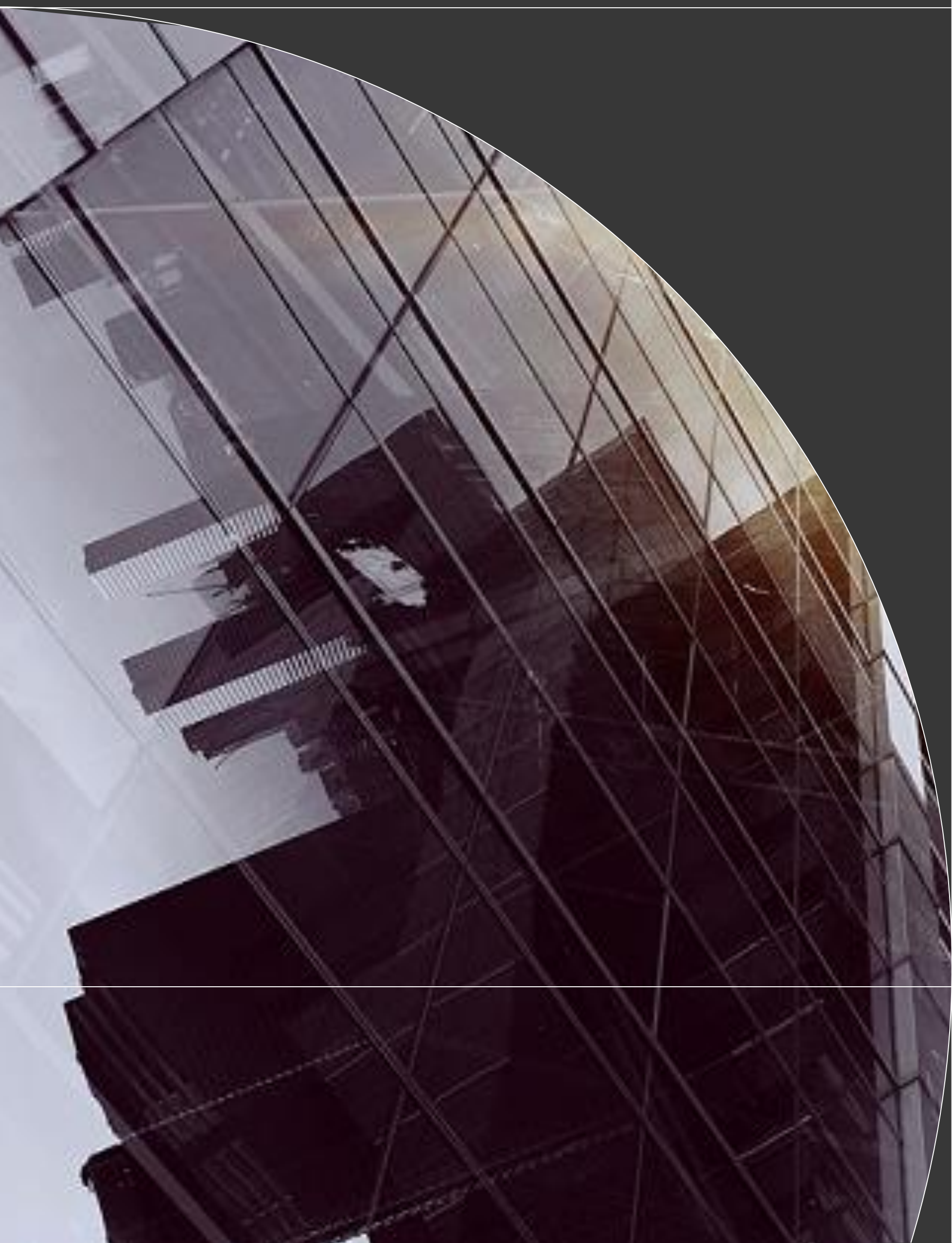
Framing the Federal Budget and Fiscal Strategy

Pre-Budget Statement

October 2022



BCA

Business Council of Australia

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Summary of Issues

This is the Business Council of Australia's pre-Budget statement for the October 2022 Budget. While we are not expecting this Budget to focus on major reforms, it is crucial the Budget lays out a fiscal strategy and builds the foundations for more substantial reform in the May 2023 Budget. This is crucial for business certainty.

