

Inheritance taxes are another economically efficient revenue-raising option. Australians currently pay taxes on the income they earn from working, but money received via a bequest is tax free. There is a strong economic case for levying some form of tax on unearned income. A relatively low inheritance or intergenerational transfer tax – levied on large gifts and inheritances – is less likely than most other taxes to distort behaviour, particularly decisions to work, and would help to reduce Australia's growing wealth inequality.[222]

Yet despite their strong economic credentials, taxes on inheritances are typically deeply unpopular.[223] An intergenerational transfer tax could be used in part to reduce income taxes, to improve both the economic payoff and its political feasibility.

222. D. Wood et al (2019b) and Productivity Commission (2021). The Productivity Commission (PC) found that while wealthier people received, on average, larger inheritances (increasing absolute wealth inequality), those inheritances were smaller as a share of their initial wealth than inheritances received by those less wealthy (reducing relative wealth inequality). That means that inheritances (when received) have a greater potential to be life-changing for poorer people. But the PC also notes that welfare payments reduce relative wealth inequality by 20 times more than inheritances (and they also reduce absolute wealth inequality).
223. Emslie and D. Wood (2019) and The Economist (2017). But see Coram (2021) on more positive attitudes to different designs.

Box 4: Some go-to revenue-raisers don't actually raise much

Cracking down on multinational tax avoidance and taxing billionaires are perennial favourites. While they have the obvious advantage of being politically easy reforms, in that almost all Australians would be unaffected, they rarely raise much.

They tend to be ineffective because billionaires and multinationals can move their income and assets around the world to take advantage of lower tax regimes and offshore tax havens.

Several recent budgets have included initiatives to crack down on multinational tax avoidance – often headlined as a major savings initiative – but with relatively small dollars attached.[a]

The Greens have proposed a 'billionaires tax' levied at 6 per cent of net wealth above $1 billion, which the Parliamentary Budget Office estimates could raise $5 billion a year. But the PBO cautions that 'there is significant uncertainty about the extent to which individuals would comply with this proposal. . . It is likely that high net-wealth individuals would employ strategies to avoid or minimise their wealth tax liability, which would significantly reduce the revenue raised by the tax'.[b]

Meaningful tax reform is never easy, precisely because it affects many, if not most Australians. This is the 'grand bargain': we contribute as we are able, and in return receive services and safety nets when we need them.

a. For example, a 'Multinational Tax Integrity Package' in the October 2022 Budget is forecast to raise $1 billion over four years. New laws and taxes put in place in 2015 and 2016 were expected to raise just $650 million over four years: Treasury (2016). Even a broader tax compliance initiative, focused on large corporations and high-wealth individuals, was expected to raise only about $1 billion a year: Treasury (2019).
b. PBO election commitment costing ECR533: PBO (2022e).

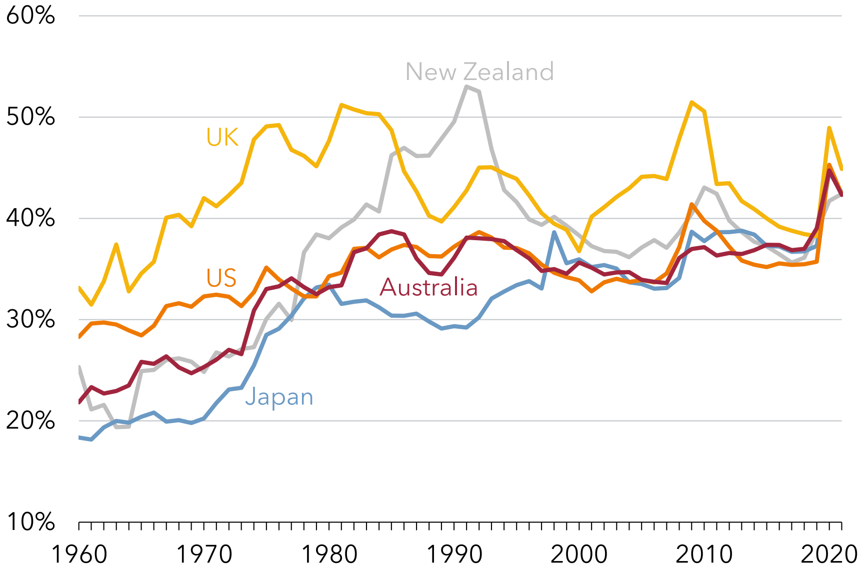
Appendix A: International comparisons

Australia is not alone with its budget problem.

Spending pressures have been building for many governments around the world, particularly in recent years (Figure A.1).

