BCA Budget Submission 2015–16

A 10-Year Plan For Growth

Business Council of Australia

Contents

The Business Council of Australia (BCA) is a forum for the chief executives of Australia's largest companies to promote economic and social progress in the national interest.

EXECUTIVE SUMMARY

A new approach is needed

This is the Business Council of Australia's submission to the Federal Government's 2015-16 Budget.

It calls for a fundamental reset of the fiscal strategy and budget process to deliver sustainable budget outcomes and stronger economic growth over the next 10 years.

This year's budget is an opportunity to lay out a positive vision for economic growth and the coherent set of policies and actions, including structural budget improvement, that will deliver it.

The budget is caught in a pincer movement. On the one hand, population ageing and other pressures are driving strong growth in public spending and, on the other, lower terms of trade, and population ageing are weakening the economy's capacity to pay for that spending. These forces are structural – without policy action the budget position will worsen significantly. This is the reality confronting any government of any political persuasion. Full acceptance of the need for a new approach is a bipartisan imperative.

Strengthening the budget will primarily require slowing the growth trajectory of major spending areas and improving program delivery and effectiveness so that slower spending growth can be maintained. While a more efficient tax system is also needed to promote competitiveness and provide a stronger revenue base, continually increasing taxes to pay for spending growth would be self-defeating.

Broader policy reforms are urgently required for lifting productivity and revitalising the economy, but economic growth alone will not address the growing fiscal gap.

Above all, spending policy redesign must be considered, credible and sustainable. Spending redesign will require an honest and mature discussion with the community about the inevitable trade-offs that government spending involves. Ultimately it is a renegotiation of what governments (taxpayers) can be expected to pay for.

A 10-year plan built around four fiscal goals

Implementing sustainable fiscal reforms demands a fundamentally different approach to reduce spending and a higher level of ambition. The Business Council is recommending a 10-year fiscal strategy that can preserve living standards in the face of global challenges and demographic change. The 10-year strategy should be built around achieving four primary goals:

- Preserving Australia's AAA credit rating to consolidate the government's financial credibility and reputation, retaining financial capacity and investor confidence.

- Progressively returning the budget to surplus to build resilience and flexibility for dealing with economic shocks and volatility, and for underpinning business confidence and investment.

- Ensuring the sustainability of priority services, including an adequate safety net, which are integral to community living standards and the functioning of our society.

- Ensuring capacity for investments in infrastructure and human capital, vital for innovation and productivity growth and higher incomes.

The four goals go to the heart of competent and prudent fiscal management in the interests of the Australian community now and in the future. We believe bipartisan commitment will be essential for achieving them. The budget strategies of both parties should demonstrate how particular initiatives will contribute to delivering these goals.

> Australia has a 10-year window to make the necessary transition in a deliberate and inclusive way. Difficult decisions will need to be made, but incremental adjustment paths will help cushion impacts on the community and prevent undue hardship.

The starting point for community support for this program of reform will be to properly explain the compelling need for action and the inevitable consequences of inaction. Coherent and consistent alignment of policy decisions with the problem, the narrative and goals outlined above will be absolutely essential.

Explaining the problem

Australia's $40 billion deficit has been ten years in the making. It is structural, not a cyclical blip that will remedy itself. It also is not a bookkeeping entry. It has real implications for every Australian.

Spending is the main driver

Spending has grown by around 3.6 per cent per year in real terms over the past decade, much higher than average revenue and economic growth. This financial year total spending will exceed $400 billion or 26 per cent of GDP, its highest share since the Global Financial Crisis (GFC). Spending has been the main driver of the structural deficit rather than past tax decisions (including tax cuts to offset bracket creep), by a factor of roughly four to one.[1] Spending decisions over the last decade have added some $300 billion to the bottom line. [2]

1. Deloitte Access Economics, analysis for BCA.
2. Parliamentary Budget Office, 'The Sensitivity of Budget Projections to Changes in Economic Parameters', November 2014, p. 3.

The 2015–16 Budget is being framed against the backdrop of a worse than anticipated $40 billion deficit in 2014–15. (Declines in commodity prices since MYEFO in December likely mean the actual 2014–15 deficit and debt will be larger than this.)

- Net Commonwealth debt is expected to grow to $245 billion or 15 per cent of GDP over 2014–15, its highest share since 1996–97.
- Official budget forecasts are for continued deficits until the end of the decade. Gross debt is projected to peak at $516 billion in 2019–20.

Revenues are 'normalising' to lower terms of trade

Revenues are falling short of expectations and this will require recalibration of expectations. Over the 2000s, record terms of trade fed bonanza revenues of more than 25 per cent of GDP. They should never have been expected to persist. Revenues are 'normalising' to a post-terms-of-trade-boom economy, at around 24 per cent of GDP. This means there is now an ongoing structural disconnect between spending and revenue.

The budget outlook faces considerable economic risk

Current forecasts for a return to surplus in 2019–20 rest on optimistic assumptions that previously announced savings measures are fully implemented (even though a number of them have been delayed, diluted or discarded); we achieve five years of above-trend real GDP growth from 2016–17; and that there is an easing in the rate of decline in the terms of trade. Bracket creep[3] is also embedded in the forecasts – about 1.7 million taxpayers will enter higher brackets over the next four years.[4]

There is always uncertainty about budget forecasts, but the global and domestic economic and political landscapes would seem to tilt the balance towards much greater downside than upside risk.

The budget outcome is especially vulnerable to lower commodity prices. Analysis for the Business Council indicates that a return of the terms of trade to their 2003 pre-boom level could add $114 billion to the deficit over four years, leaving the 2017–18 deficit 1.8 per cent of GDP larger than otherwise.[5]

Economic growth alone cannot be relied on to fix the deficit

The economy is undergoing substantial structural change in response to the largest fall in the terms of trade in 50 years, just as it begins to transition to a much older population.

3. Bracket creep occurs when taxpayers' average tax rates increase as their incomes rise, due to progressive personal income tax scales. Bracket creep as discussed here occurs due to price or inflationary effects, as well as real wage increases.
4. Deloitte Access Economics, analysis for BCA.
5. Ibid.

Truly disruptive technologies will also test the viability of established business models and challenge our competitiveness.

While government clearly must pursue the twin strategy of growing the economy and improving our budget position, expectations must adjust to the reality that future national income, and hence revenue growth, will have to come mainly from improving aggregate productivity rather than windfall gains in the terms of trade.

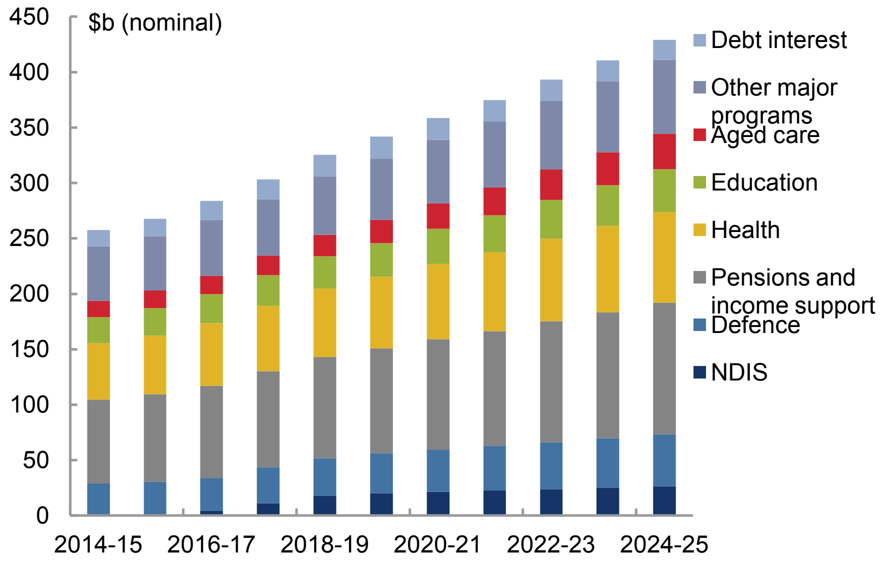
Bigger spending just beyond the forecasts

Even if the budget were to return to surplus by the end of the decade as forecast, any reprieve will be short-lived. The forecast period finishes just before the impacts of rapid growth of many major spending programs are felt. (This reinforces the importance of a 10-year budget horizon.)

Real spending growth is conservatively projected to grow by 2.7 per cent per year over the medium term.

- Aged care costs are expected to almost double in real terms by 2024–25, reaching $24 billion (2012–13 dollars).
- Public hospital spending will be $19 billion (2012–13 dollars) or 40 per cent larger than today and child care spending $8.5 billion, 70 per cent higher.[6]

Figure 1: Rapid spending growth beyond the forward estimates



Source: Parliamentary Budget Office, 'Projections of Government Spending over the Medium Term', August 2014 and BCA.

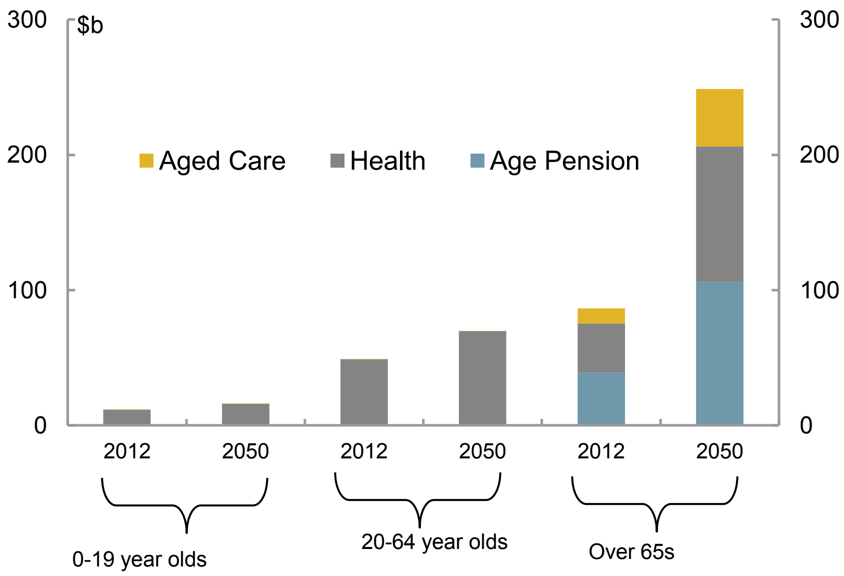
6. Parliamentary Budget Office, 'Projections of Government Spending over the Medium Term', August 2014 and BCA calculations.