Our goals for Australia

- *The Business Council stands for:*
  - *Better living standards for Australians and higher wages;*
  - *A productive, dynamic economy that allows businesses to invest, innovate, hire and pay more;*
  - *A more diversified economy that allows new industries to take a leading role in global supply chains and drive the clean energy transition;*
  - *Workforces with the skills and training needed to prosper across a lifetime of learning;*
  - *Ethically and well-run businesses that play their role in a high wage, high productivity economy; and*
  - *A sustainable system of social services that protects vulnerable Australians and provides a strong safety net.*

The rebounding economy faces strong headwinds

- *Australia's economy has rebounded strongly from the effects of the pandemic, with the jobless rate close to a 50-year low. The Reserve Bank's interest rate hikes, though, are starting to bite, and most economists expect the jobless rate to be rising in 2023.*
- *The economic outlook has become more challenging, with storm clouds gathering, particularly overseas. Growth forecasts are being downgraded, inflation is yet to peak and central banks will continue to raise interest rates. Geopolitics remain challenging.*
- *The fiscal accounts have improved substantially since the Budget back in March, due lower than expected payments and a substantial lift in tax collections. The rate of improvement is unlikely to be sustained, though, particularly if commodity prices fall from recent record highs.*
- *The Budget is facing significant medium-term challenges, including:*
  - *Rapid growth in long term spending commitments in areas like health, aged care, the NDIS and defence, alongside a rising interest bill;*
  - *An inefficient tax system that hold back economic growth and delivers revenue that is volatile and difficult to predict; and*
  - *A widening fiscal gap that needs to close to cap public debt and control interest costs.*

A sustainable fiscal strategy

The Business Council is calling for:

- *A long-term fiscal strategy that makes the fiscal position sustainable and resilient over time;*
- *Clear pathways to grow the economy, including:*
  - *improved productivity via a return of economic dynamism;*
  - *creation of new industries while strengthening existing industries;*
  - *seizing the opportunity and managing the risk of decarbonisation through better investment incentives; and*
  - *a more competitive tax system that drives innovation, hiring and higher wages.*
- *Strategies to release the handbrakes on growth via renewed microeconomic reform; and*
- *Disciplined spending and controlling costs in major structural commitments predicted for rapid growth such as health, aged care and the NDIS by improving outcomes for consumers and the efficiency of service delivery.*

No regret decisions

We understand the Government will be implementing its election promises. The nation's Budget strategy over the next five to ten years needs to be about balancing fiscal discipline, reform of spending and growing the economy, which is still the most effective way of shoring up funding for services.

What we cannot afford to do is make a series of short-term decisions that compromise our capacity to continue to grow. These would include:

- *imposing punitive taxes on companies;*
- *removing incentives for innovation; or*
- *creating an industrial relations system that causes widespread industrial action and imposes unnecessary costs, particularly on small business.*

1. Overview

Introduction

The Business Council of Australia (BCA) welcomes the opportunity to provide this submission on the upcoming budget, the first for the new Albanese Government. The October Budget will set an important tone for the government's first term. The Treasurer has described the upcoming Budget as "bread and butter", implying there will be few new policy announcements, outside the already announced expanded childcare subsidies, tightening of multinational tax arrangements, the expansion to paid parental leave arrangements, the new commitments on infrastructure and a review of "waste and rorts".

Budgets are hugely important for business. They provide much-needed policy direction and certainty, so it is essential that the government outlay a long-term fiscal strategy, with the policy detail to follow in the Budget next May. For now, the government should act to achieve the right balance between growing the economy and imposing more fiscal discipline and expenditure reform.

The Business Council will provide a submission ahead of the May 2023 Budget that will include detailed policy proposals. For now, this submission includes mainly higher-level discussion, including on the economic outlook, the importance of fiscal sustainability, plans to grow the economy, revenue sustainability and expenditure quality and control, and long-term opportunities and challenges.

Budget context – the problem

It is critical that the government strike the right balance between fiscal discipline and growing the economy in the context of a long-term fiscal strategy. The alternative approach risks the budget drifting to higher levels of both spending and taxation as a share of GDP and higher debt, which is not sustainable.