Figure A.1: Government spending in Australia has grown over time, as in many other advanced economies

General government expenditure as a proportion of GDP

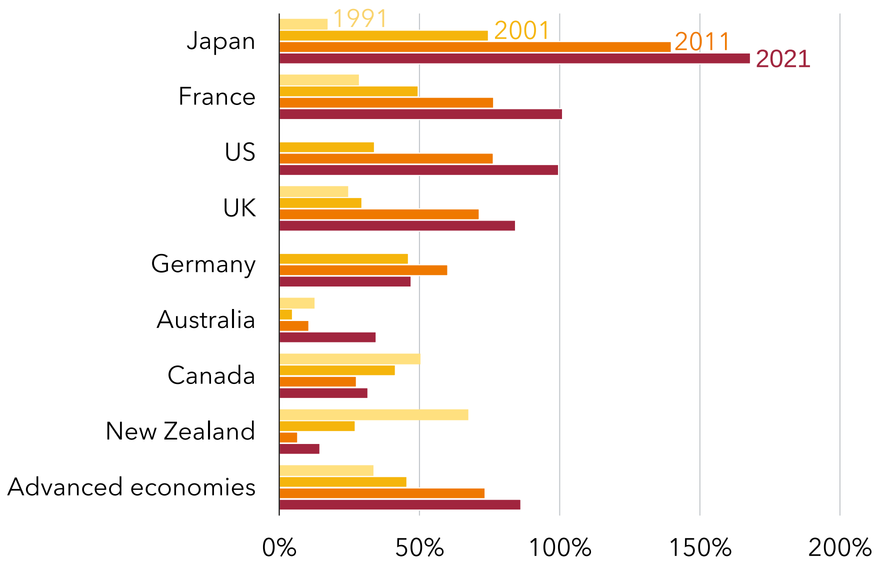


Source: IMF (2023).

Australia's net debt remains lower than many other developed nations, but it has grown much more rapidly in recent years (Figure A.2).

Figure A.2: Australian government debt has grown rapidly over the past decade, but remains low among advanced economies

General government net debt as a proportion of GDP



Notes: Data are not available for Germany and the US in 1991.

Source: IMF (2022).

Appendix B: How debt affects a government's ability to borrow

Governments with higher net debt relative to GDP tend to have worse ratings from the major credit ratings agencies and higher yields on their bonds, making it more costly to borrow.[224]

Empirical evidence suggests that when a government's fiscal position deteriorates – whether measured by gross debt, net debt, budget balance before interest payments, or structural balance – the interest rate it must pay to borrow increases.[225]

Some studies have found these relationships to be non-linear: an increase in debt levels may not matter to borrowing costs until debt is above a certain threshold; similarly, widening deficits may have a larger effect on interest rates when public indebtedness is already high.[226] Financial markets also pay more attention to budget positions following a financial crisis.[227]

224. Hadzi-Vaskov and Ricci (2019, Figure 1B). While a small number of countries with very high levels of public debt, such as Japan and the US, have been able to maintain low bond yields, they tend to be 'safe haven' countries that investors turn to in crises and periods of high volatility: see Hadzi-Vaskov and Ricci (ibid, p. 34) for a discussion. US Treasury bonds are one of the most liquid assets and therefore desirable in a crisis, while the Japanese yen is widely seen as a safe haven currency.
225. This result holds among OECD countries after taking the business cycle and current conditions into account: Gruber and Kamin (2012, Table 1).
226. For instance, among OECD economies, an increase in debt levels only matters for interest rates when debt is above average: Ardagna et al (2007); and changes in deficits in the euro area have a larger effect when debt levels are high: Haugh et al (2009). However, Gruber and Kamin (2012) found no evidence for similar non-linearities.
227. See Reusens and Croux (2017) for a comparison of the effect of macroeconomic variables on credit ratings before and after the European debt crisis.

A government's borrowing costs can also change suddenly if the market becomes sceptical of the government's ability to prudently manage its finances, even when the possibility of default is remote.

A recent example among Australia's economic peers is the market's reaction to the UK Government's September 2022 'mini budget', which contained the UK's largest tax cuts in 50 years without commensurate spending cuts or new revenue measures.[228] Yields on long-term UK government bonds spiked immediately; 30-year yields rose by 1 percentage point in two days and triggered an extended period of market dysfunction.[229] The UK Government abandoned the tax cuts a few weeks later.[230]

228. Adam et al (2022).
229. The initial market reaction to the mini budget triggered a vicious cycle of margin calls and fire sales of UK government bonds, which led to even higher yields and eventual intervention by the Bank of England: Samson et al (2022); and Aldrick (2022).
230. Morton and Rhoden-Paul (2022).

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