Demographic pressures are already upon us

Projected growth in aged care and public hospital spending over the next ten years confirms that our demographic profile has already turned a corner. The effects will build steadily over the next few decades. One in four people will be over 65 years old by 2060, compared with one in seven today.[7] Older people naturally consume more government services and also have lower labour market participation than younger age groups.

Total spending on health and aged-related services for people over 65 years is conservatively projected to increase roughly threefold by 2050 to almost $250 billion in 2011–12 dollars (Figure 2).

Figure 2: Real spending on aged-related programs is set to increase



Source: Productivity Commission, 'An Ageing Australia: Preparing for the Future', November 2013 and BCA.

Demand for access to new and generally more expensive health technologies could more than double these estimates. For example, the 2010 Intergenerational Report (IGR) projected that by 2050 real federal spending on health would increase roughly sevenfold for people over 65 years, and around twelvefold for those over 85 years. State and territory government spending – which currently accounts for 40 per cent of total health spending – would be on top of this.[8]

At the same time labour force participation rates will fall, putting pressure on growth and tax revenues. The Productivity Commission estimates that aggregate participation could fall from around 65 per cent in 2012–13 to 60 per cent by 2059–60, reducing hours worked per head by 4.5 per cent, with an equivalent depressing effect on GDP.[9]

7. Productivity Commission, 'An Ageing Australia: Preparing for the Future', November 2013, p.33.
8. Commonwealth of Australia, 'Australia to 2050: Future Challenges', 2010, p. 51.
9. Productivity Commission, November 2013, p.2.

The consequences of inaction

Expected increases in program outlays beyond the forecast period could see the deficit entrenched at 3 per cent of GDP (around $50 billion in today's terms). Ageing is projected to lead to increasing structural deficits, leaving a fiscal gap across all levels of government of around 4 per cent of GDP by 2060. We expect the next Intergenerational Report (IGR) to reconfirm this outlook.

An ongoing deficit of 3 per cent of GDP would mean (in today's terms) around $50 billion additional debt each year and increasing interest payments to service it.

Continued debt build-up will jeopardise Australia's AAA credit rating, directly impacting borrowing costs of the federal government and indirectly for other levels of government, business and consumers.

Ongoing deficits will compromise our capacity to weather economic shocks and volatility, and further weaken business confidence, investment and jobs growth. As the Reserve Bank Governor Glenn Stevens recently warned, an economic downturn could see the deficit 'go from 2% of GDP to five or six in a heartbeat'.[10] A deficit of 6 per cent of GDP is around $100 billon today.

Higher interest payments will constrain capacity to provide services, potentially triggering blunt and inequitable rationing of services and cuts in base entitlements. We are already paying the cost of debt built up over the past six years. While Australia's net debt of 15 per cent of GDP might seem modest, $11 billion of taxes will still be needed to pay the interest bill this year. That is $2 billion more than spending on higher education and $3 billion more than support for carers. Interest payments will increase for as long as deficits persist.

Higher interest payments and debt costs will also crowd out capacity for governments to invest in human capital and infrastructure, reducing long-term growth prospects.

A perfect storm?

The GFC triggered a $70 billion deterioration in the budget over just two years. If another GFC hit today our starting point would be a $40 billion deficit and net debt of 15 per cent of GDP, in stark contrast to the $20 billion surplus (and zero debt) in 2008.

A similar shock and response today would leave a deficit of around $110 billion or 7 per cent of GDP, and increase Commonwealth net debt to around 20 per cent of GDP. A deficit of this order of magnitude is nearly twice the Commonwealth's current health spending and more than half total individual income tax receipts.

10. Glenn Stevens, appearing before House of Representatives Standing Committee on Economics, 13 February 2015.

Careful fiscal repair means better choices and outcomes

Deficits have inevitable consequences. They are a claim on our future incomes: debt must be serviced and repaid, either by raising more taxes or spending less on services. There are no other options.

Australia has a choice between taking action early and adjusting gradually by design, or doing nothing and having blunt, costly and more than likely inequitable spending cuts and tax increases imposed, possibly in crisis.

Doing nothing and, for example, relying on bracket creep to mend the deficit would be unsustainable. Analysis for the Business Council by Deloitte Access Economics finds that using bracket creep to return to a surplus of 1 per cent of GDP could take two decades. It would mean people earning just 10 per cent more than average weekly ordinary-time earnings (today about $85,000 per year) would face the top marginal income tax rate, paying some $15,000 more tax than they pay now (in current dollars), due to real wage and inflation increases.

Spending is the main driver of the structural deficit and only a slower spending trajectory can fix it at its source. Only spending redesign can ensure that the community's scarce resources are being used to deliver the best value for money, that savings are sustained and offer taxpayers the prospect of relief from the deadweight effects of bracket creep.

Spending redesign will require improving the efficiency and effectiveness of service delivery, and better targeting through encouraging greater self-reliance where appropriate.

Options include tighter eligibility and market-based mechanisms to promote efficiency, innovation and greater use of technology and data, and a greater role for the private sector and user payments. In some areas investments will be needed to achieve longer-term savings and to improve program effectiveness.

Identify what governments should pay for

- Spending programs should deliver maximum net community benefit and value for money.
- Build a better evidence base for programs requiring government funding.

Better targeting

- Tighten eligibility in line with capacity to self-fund and target services to those in greatest need.
- User pays, including income contingent loans (such as HECS), co-payments and user charges.

Improve how services are provided

- Provide incentives and capacity-building investment to promote self-sufficiency (such as New Zealand's 'investment' approach to welfare).
- Remove duplication and overlap.
- More innovative service delivery including through:
  – collaboration with and outsourcing to the private sector
  – investment in and better use of digital technologies and big data
  – better use of evidence and innovation in program design
  – market contestability, competition and market-based incentive mechanisms.

The 10-year fiscal plan

The 10-year strategy should be implemented across three horizons.

Horizon 1: 2015–16

The 2015–16 Budget should commit to fiscal goals and lay the groundwork for achieving them. First and foremost it should clearly spell out the need for action. It should also give the community a sense of the end point and the transition.

Government must hold the line against further deterioration in the budget position. It should avoid any new net expenditure commitments. Decisions to increase net spending would give the wrong signal to the community and further reduce business confidence.

It should seek to make only modest fiscal corrections. Any savings measures must be demonstrably evidence-based. There should be no ad hoc changes to business or other tax arrangements – tax reforms must be considered in the context of the comprehensive tax white paper process.

Some previously announced reforms should be implemented with modification:

- Tertiary education reforms should include better safeguards and transitional arrangements.

- Pension indexation should be reconsidered in consultation with key stakeholders with a view to designing a more graduated taper.

Proposed changes to Newstart eligibility should be reconsidered in the context of a wider program review, and look to the New Zealand model where jobseekers undergo a series of proactive pre-benefit activities before receiving payments.

The budget's main task should be to frame a medium-term strategy with clear horizons to deliver twin objectives of containing spending growth, and improving service quality and outcomes. This will be challenging, but in many areas, including health care, improvements in outcomes and greater efficiency can go hand in hand.

A double dividend from improving health sector efficiency

Improvements in health sector productivity from better targeting of treatments and leaner management would save money, while delivering better health outcomes. A 5 per cent productivity improvement in health could reduce fiscal pressures by 0.5 per cent of GDP in 2060 or ($8 billion in today's terms).

Source: Productivity Commission, 2013.

The strategy should commit to progressive, transparent review and restructure of major expenditure programs to target services where needs are greatest, to ensure that programs have sound objectives, are effective and are delivered as efficiently as possible. In particular, policy design must be fit for purpose for the future. In other words, there is a need for a 10-year policy perspective in parallel with 10-year projections.

The process must embed an ongoing and inclusive dialogue with key stakeholders and the wider community to help ensure that reforms are supported and sustained. Reforms should be demonstrably evidence-based. People must be given adequate transition times.

Large and fast-growing programs such as health and other aged-related programs should top the list. No area of expenditure should be pre-emptively quarantined.

The Business Council is not advocating particular initiatives as this is ultimately a matter for policymakers, but many areas ripe for reform have been flagged by the Parliamentary Budget Office, the Productivity Commission and Grattan Institute among others. System-wide reviews will minimise unintended consequences and ill-considered cost-shifting, including to other governments. Australia's fiscal credentials would not be improved by merely shifting the deficit burden to the states and territories.

The Business Council sees merit in independent and comprehensive reviews, preferably by the Productivity Commission. The reviews of the health system and the aged pension and retirement income system should commence in 2015–16.

- The health review should be given broad terms of reference to examine how to apportion shares of private and public funding of health care, as well as the institutional and incentive structures, and investments that will give better value from health dollars.

- The review of the aged pension and retirement income system will need to consider the alignment of all incentives and concessional arrangements. It will need to design appropriate transitional arrangements for recommended changes.

Horizon 2: the medium term

Budgets from 2016–17 onwards would progressively implement reforms of major expenditure programs, and taxation and federation reforms resulting from current and foreshadowed reviews. They would invest in economic growth by implementing the government's infrastructure, innovation and human capital policy agendas.

Horizon 3: the longer term

Over the longer term – 10 years and beyond – policy settings would be calibrated to ensure the budget position remains sustainable and consistent with delivering the strategic fiscal goals.

Complementary reforms will be critical for growth and the budget

Strengthening the budget is an integral part of a broader reform agenda that must be pursued simultaneously and cohesively to promote economic growth.

Stronger growth will not only boost income and living standards but also build the revenue base and the capacity to pay for valued services, at the same time as easing demands on income support programs. Progressive reform over a wide front has the added advantage of spreading the adjustment task – and the benefits – more equitably across the community. Priority areas include:

- fully implementing the Industry Innovation and Competiveness Agenda — particularly the establishment of growth centres
- removing unnecessary regulatory imposts
- building efficient infrastructure
- redesigning our tertiary education system
- improving the operation of the federation
- reshaping our workplace relations system so it is fit-for-purpose for a modern economy
- maintaining current immigration levels with a skills focus.