Controlling growth in spending and making the tax system more efficient are both critical. But, so too is growing the economy – the denominator in key fiscal metrics. The structural budget deficit would be materially smaller if growth in the economy could be improved over the next decade.

Unfortunately, however, the macroeconomic backdrop to the Budget has become less supportive. Global growth forecasts have been downgraded, inflation has soared and central banks are responding with sharply higher interest rates. Much of this reflects the worsening conflict in the Ukraine, which has pushed up energy prices and worsened supply constraints. There also are worsening geopolitical challenges, not least the impact of China's contested strategic objectives.

Growth forecasts for Australia have also been downgraded to reflect slower global demand for our exports and the coming crunch of sharply higher inflation and official interest rates. Most economists expect slower growth in household spending, in particular, in the months ahead. Australia's unemployment rate remains close to 50-year lows, but is likely to rise in 2023 as growth in the economy slows.

The Business Council welcomes the Treasurer's desire not to fuel the fires of inflation with more fiscal stimulus. The harsh lessons drawn from the recent UK experience are well-learned, with financial markets reacting badly to the lack of a sustainable fiscal strategy at a time the Bank of England is assertively tightening monetary policy.

The community has decided on a level of government services it desires, including delivering economic and geopolitical security and a suitable level of care for the vulnerable. A widening fiscal gap, though, indicates society has not yet settled on a sustainable way to fund these services. The widening gap between projected growth in spending and revenue is not sustainable, with debt inevitably growing and the interest bill rising.

There are *five* major forces driving pressures on the budget:

- Structural spending commitments have become embedded and are projected to grow quickly in portfolios like aged care, the NDIS, health and defence, plus the growing interest bill. The Business Council acknowledges the government's substantial review of the NDIS currently underway;

- A weak, inefficient and volatile revenue base ill-equipped to fund the growing demands on government services and that does not provide the right incentives to work, innovate and invest;
- The puzzling situation of the unemployment rate at a record low and the terms of trade at record highs, yet there are yawning budget deficits and public debt is approaching $1 trillion;
- The long fiscal hangover from higher government spending during the pandemic which, admittedly, was delivered at a time of unprecedented uncertainty; and
- A hugely complex overseas environment, with weakening GDP growth, high inflation, sharply rising interest rates and worsening geopolitical tensions.

Business Council priorities – the proposed solutions

In this context, the Business Council calls on the government to produce a long-term fiscal strategy that outlines the government's priorities. A credible plan for spending control, debt management and fiscal sustainability over time should be a key part of this strategy, in order to rebuild the nation's depleted buffers. Fiscal buffers are essential resources to be deployed by governments at times of crisis in the future – and they are more than bookkeeping exercises or ends in themselves. They provide the flexibility to respond to an economic shock, and fund the services the community expects and deserves, such as world-class hospitals, schools and transport services, or to lower taxes.

The government should not simply allow spending as a share of the economy to drift up while not focusing on growing the economy to improve fiscal sustainability. This submission includes suggestions for growing the economy in a sustainable fashion and getting back our dwindling economic dynamism. Another way to grow the economy would be to reform the tax system to make sure it is better suited to funding the services demanded by Australia's population and designed in a way to drive investment, innovation and hiring.

Australians rightly expect their taxes to be spent well and that governments will be efficient and effective in delivering services. Value for money does not mean fewer services. Rather, it means making sure services are delivered efficiently and effectively, without duplication. This is best achieved through careful redesign of programs and innovations in service delivery to drive better value and better outcomes.

Business leaders make long term investment and hiring decisions every day that affect hundreds of thousands of employees and related commercial activities, including via supply chains. It follows that managers making these decisions crave the certainty that comes from stable government policy and the fiscal context over the long term. Uncertainty around the national policy stances can act as a major disincentive and could even see investment and hiring head elsewhere. Economic policy uncertainty has been shown to lower investment spending and employment.