Comprehensive taxation reform will be essential for improving the efficiency of revenue collection and reducing the deadweight costs of disincentives to work and invest. A more efficient, balanced tax system has the potential to deliver a double dividend of higher incomes and a more stable and sustainable revenue base.

Importantly, taxation reform must be achieved through a comprehensive process, not ad hoc changes. Everything must be put on the table, including broadening the GST base and increasing the rate.

Key recommendations for resetting the budget

▶ The 2015–16 Budget should commit to a 10-year budget goal consistent with prudent fiscal rules and the restructuring task required to achieve it. Principal objectives should be:

- preserving Australia's AAA credit rating
- progressively returning the budget to surplus
- ensuring the sustainability of priority services, including an adequate safety net
- making efficient capacity-building investments in the economy.

▶ The 2015–16 Budget should:

- Hold the line against deterioration of the budget. It should avoid any new net expenditure commitments. Decisions to increase net spending would give the wrong signal to the community and further reduce business confidence.
- Seek to implement modest fiscal correction. Any savings measures must be demonstrably evidence-based. There should be no ad hoc changes to business or other tax arrangements – tax reforms must be considered in the context of the comprehensive tax white paper process.
- Complete some unfinished reforms with modifications including:
  - the proposed higher education reforms with better safeguards and transition
  - more graduated steps for pension indexation.
- Reconsider Newstart eligibility in the context of wider review and consultation, drawing on New Zealand's 'investment' approach to welfare.

▶ The main task of the budget should be to explain and map out a path for fiscal reform over three horizons:

- Frame a medium-term strategy to progressively review and reform expenditure programs in consultation with key stakeholders and the wider community.
  - Prioritise large and fast-growing programs for review to contain growth in spending while improving service quality and program outcomes.
  - Establish system-wide reviews of the health system and the aged pension and retirement income system.
- Begin publishing 10-year projections for major revenue and spending items that better integrate intergenerational report (IGR) analysis and incorporate assessments of the long-term impacts of budget measures.

▶ Budgets from 2016–17 onwards should progressively implement reforms of major expenditure programs, taxation and federation reforms, and the government's competitiveness agenda. There should be investment in economic growth consistent with the infrastructure and human capital policy agendas.

▶ Over the longer term, policy settings would be calibrated to ensure the budget position remains sustainable and consistent with the strategic fiscal goal and rules.

Recommendations (continued)

▶ Fiscal reform must be supported by broader economic reforms to promote competitiveness and growth and underpin revenues. Key areas include:

- Redesigning tertiary education to provide skills development across all stages of a person's life.
- Using the federation white paper process to put in place governance and funding arrangements that incentivise continual reform at every level of government.
- Using the tax white paper process to rebalance the tax mix to encourage investment and innovation while supporting efficient and equitable revenue collection. The tax paper must have everything on the table – including the reach of the base and the rate of GST.
- Sharpening the deregulation agenda's focus on improving competitiveness, including in areas such as shipping costs and major project red tape.
- Fully implementing the Industry Innovation and Competitiveness Agenda including accelerating new growth centres.
- Using the workplace relations review to reshape our workplace relations system to be fit-for-purpose for a modern economy.
- Building the infrastructure Australia needs including through: continuing the asset recycling initiative and privatisation, greater use of public-private partnerships and user pays, an independent Infrastructure Australia, and rigorous cost–benefit analysis.
- Maintaining immigration at least at current levels, with two-thirds of the program filled by skilled migrants and retaining flexibility of the temporary migration program.

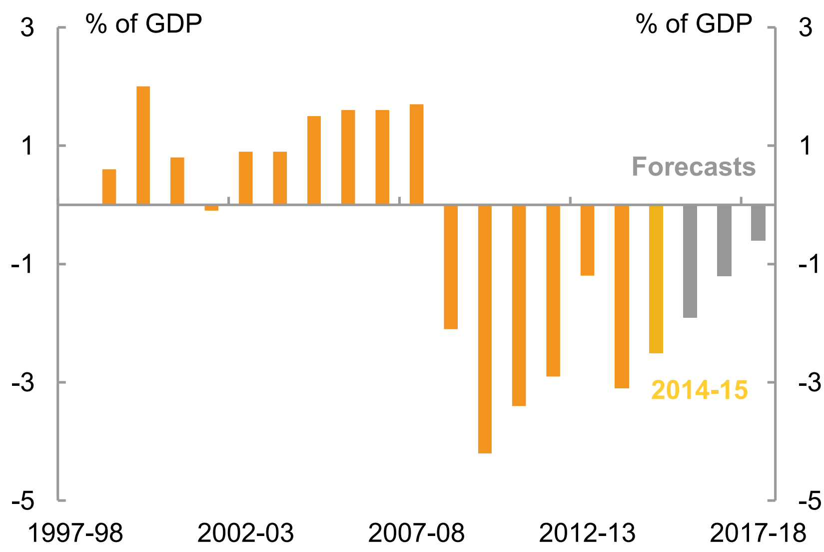
Table 1: 10-year goals and key actions to deliver them

10-year goal	Action
Maintain AAA credit rating	• Commit to a 10-year fiscal strategy to restore budget to surplus over the economic cycle and pay down debt. • Commit to longer-term budget outcomes consistent with prudent fiscal rules, including maintaining an operating surplus on average over the economic cycle. • Commit to reforming programs to make them sustainable over the longer term.
Progressively return the budget to surplus	• Implement a medium-term strategy to progressively review major areas of spending, with a view to containing spending growth and improving service quality. • Implement broader growth-enhancing reforms and taxation reform to provide a sustainable revenue base.
Ensure the sustainability of priority services, including an adequate safety net	• Systematically review and redesign major programs to better target services, improve their effectiveness and efficiency. • Require greater self-reliance where appropriate and explore innovative ways to build self sufficiency.
Ensure capacity for productive investments	• Progressively return the budget to surplus. • Differentiate recurrent expenditure from investment in human capital and infrastructure that can improve productive capacity (and possibly justify government borrowing). • Improve project planning and rigorously apply cost–benefit analysis. • Promote efficient privatisation, private sector involvement and user charging, including for roads.

1 THE STATE OF THE BUDGET AND THE OUTLOOK

The Commonwealth Government's fiscal position remained weak in 2014–15 with an estimated deficit of $40 billion or 2.5 per cent of GDP, $10 billion higher than initially estimated at budget. Net debt will grow to $245 billion or 15 per cent of GDP, its highest share since 1996–67.

Figure 3: The government's fiscal position remains weak



Source: Commonwealth of Australia, Mid-Year Economic and Fiscal Outlook 2014-15.

Official and other expert sources concur that the budget has been in structural deficit, at more than 3 per cent of GDP since 2009. In other words, there is a disconnect between spending and revenue growth, which is not due to the economic cycle.

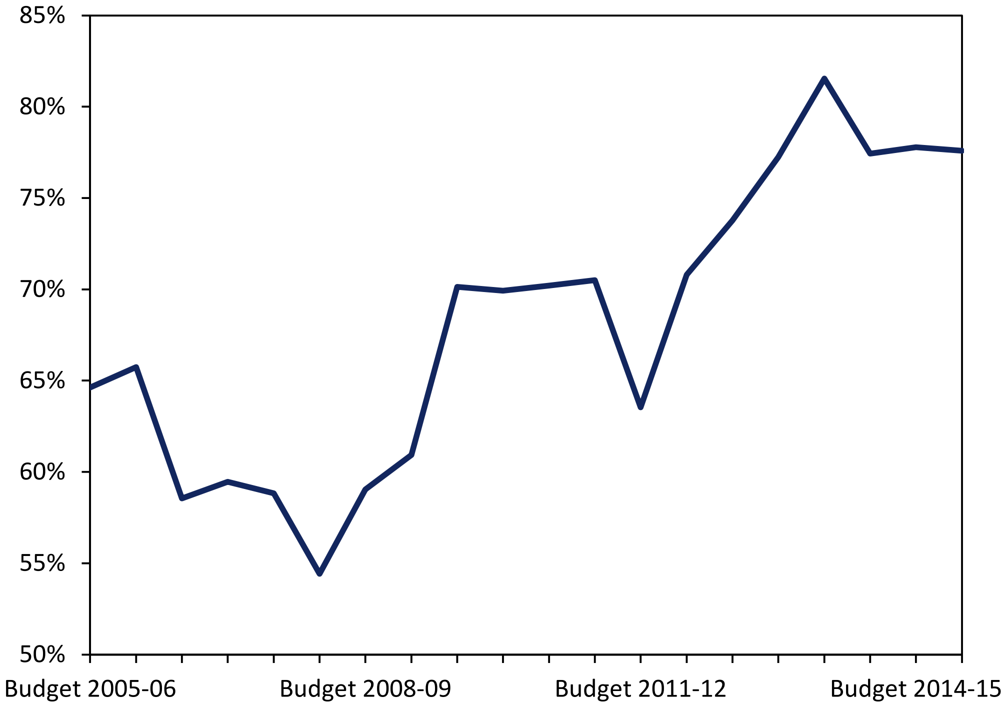
A structural spending problem

According to the Parliamentary Budget Office discretionary spending over the past decade added more than $300 billion to the bottom line.[11] Spending has grown by 3.6 per cent per year in real terms over the past decade.

Analysis for the Business Council by Deloitte Access Economics indicates that spending decisions taken over the past ten years are the dominant driver of the structural deficit problem, not tax cuts (including to offset bracket creep), by a factor of four to one.

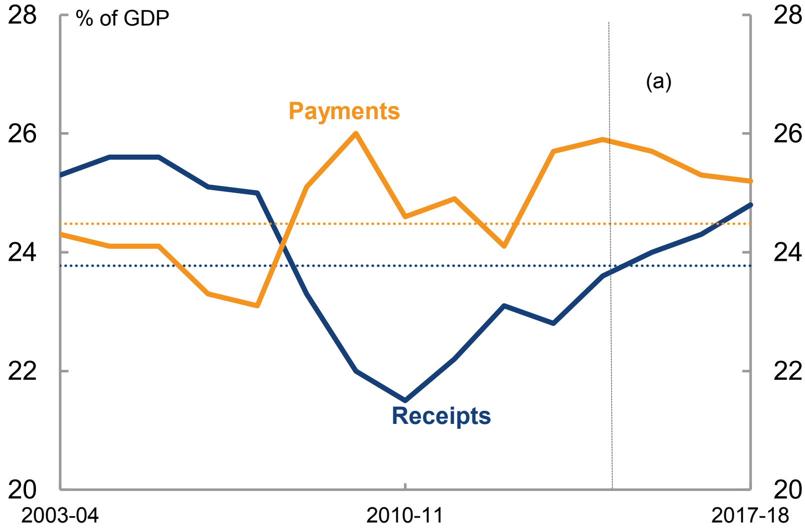
11. Parliamentary Budget Office, p. 3.