In this budget, the Business Council is calling for:

- A renewed focus on fiscal sustainability to manage growth in debt, which the budget projects soon will exceed $1 trillion. The resulting rise in the interest bill means the government has diminished capacity to deliver public services and nation-building infrastructure;
- Pathways to grow the economy, including via enhanced productivity, better regulation, enhancing training and skills, better coordinating infrastructure decisions and rebooting a program of long-term tax reform to deliver a system fit for purpose that better incentivises investment, innovation and hiring;

– Establishment and adherence to fiscal rules to better control expenditure and delivery of higher quality of spending and outcomes, including via making productivity gains across government services sector to manage funding pressures. The budget is forecast by Treasury to remain in deficit, albeit falling gradually to 0.7% of GDP over the decade. Real spending is forecast to grow around 3% per year beyond the forward estimates. If, instead, real spending growth is limited to 2% a year – still faster than population growth – this could support a budget surplus within a decade; and

- A renewed focus on microeconomic reform to make it easier to do business by removing the barriers to recovery as a fundamental step to laying the foundations for long-term and sustained economic growth.

Long term fiscal challenges

Australia has many advantages, not least our abundant natural resources and proximity to rapidly growing and developing economies in Asia. We also are uniquely placed to capitalise on the decades-long process of decarbonisation and climate change abatement.

That said, Australia's economy also faces significant long-term challenges, including from an ageing population, the slowest decade for productivity growth in six decades, with an accompanying loss of economic dynamism, long-term threats to fossil fuel exports as the world decarbonises and energy supply challenges.

These will make it more difficult for Australia to sustain the rates of economic growth delivered in previous decades. The government's own Intergenerational Report (IGR) from 2021 predicts average GDP growth of 2.6% a year over the next 40 years, down from 3.0% a year over the previous 40 years before the pandemic.

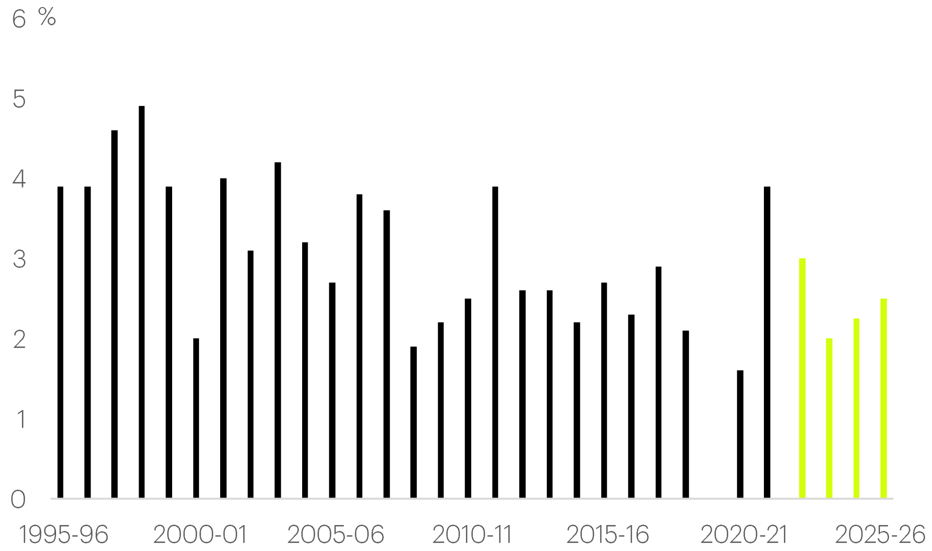
The Business Council welcomes the decision to produce an IGR once every parliamentary term. This provides a platform from which to reflect on other ways to improve how all Australian governments report on their long-term fiscal outlook and learn from best practice around the world so that IGRs continue to serve the Australian community well in the decades to come.

2. Budget themes – growth is essential

The Business Council welcomes the Treasurer's comments that this Budget is the first of a number of steps needed to put the budget back on a path to repair. As RBA Governor Phil Lowe has pointed out, it is important that the nation's fiscal position be sustainable, not least so there are buffers that allow fiscal support to be deployed during difficult times, like the COVID pandemic.

That said, the heaviest burden for demand management in the economy should be placed on monetary, not fiscal, policy. The Reserve Bank's active management of the interest rate cycle is best placed to deal with excess demand, with the RBA already having lifted the cash rate five straight months, with more hikes expected. Fiscal policy is better placed at funding efficient delivery of government services demanded by Australia's growing population.

Figure: 1 – GDP growth, including projections for outyears



Source: ABS and Ministerial Statement on the Economy, July 2022.