Figure 4: Spending decisions are the main driver of the structural deficit



Source: Deloitte Access Economics, analysis for BCA.

Figure 5: Spending continues to exceed receipts



Note: (a) Forecasts. Dotted line denotes 10 year average to 2013-14.

Source: MYEFO 2014-15.

Estimated spending in 2014–15 increased relative to budget forecasts due to the delay or dilution of announced savings measures, some new spending decisions and higher than anticipated costs of programs such as childcare assistance, family tax benefits, defence and income support. Increased outlays for some programs reflect difficult economic conditions, particularly weak employment and wages growth. Others such as childcare rebates reflect the demand- and cost-driven nature of the program.

As a result, total payments are anticipated to grow slightly in real terms (0.1 per cent) and rise to 25.9 per cent of GDP, their highest share since 2009–10 after the GFC.

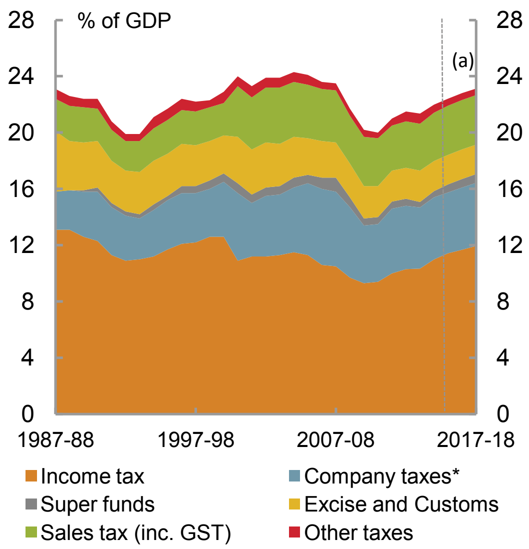
Revenues have increased – but by less than hoped for and not enough to keep pace with the current spending trajectory

Total revenues are forecast to rise from 22.8 per cent to 23.6 per cent of GDP over the year but by less than initially budgeted due to a larger than expected terms of trade decline. Tax revenues are still expected to grow by more than 4 per cent over the year and comprise a higher share of GDP in 2014–15 (22 per cent) than 2013–14 and the five years before that.

Declining terms of trade and weak nominal GDP growth, as well as past and recent policy decisions (for example, the deficit levy) and recent bracket creep, have shifted the composition of tax receipts to taxes on individuals. Company tax receipts have continued to rise in absolute terms though at a slower rate than the early to mid-2000s. Relative to GDP, company tax receipts have reverted to levels recorded in the early 2000s.

The recalibration of the tax share of GDP and mix to a large extent reflects the unwinding of the transient effects of unprecedented terms of trade which saw tax revenues peak at more than 24 per cent of GDP in the mid 2000s – *a level that should never have been expected to persist*.

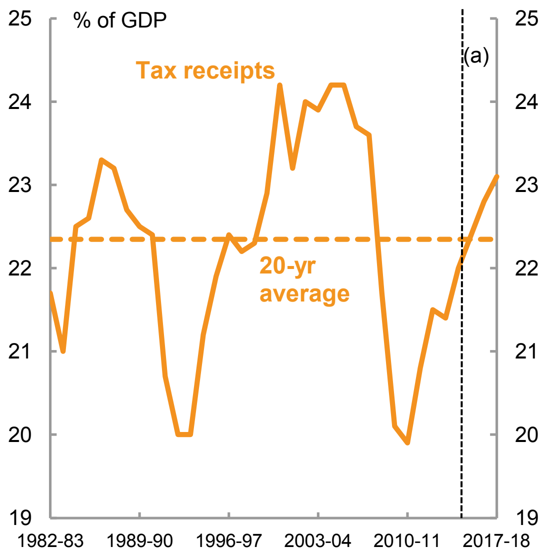
Figure 6: Recalibration of the tax mix



*including Resource Rent Tax
(a) Forecasts

Source: Treasury, updated for MYEFO 2014–15.

Figure 7: Tax receipts are increasing



(a) Forecasts

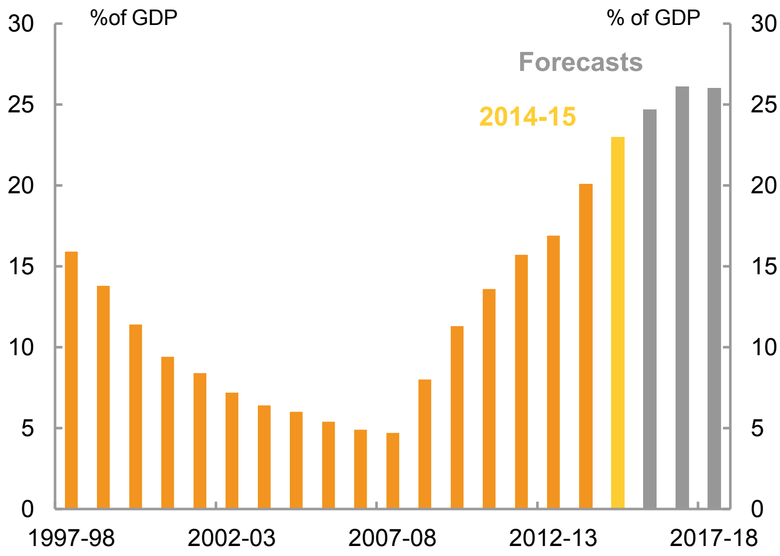
Source: MYEFO 2014–15.

The budget outlook is uncertain

The Mid-year Fiscal and Economic Outlook (MYEFO) indicates that projected deficits will increase significantly over the medium term compared with initial 2014–15 budget estimates. Official budget forecasts are for continued deficits until the end of the decade.

Net debt is forecast to rise to 17.2 per cent of GDP in 2016–17 ($304.4 billion) and gross debt to peak at $516 billion in 2019–20.

Figure 8: Federal gross debt continues to build



Source: MYEFO 2014–15.

A projected return to surplus in 2019–20 occurs mainly on the back of what would appear to be optimistic assumptions, including that announced cuts in spending are fully implemented and five years of above-trend real GDP growth from 2016–17.

MYEFO forecasts also have nominal GDP growth recovering from historically low levels to around trend, due to an easing of the rate of decline in the terms of trade. This would see revenues increasing to 24.8 per cent of GDP by 2017–18, including from bracket creep.

Deloitte Access Economics estimates that bracket creep will contribute around $4 billion to revenues by 2017–18, notwithstanding subdued inflation and wages growth. This will involve some 1.7 million or 18 per cent of all taxpayers moving into higher tax brackets over the four-year estimates period, mainly due to price inflation.

Uncertainties around budget forecasts are inevitable and they could play out either way. But the fragility of the global and domestic economic outlook and flat productivity and participation, combined with the relentless demand pressures on government services would seem to tilt the balance to greater downside than upside medium-term risks.

The budget forecast error range is large

Published confidence intervals around current budget estimates (based on past forecast errors) are large – for example, all that can be said with 90 per cent confidence is that the 2015–16 budget outcome will lie somewhere between a surplus of around 1 per cent of GDP and a deficit of around 4.5 per cent of GDP.

The economic outlook is delicately poised

Though official forecasts indicate slightly stronger real and nominal GDP growth in 2015–16, the lower exchange rate and interest rate environment are not expected to induce stronger business investment. Private business investment is forecast to decline further over the next two years. Confidence levels remain weak, reflecting uncertainty about global and domestic markets.

An economy in transition

Over 2014 the economy continued to face the task of adjusting to the largest fall in the terms of trade in 50 years and the end of the mining investment boom.

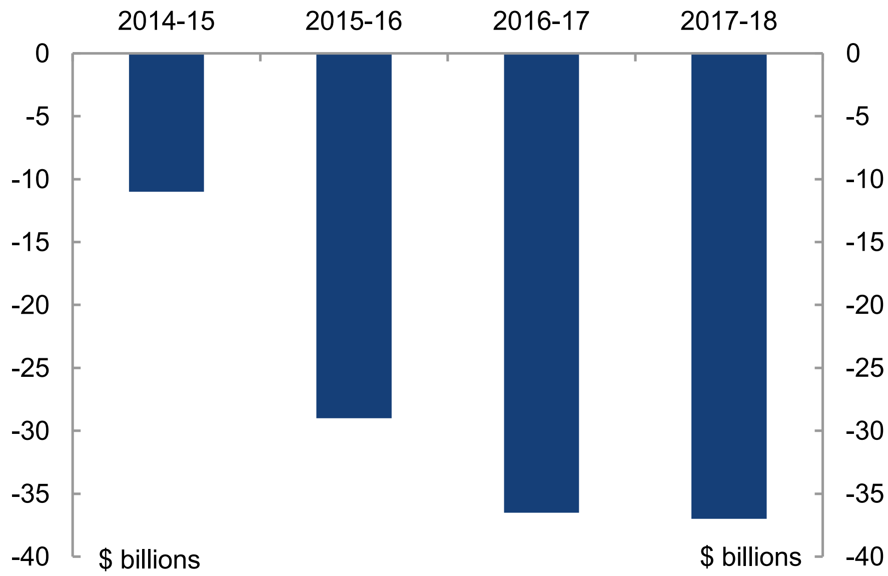
The currency has depreciated significantly against the $US and most major currencies. Depreciation will facilitate required structural adjustment, but the process takes time and is not painless. As noted in the Business Council's 2014–15 budget submission, depreciation will need to flow through as real reductions in costs – a *real* depreciation – to lift competiveness and growth.

Real GDP growth of 2.7 per cent in the year to September 2014 remained below trend. Declining terms of trade have seen *nominal* GDP growth fall to historically low levels and real net national disposable income decline in the June and September quarters. The unemployment rate has risen to 6.4 per cent, its highest level since the early 2000s.

In particular, new uncertainties have emerged, including volatility in iron ore and oil markets. Falls in the terms of trade translate to weaker nominal GDP growth and net national disposable income. This poses considerable risks for the budget. Expectations must adjust to the reality that future income and revenue growth will have to come mainly from improving productivity, rather than windfall gains in the terms of trade.

MYEFO sensitivity analysis indicates that a 1 per cent reduction in nominal GDP arising from a terms of trade decline of about 4 per cent would increase the current year deficit by almost $3 billion and next year's by $5.6 billion. Deloitte Access Economics has modelled the terms of trade return to their 2003 pre-boom level and consequential real economic effects. This could see $114 billion added to the deficit (and debt) over four years.

Figure 9: Budget impact of the terms of trade returning to pre-boom levels



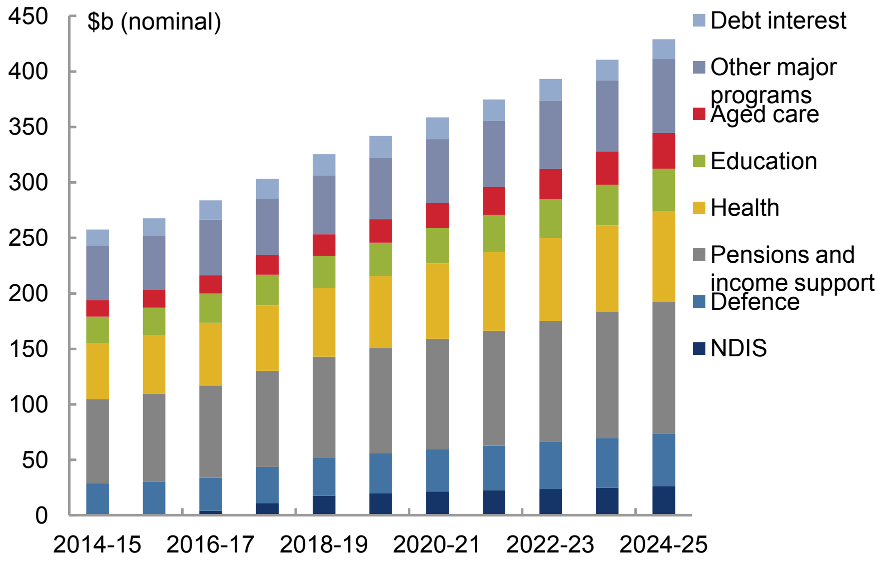
Source: Deloitte Access Economics, analysis for BCA.

Bigger spending demands just beyond the forecasts

Even if the budget were to return to surplus by the end of the decade as forecast, any respite will be short-lived. The forecast period finishes just before major impacts of rapid growth of many programs – including child care, age pensions and aged care, defence, the NDIS, health and education – are felt. Strong spending growth is anticipated, even assuming savings measures announced in the 2014–15 Budget are fully implemented. (Among other things, this highlights the importance of implementing a 10-year budget horizon.)

Aged care costs are expected to almost double in real terms by 2024–25, reaching $24 billion (2012–13 dollars). Public hospital spending will be $19 billion (2012–13 dollars) or 40 per cent larger than today and child care spending $8.5 billion, 70 per cent more than now.

Figure 10: Major spending programs grow rapidly beyond the forward estimates



Source: Parliamentary Budget Office, 2014 and BCA.

Population ageing is the elephant in the room

Much of the projected spending growth is in aged-related programs. Australia's demographic profile has turned a corner that will have increasingly profound implications for the economy and government budgets at all levels. As overall population growth rates decline over the century, the oldest age groups will grow dramatically. One in four Australians will be 65 years or older by 2060 compared with one in seven today.[12]

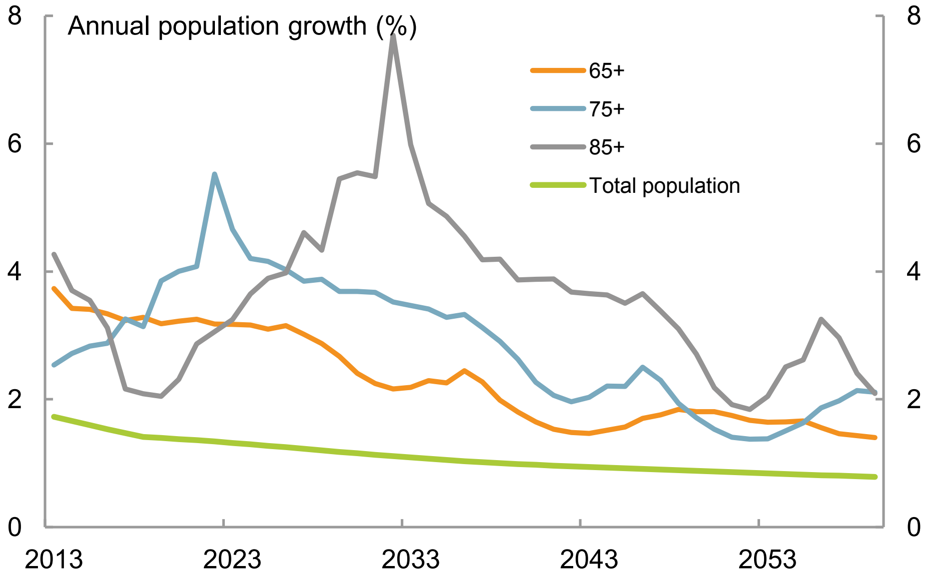
Older people naturally consume more government services than younger people. Total spending on health and aged-related services for people over 65 years is projected to increase roughly threefold by 2050 to almost $250 billion (2011–12 dollars), before taking increased demand for services into account.[13]

Experience would also suggest that spending per person will almost certainly increase, reflecting community expectations for better quality services and access to the latest and frequently more expensive services and technologies, particularly in health care. Combined with rising numbers of older Australians, this will make for a potent mix.

For example, the 2010 IGR projected that by 2050, total real federal spending on health would increase roughly sevenfold for people over 65 years, and around twelvefold for people over 85 years.[14] Real spending on health across all governments will be even higher. States currently pay around $40 billion for health programs on top of the Commonwealth's $60 billion.[15]

12. Productivity Commission, November 2013, p.33.
13. BCA calculations, based on Productivity Commission estimates.
14. Australia to 2050: Future Challenges, 2010, p. 51.
15. Australian Institute of Health and Welfare, 'Health expenditure Australia 2012–13,' September 2014, p.15 and 17.

Figure 11: Older populations will skyrocket



Source: Productivity Commission, 2013.

Older people also have lower workforce participation rates. Even if their participation levels increased significantly, the incremental benefit would be swamped by their growing numbers relative to younger age groups. Aggregate participation rates are expected to fall, putting a drag on growth and income tax revenues. The Productivity Commission estimates that aggregate participation could fall from 65 per cent in 2012–13 to 60 per cent by 2059–60. Hours worked per capita could fall by 4.5 per cent over the same period, implying an equivalent impact on GDP.[16]

The National Commission of Audit found that even allowing for a decline in the proportion of people receiving the full pension (due to superannuation), a rise in the number of people receiving a part pension would mean that the proportion of older Australians eligible for the Age Pension would remain constant at 80 per cent over the next 40 years or more. This highlights the need for an holistic review of the entire aged pension and retirement income system.[17]

16. Productivity Commission, November 2013, p.2 and 101.
17. National Commission of Audit, 'Towards Responsible Government', Commonwealth of Australia, February 2014, p. 81.

Figure 12: Governments spend more on older age groups

Demand for health care and other aged-related services grows rapidly by age group.

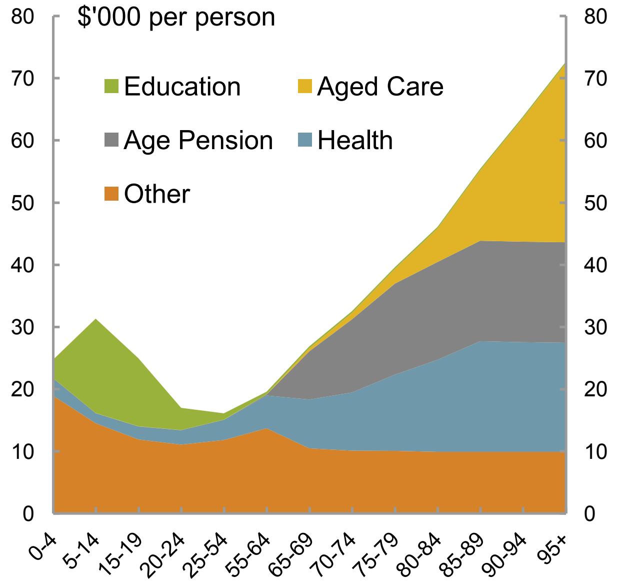


Figure 13: Real spending on aged-related programs will increase as the population ages

Real spending on health and aged-related programs for over 65s as a result of demographics alone is likely to triple by 2050.

In reality it could be much higher than this. Experience suggests that community expectations for better quality services and access to the latest technologies will put upward pressure on spending in these areas.

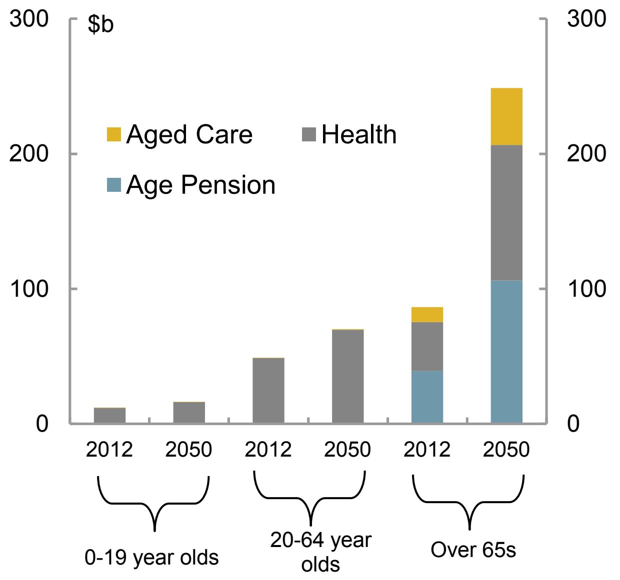
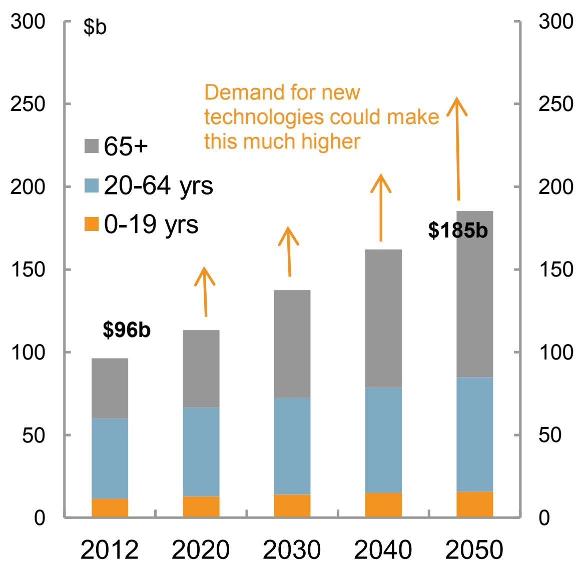


Figure 14: Health spending will at least double in real terms by 2050

The 2010 IGR projects that by 2050, total real federal spending on health could increase roughly sevenfold for people over 65 years.

Real spending on health across all governments will be higher again. States currently pay around $40 billion for health programs on top of the Commonwealth's $60 billion.



Source (all): Productivity Commission, 2013 and BCA.

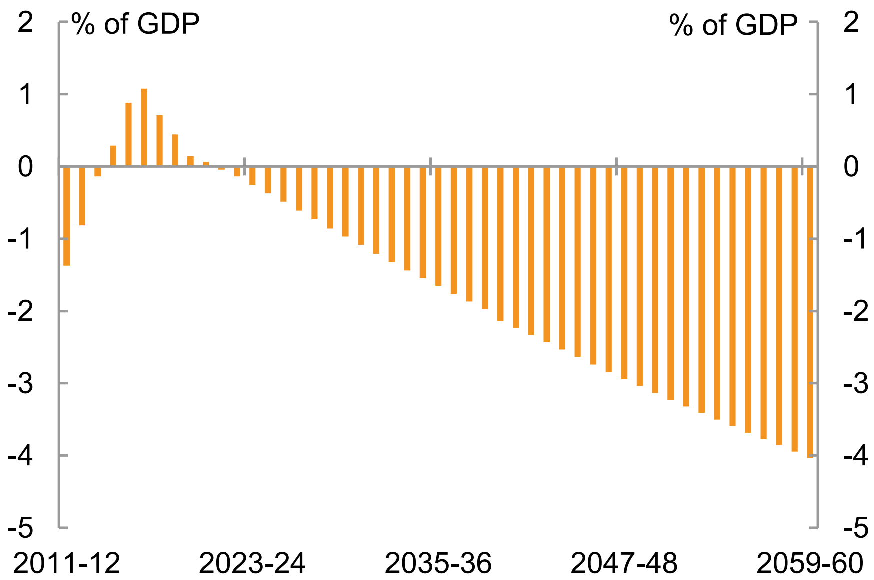
2 THE CONSEQUENCES OF INACTION

The reality facing current and future governments is that without policy action the budget position will worsen. This will affect Australians individually and constrain choices.

Increases in program outlays beyond the forecast period could see the current structural deficit of 3 per cent of GDP persisting over the long term. Population ageing is projected to generate a fiscal gap across all levels of government of around 4 per cent of GDP by 2060.

Such projections are highly sensitive to numerous assumptions about productivity, labour force participation and spending parameters. But in many respects they are likely to be conservative, given rising expectations in the community for access to better services.

Figure 15: The federal and state fiscal gap is set to grow



Source: Productivity Commission, 2013.

Persistent structural deficits of around 3 per cent of GDP (or nearly $50 billion in today's terms) would rapidly build debt to perilous levels. They imply around $50 billion additional debt each year, growing the stock of debt and the interest payments that must service it. It is worth recalling that this year's net debt of $245 billion accumulated over just six years.

A feasible worst case?

The budget consequences of ongoing structural deficits and debt accumulation combined with inevitable future economic shocks could be dire. As the Reserve Bank Governor Glenn Stevens recently warned, an economic downturn could see the deficit 'go from 2% of GDP to five or six in a heartbeat'.

The GFC increased the deficit by around $70 billion starting from a $20 billion surplus. A shock of similar magnitude today, starting from a $40 billion deficit, would increase the deficit to $110 billion or 7 per cent of GDP and net debt to around 20 per cent of GDP. Put in context, a deficit of this magnitude currently is nearly twice the Commonwealth's health spending and more than half total individual income tax receipts. Lower terms of trade could amplify this further.

3 WHY A STRONG BUDGET IS NEEDED

Deficits are not a bookkeeping entry. They are a claim on our future incomes: debt must be serviced and repaid, either by raising more taxes or spending less on valuable services. There are no other options.

Deficits are a credit card not a gift card

Government spending not paid for by direct user contributions sooner or later must be paid for from taxes. Government deficits do not offer an escape from the need for taxpayer funding, they can only shift the burden of today's spending to future taxpayers.

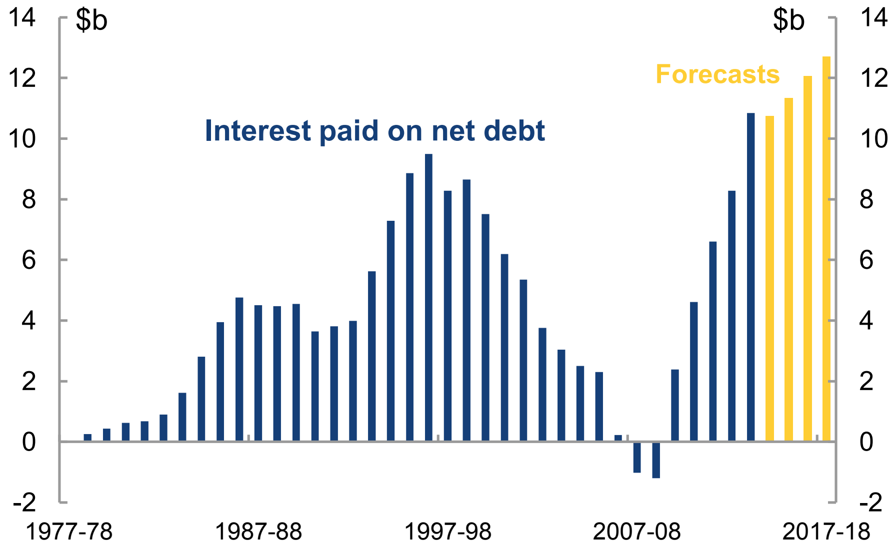
Borrowing may be justified when the upfront costs of a government project are incurred today while the benefits accrue to future taxpayers (although for routine investments 'pay-as-you-go' is just as equitable if the annual expense is broadly similar).

But in practice there are incentives to do the opposite, that is, to shift the cost of services benefiting today's population to future taxpayers. The true cost of spending today is hidden. This is inequitable and ultimately unsustainable.

A stronger budget will restore capacity to provide valuable services and investments

Australian taxpayers today are bearing the burden of debt accumulated over the last six years. Australia's net debt of 15 per cent of GDP may not seem large compared with many other countries, but nonetheless the interest bill of $11 billion on $245 billion of net debt represents $2 billion more than annual spending on higher education and $3 billion more than support for carers. Crucially this bill will continue to rise with future deficits and debt accumulation.

Figure 16: The interest bill will grow with continuing deficits



Source: MYEFO 2014–15.

Budget improvement is needed to give governments capacity to deliver the services and public investments that maximise community value today and in future, including:

- Providing a sustainable social safety net for the most disadvantaged in society. Without reform, higher debt servicing costs could trigger blunt and inequitable rationing of services and cuts in base entitlements.
- Supporting productivity and income growth through efficient capacity-building public investments in human capital and infrastructure. Such investments could be crowded out by higher debt servicing and higher recurrent spending, reducing future growth.

A stronger budget is needed for fiscal resilience and investor confidence

Continued debt build-up would risk Australia's AAA credit rating, directly impacting borrowing costs of the federal government and indirectly for other levels of government, business and consumers. It would also undermine confidence and deter foreign investment.

Determinants of AAA — what ratings agencies watch out for

Ratings agencies primarily assess a country's fiscal flexibility. Fiscal flexibility reflects surpluses and deficits but also revenues and expenditure flexibility, the effectiveness of expenditure programs and the policy mix (for example, between recurrent spending and investment). Future pension obligations are a key component of ratings assessments. The strength of a country's political and economic institutions are also influential.

The overall gross and net debt burden is naturally of great importance, as is the proportion of revenue required to service the interest bill. The currency composition and maturity profile of debt, and breadth and depth of local capital markets, are also factors.

While the precise criteria are not available, a rough rule of thumb is that a net debt threshold of 30 per cent of GDP (combined debt of the Commonwealth, states, territories and local governments) has the potential to trigger a ratings downgrade. Australia's combined government net debt is currently around 17 per cent of GDP. It is important that Commonwealth savings measures do not just shift the deficit burden to the states.

High debt would also compromise our capacity to weather economic shocks and volatility and business confidence. Australia may seem a long way from the debt quagmire engulfing many countries, but it would be folly to ignore the risks of incremental debt increases. As noted earlier, if another GFC were to hit the Australian economy today the starting point would be a $40 billion deficit, in stark contrast to a $20 billion surplus in 2008.

A strong fiscal position and low country risk, including preservation of Australia's AAA credit rating, is needed to enhance the capacity of governments to weather and respond to economic shocks, and to underpin business and investor confidence.

4 HOW THE DEFICIT IS REDUCED WILL BE CRUCIAL

The overriding objective of policies to strengthen the budget must be to ensure that the community's scarce resources – primarily its labour and capital – are being used as efficiently and effectively as possible. This means that deficit reduction should not be achieved by any means, at any cost: measures must be carefully considered and sustainable. Proper transition and communication are essential.

Higher taxes are not the answer

Tax revenues are already close to their long-run average relative to GDP, notwithstanding weaker economic conditions. Stronger revenue growth is expected as the economy recovers, but the days of windfall receipts from the mining boom are over.

Moreover as noted earlier, income taxes for the average taxpayer are already set to rise, by stealth. Over the next ten years it is estimated that bracket creep will see the average tax rate for a taxpayer on average full-time earnings increase from 23 per cent to 28 per cent, in today's terms more than $3000 extra tax.[18] But this would still not be enough to fix the deficit.

The deadweight costs of taxation

Taxes involve more than just transfers between groups in the community – they change people's behaviour. Most notably they affect incentives to work, save and invest. These effects, known as the 'excess burden' or deadweight cost, must be fully accounted for in any decision to increase taxes to pay for government spending. Importantly, deadweight costs generally increase exponentially with higher tax rates.

Analysis for the Business Council by Deloitte Access Economics indicates that relying on bracket creep to fix an ongoing fiscal gap of 3 per cent of GDP and return to a surplus of 1 per cent of GDP could take two decades. It would mean people earning just 10 per cent more than average weekly ordinary-time earnings (today about $85,000 per year) would face the top marginal income tax rate, paying some $15,000 more tax than they pay now (in current dollars), due to real wage and inflation increases.

Taxation reform *is* needed to improve the efficiency of revenue collection and to reduce the deadweight costs of disincentives to work and invest. Reform must be achieved through a comprehensive process, not ad hoc measures. A more efficient tax system could deliver a double dividend of higher incomes while providing a more stable and sustainable revenue base.

But imposing ever higher taxes, by decision or stealth, to pay for wasteful or ineffective government spending would exacerbate disincentives to work, save and invest and undermine the income growth that ultimately must pay for future public spending, and not address the source of the problem.

18. Prime Minister's speech to the Business Council of Australia 2014 Annual Dinner, 29 October 2014.

Sustainable fiscal improvement requires *careful* spending repair

Budget repair first and foremost will require fundamental reform of spending programs to ensure that spending is effective and delivers value for money to the community after accounting for the full costs of the resources used up, including the cost of raising taxes to fund them. Without spending reforms there will be no scope to deliver relief from the effects of bracket creep. Nor could the safety net be guaranteed.

Savings measures must be structural and ongoing. They must deliver real savings and not merely shift costs to other balance sheets, including to other levels of government.

Savings measures must be sustainable. Blunt rationing of services, arbitrary cuts in base entitlements or other quick fixes are unlikely to produce good outcomes or be accepted by the community.

Making savings by cutting efficient investments in human capital and infrastructure could impair productivity and income creation, just like the deficits they are intended to correct.

Making cuts that impair the capacity of the public sector to design and deliver policy improvements would be short-sighted and ultimately self-defeating. In some cases upfront investments in technology and data will be required to make longer-term savings and to improve program outcomes.

Above all, implementing sustainable spending measures will require a systematic process of transparent review and consultation. This is what the Business Council is recommending.

5 RESETTING THE BUDGET PROCESS

A 10-year fiscal strategy to support economic growth over three horizons

The Business Council considers the key task for the 2015–16 Budget is to set out a strategy that will bring Australia's fiscal situation under control and to map out a reform path that focuses on redesigning major spending programs.

Redesign of the major expenditure programs ideally will seek to reduce the growth trajectory of spending, while also improving service delivery and the effectiveness of programs. Crucially, reforms should follow extensive consultation with key stakeholders and transparent and independent review.

Setting out a credible reform path for structural change to major spending programs will be far preferable to making abrupt changes which are unlikely to be sustained.

Set a 10-year goal for the budget

The reform path should be designed to meet a 10-year goal for a budget position that will support long-term economic growth, with changes to spending programs designed to deliver that outcome and the services needed for the long term. Ideally this 10-year goal would be underpinned by bipartisan support. Indeed, we believe bipartisan commitment will be essential for achieving it. The budget strategies of both parties should demonstrate how particular initiatives will contribute to its delivery.

Setting a 10-year goal for the budget will maintain the focus on substantive structural program reforms that will take effect over the medium term rather than on policy changes affecting only the four-year horizon of the forward estimates.

The longer-term goal for the budget should be consistent with a set of prudent fiscal rules that seek to limit the size of government and target an operating surplus on average over the economic cycle.

The Business Council is advocating that budget setting target four broad objectives:

- Preserving Australia's AAA credit rating to consolidate the government's financial credibility and reputation, retaining financial capacity and investor confidence.
- Progressively returning the budget to surplus to build resilience and flexibility for dealing with economic shocks and volatility, and for underpinning business confidence and investment.
- Ensuring the sustainability of priority services, including an adequate safety net, which are integral for community living standards and functioning of our society.
- Ensuring capacity for investments in infrastructure and human capital, vital for innovation and productivity growth and higher incomes.

Implementation

The budget strategy should be implemented across three horizons:

- The 2015–16 Budget must hold the line against further budget deterioration. It should seek to implement only modest fiscal correction, including completing some unfinished business. Priorities include finalising higher education reforms with modifications to improve transitions and safeguards and pension indexation with a more graduated transition path. Proposed changes to Newstart eligibility should be reconsidered, looking to New Zealand's investment approach to welfare. The budget should be used as an opportunity to outline Australia's fiscal problem and explain why spending reforms are needed.
  - It would set and commit to 10-year goals for the budget and identify the restructuring task required to achieve them, and frame a medium-term strategy to progressively review and reform expenditure programs in consultation with key stakeholders and the wider community.
  - It should establish comprehensive reviews preferably by the Productivity Commission into the healthcare system and the aged care and retirement income system.
  - It and subsequent budgets would publish 10-year projections for major revenue and spending items including assessments of the long-term impacts of new measures such as the NDIS and better integrate IGR analysis to help prioritise spending reforms
- In the medium term, the 2016–17 Budget onwards would implement structural reform of major expenditure programs; progress the government's policy agenda to improve competitiveness and tax and federation reforms; and invest in growth by implementing the government's infrastructure, innovation and human capital policy agendas.
- In the longer term (ten years and beyond) policy settings would be calibrated to ensure the budget position is consistent with the announced strategic fiscal goals and performance criteria.

A 10-year, staged reform path with clear horizons will allow changes to be made gradually and assist business and the community to transition to new policy settings. The horizons for spending reforms should be published in the budget papers, with clear decision points at each horizon. This will enhance prospects for community acceptance and reduce the risk of ill-conceived savings measures weakening the economy.

In redesigning spending programs, the twin objectives should be containing spending growth and improving service quality and program outcomes. This will be a challenge, but in many areas, including health and aged care, there is substantial scope for efficiencies in service delivery, including through use of technology and better targeted, evidence-based spending. The government should draw from past reviews and best practice program delivery in other jurisdictions to help achieve this goal. The New Zealand Government's investment approach to improving public services and welfare reform warrants close examination.

New Zealand's Better Public Services Program

The Better Public Services Program was launched in March 2012 in response to a report on how the New Zealand public service could 'do more and better with less'.

Key objectives were to encourage the public service to act as a system focused on a few priority outcomes and to motivate public servants to continuously innovate and improve.

The government announced 10 targets for the public service to meet across five broad areas by 2015 to 2017:

- reducing long-term welfare dependence
- supporting vulnerable children
- boosting skills and employment
- reducing crime
- improving interaction with government through greater use of digital technology.

New Zealand's 'investment approach' to welfare

Under the 'investment approach', the average lifetime cost of existing recipients in the welfare system is determined using actuarial assessment. Resources are then directed towards areas that lead to the biggest reduction in overall costs and have the greatest impact on the lives of people over the long run.

The total lifetime cost of recipients in NZ's welfare system was around $NZ 78 billion dollars. Recipients with the highest lifetime cost were those with a sickness or disability, and sole parents. For instance, teen parents spend 19 years on welfare benefits on average, costing around $NZ 246,000 each.

Those who had capacity to work but were likely to become welfare-dependent were provided with intensive one-on-one case management to support them into education and work. In the past financial year the number of people on working-age benefits for more than 12 months decreased by 9.4 per cent.

Sources: Hartwich, O., 'Quiet Achievers: The New Zealand Path to Reform', Connor Court Publishing, Victoria, 2014. Ministry of Social Development, 'Reducing long-term welfare dependence: Snapshot June 2014', accessed 3 February 2015.

Practical options include tightening program eligibility and the implementation of more market-based approaches to service delivery to promote efficiency and innovation, including through a greater role for the private sector and user charges.

The medium-term budget strategy should also differentiate between recurrent expenditure and investment in human capital and infrastructure that can improve productive capacity (and possibly justify government borrowing to pay for them). Efficient investments should not be crowded out as a consequence of exponential growth in spending on health and ageing programs.

Table 2: Benefits of reform

The 'how'	Potential pay-offs
Enhancing productivity in health care • Relaxing workforce demarcation and regulations that inhibit efficient skill mixes • More cost-effective use of health technologies and evidence-based medicine • Efficient 'lean' management and coordinated procurement practices across hospitals • Better financial and incentive alignment and regulation to promote cost-effective treatments. • Better use of data and digital technologies to improve information, evaluation and choice	• A 5% improvement in health sector productivity could reduce fiscal pressures by 0.5% of GDP in 2059–60. This represents about 10% of the estimated fiscal pressure in 2059–60 from an ageing population. • At the same time there would be significant benefits for community health outcomes from more effective treatments and fewer adverse events. **Productivity Commission 2013**
Better service delivery and fairer cost-sharing in aged care • Co-contributions based on affordability and capacity to pay coupled with a lifetime limit on total contribution • Aged care home credit scheme • Australian Seniors Gateway Agency to coordinate the system	• Greater efficiency through removal of duplication and better services coordination • Easier access to and navigation of aged care • Transparent and fair consumer contributions that better reflect capacity to pay **Productivity Commission, Caring for Older Australians, 2010**

An inclusive and evidence-based approach to program redesign

An inclusive and transparent consultative approach during the program review and redesign will be essential for securing support for the reforms that are made.

Major changes to spending programs should involve consultation in the same way that regulation is subject to consultation under the Regulatory Impact Statement process. The changes should also be evidence-based in order to build a case for change.

Redesign of individual spending programs needs to include key stakeholders likely to be affected by any change. The clear purpose of such consultation should be to assist the government to reach its fiscal goals within the criteria outlined earlier.

While the annual budget process invites stakeholders to make submissions to government on budget priorities, this does not substitute for full stakeholder input on the design and the impacts of major changes to spending programs under consideration.

Integrate the IGR findings and approach into the medium-term budget strategy

As with past editions, we expect the upcoming 2015 Intergenerational Report (IGR) to be particularly helpful in prioritising major spending programs for review and reform, and for explaining the need for reform to the community. In general, the Business Council would like to see the IGR analysis better integrated into the annual budget process.

The Business Council regards the IGR as very important for sound, long-term fiscal policy and considers that the IGR itself could be further improved by including:

- an assessment of state budget pressures and intergovernmental transfers
- population and migration scenarios
- a discussion of policies to boost participation, productivity and innovation
- the full set of assumptions and data used to aid transparency.

Principles and approaches for redesigning major programs

The overarching objective should be that spending programs deliver maximum community benefit and value for money.

Generally this will require targeting services where needs are greatest, ensuring that programs have appropriate objectives, are effective and that services are delivered as efficiently as possible. It follows that program redesign does not imply simply cutting benefits; indeed it may require upfront investments to build self-sufficiency.

Approaches that will need to be explored include:

- Setting clear objectives for program outcomes and better measures of effectiveness.
- Reducing or tapering eligibility in line with capacity to self-fund. Where greater self-reliance is expected, grandfathering arrangements may be required for some, while others will need adequate time to adjust.
- Income contingent loans that defer payment for a service to when an individual has a higher capacity to pay and co-payments and user charges. User payments have the advantage of promoting better quality services and value for money.
- Incentives and capacity-building to promote self sufficiency.
- Removal of duplication and overlap.
- Collaboration with the private sector to promote innovation in service delivery and better quality services.
- Investing in and applying digital technologies and data to improve efficiency and effectiveness of service delivery.
- Introducing competition and market-based mechanisms where feasible to improve incentives, promote choice and more efficient service delivery.

6 THE NEED FOR BROADER ECONOMIC REFORM

Fiscal repair is an essential element of a broader reform agenda that must be pursued simultaneously and cohesively. Reducing costly distortions and improving productivity growth and competiveness are essential for future growth, jobs and incomes.

Stronger growth will help build the revenue base and the capacity to pay for valued services, at the same time as easing demands on income support programs. Crucially, progressive reform over a wide front will spread the adjustment task – and the benefits – more equitably across the community.

Priority areas include removing unnecessary regulatory imposts, redesigning the tertiary education system, a more efficient tax system, improving the operation of the federation, building efficient infrastructure, reshaping our workplace relations system to be fit-for-purpose for a modern economy and maintaining a skills-focused immigration policy.

Industry Innovation and Competitiveness Agenda

The Government's Industry Innovation and Competitiveness Agenda draws together new and existing policies into a cohesive strategy for restoring Australia's competitiveness. The four overarching objectives provide a sensible framework for promoting growth – a lower cost business environment through less regulation, lower taxes and more competitive markets, a more skilled labour force, better economic infrastructure and industry policy that fosters innovation and entrepreneurship.

Specific policies include the establishment of industry growth centres and a focus in schools on science, technology engineering and mathematics (STEM) subjects.

The Business Council urges the full implementation of the agenda, and has strongly endorsed recent announcements progressing the architecture for the growth centres as a driving force of innovation in the economy.

Reform of the federation

The white paper on reform of the federation is a critical opportunity to improve the operation of our federation. Throughout the process, the Business Council will contribute its ideas on governance and institutional changes within the Australian Federation that support a more competitive economy and business environment, as well as reforms to key areas of government service provision that improve efficiency and outcomes for Australians.

We encourage the government to use this review to:

- focus on improving service
- put in place governance and funding arrangements that incentivise continuous reform at every level of government to lift Australia's productivity.

It will be important that the review process identifies a clear and achievable transition path that is agreed by all stakeholders to support any major reforms arising from the review. This is essential for achieving enduring changes.

The institutional architecture for progressing competition reforms will be crucial. The Business Council strongly supports the Competition Policy Review panel's recommendation for a new Australian Council for Competition Policy (ACCP). The Business Council believes the ACCP is needed to:

- consolidate in one body the institutional arrangements to implement competition policy reforms, including absorbing the National Competition Council
- progress the microeconomic reform agenda
- fill a gap in Australia's institutional framework – there are no other obvious organisations to effectively discharge the microeconomic reform agenda responsibility
- link microeconomic reform to incentive payments, or the 'competition policy payments' referred to by the panel.

Tertiary education

Tertiary education is a continuum that starts with vocational education in the senior years of secondary school and extends into the VET and higher education sectors. Over the last generation we have shifted from having a tertiary education servicing 30 per cent of the population, to wanting and needing one to service the majority of the population. This is a significant and important policy change. But this change has not been accompanied by a systematic rethink of how we should design our tertiary system to best deliver to this wider group of users.

Given the federation white paper and the higher education reforms before the Senate, it is the right time to undertake a comprehensive review of VET and higher education, and design a broad tertiary system with an entitlement to government support for upskilling as its centrepiece.

Redesigning a fit-for-purpose tertiary education system

A broad tertiary system should be a quality and fit-for-purpose model that delivers skills development to people across all stages of their lives – ranging from literacy and numeracy through to higher-level research qualifications. It should:

- Include a level of government-subsidised access for students across both VET and higher education, with a single entitlement model.
- Ask students to make a personal contribution to their education that can be deferred. This personal contribution should reflect a person's ability to pay in the future, based on their earning capacity.
- Provide government assistance to students in the form of an income contingent loan, to help them make their personal contribution. This would ensure people are able to participate in education regardless of their background.
- Give students choices about what they study and where.
- Have extensive market information about the quality and cost of training delivery and potential labour market outcomes.

These features would deliver a tertiary sector that is dynamic and diverse, where providers focus on their strengths to differentiate and specialise. It would value research and teaching equally and deliver both vocational and academic learning in a way that is relevant to students and the jobs of the future. It would also deliver products and services that are needed on a globally competitive basis, setting people up for success in a global marketplace.

Tax white paper reforms

A competitive tax system, alongside prudent fiscal policy and reform of the federation, is important in maintaining a strong economy and lifting living standards. The government's tax white paper process provides the opportunity for a coherent, comprehensive and holistic approach to build consensus for change and to demonstrate that tax reform need not be a zero-sum game.

The central role of the tax system is to raise enough revenue to fund the 'agreed' level of expenditure, not to fund any level. It should do so in a way that offers the right incentives to work and invest in an increasingly competitive global environment. A simpler and more competitive tax system will also better support economic growth. Reform of the tax and transfer system should also promote equity and the appropriate incentives for participation.

There is a strong body of evidence, including from the OECD, that a change in the tax mix from direct to indirect taxes would better encourage investment, innovation and entrepreneurialism – key drivers of economic growth. Ad hoc changes in the interim will undermine the process of tax reform and harm business confidence.

The tax reform process should:

- be mindful of the need to raise revenue sufficient for efficient expenditure
- take into consideration the possibility of a change in the tax mix that can lead to a more competitive tax system to foster investment and growth
- aim for a tax system characterised by a broad base and with low rates
- be comprehensive, with effective community engagement that is conducted in a consultative and transparent way and have appropriate transitional and compensation arrangements if necessary.

Regulation reform

The government's focus on cutting red tape and improving the quality of the regulatory process is welcome and needs to continue as a focus. Australia's regulatory environment is critical to enabling innovation and driving productivity.

Important regulatory improvements have already been achieved, particularly the development of the government's regulatory performance framework, progress towards removing double handling of environmental assessments between the Commonwealth and the states and streamlining of the 457 visa process. We also welcome commitments to review compliance costs associated with Australia's tax system as part of the tax white paper, establish one-stop shops for environmental approvals, to identify and recognise trusted international standards and to consider removing cabotage restrictions on coastal shipping.

As part of its deregulation agenda the Business Council suggests that the government consider the following areas:

- Removing the requirement in the Australian Jobs Act that mandates government approved Australian Industry Participation plans for private investment over $500m.
- Investigating whether restrictions can be removed that inhibit the capacity of airports to operate efficiently and which are no longer required to manage environmental or health risks, given the use of quieter, more efficient new-generation aircraft during curfew periods.
- Implementing a more proportionate, risk-based approach to corporate governance reporting requirements, including removing the requirement for external auditors to audit remuneration reports under s300A of the Corporations Act 2001.
- Introducing stronger incentives for state and local governments to improve their regulatory systems.
- Rigorously applying principles for best practice regulation as it investigates extending the unfair contract term protections to small businesses, introducing an effects test in section 46 of the Competition and Consumer Act 2010 and mandating standards for fuel price boards.

Building efficient infrastructure

Australia needs ongoing investment in productive infrastructure to meet the needs of a growing population and to support economic growth.

- The Business Council supports the use of incentive payments in the budget to encourage states to sell assets and recycle capital into new infrastructure under the Asset Recycling Initiative (ARI). Asset recycling is an innovative way to deliver better infrastructure services for the community, improve public finances and build a more productive economy.
- The budget should prioritise funding for nationally significant infrastructure projects that are on Infrastructure Australia's priority list and which have been subjected to a rigorous, transparent cost–benefit analysis. The current, relatively subdued economic environment provides an opportunity for investing in beneficial public projects. An independent Infrastructure Australia should be supported.
- The government should implement the Productivity Commission's recommendations for:
  - improved project planning and prioritisation
  - the mandatory use of cost–benefit analysis
  - the establishment of road funds ahead of the introduction of distance and location charging for road use
  - more efficient project tendering
  - the establishment of a benchmarking framework for assessing the cost and time performance of infrastructure projects
  - the privatisation of mature infrastructure assets.

Supporting skilled immigration

Australia's migration policies should support sustainable population growth and build Australia's position as an open and competitive participant in a global economy.

- The permanent migration program should remain at least at current levels of 190,000 per annum with two-thirds of the program filled by skilled migrants. Projections may need updating in the context of the next IGR.
- The flexibility of Australia's temporary migration program should be maintained by preserving the demand-driven and uncapped nature of the 457 visa scheme and streamlining of visa processes.

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