Low unemployment, record terms of trade … and budget deficits

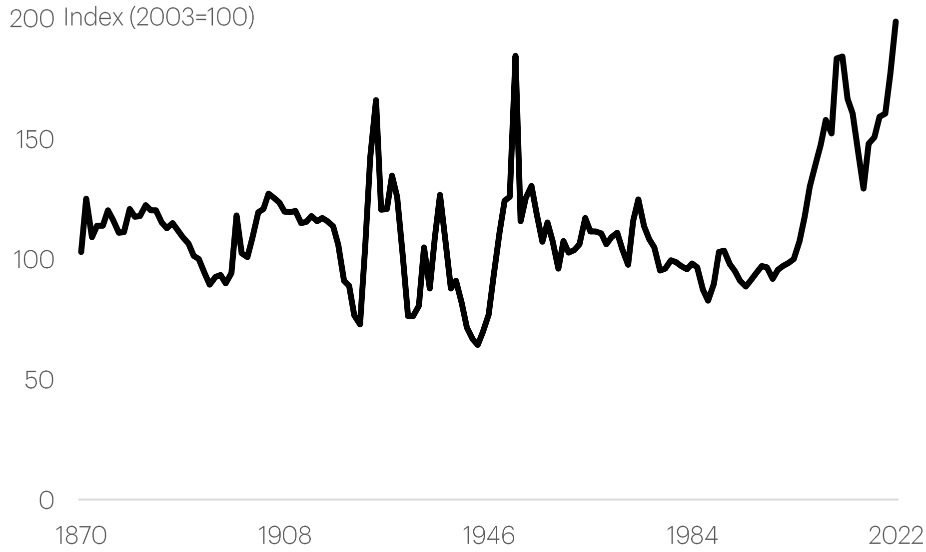
It is troubling that the budget remains deep in deficit, with no projected return to surplus over the next decade, despite the unemployment rate near 50-year lows and the nation's terms of trade recently at record highs. This is unprecedented. Normally, such favourable economic tailwinds would have delivered a sizeable budget surplus to be banked for when tailwinds inevitably turn to headwinds.

Clearly, something has gone wrong. To be fair, the Treasurer's recent fiscal update revealed an almost $50 billion improvement in the headline budget balance relative to what was expected at the time of the last budget of the previous government back in March. The improvement reflected both a revenue bounce, but also lower spending due to a mix of factors, including COVID-19 related issues, supply chain delays and labour shortages.[1]

Still, the fact that the Budget remains in deep deficit despite this improvement indicates there remain strong structural headwinds that the government should confront and overcome. One such headwind is the significant spending demands arising from the ageing population. Another is evidence that the fiscal levers were deployed too enthusiastically during the pandemic, as discussed below.

[1] Final Budget Outcome 2021-22.

Figure: 2 – Terms of trade



Source: ABS and Gillitzer and Kearns (2005).

Lessons learned during the COVID pandemic

The arguments continue over whether governments spent too much in response to the pandemic. Hindsight is a wonderful thing and the fiscal support packages delivered during COVID were prepared at a time of unprecedented uncertainty. The world was staring into another abyss, this time in health and the real economy, not financial markets as was the case during the financial crisis a decade earlier. Before the development of viable vaccines, it was not clear the extent to which civil society would be affected.

It now is clear that the fiscal support helped protect jobs and deliver health outcomes in Australia that are the envy of much of the rest of the world. Our economy has rebounded quickly, and the jobless rate is close to a 50-year low. That said, little of the emergency government spending delivered during the pandemic can be said to have delivered meaningful change in the structural dynamics of the economy.

Indeed, there are lessons to be learned from the pandemic experience. The stimulus delivered was substantial, amounting to over 14% of GDP, on top of the support provided by state governments. This was in addition to the unprecedented monetary stimulus delivered by the Reserve Bank, including via a record-low cash rate and unconventional policies.

The reality is that wherever the debate on whether governments spent too much settles, society is left with the substantial fiscal consequences. The fiscal dislocation caused during the pandemic follows the significant fiscal hole left by the global financial crisis (GFC) more than a decade earlier. The fiscal support back then amounted to 4% of GDP, mainly via the delivery of two separate stimulus packages in 2008-09. The long process of repairing the budget from that episode was underway until the onset of the pandemic.

That said, the priority now is to look forward, not back, to deal with inflated community expectations for government assistance across a variety of circumstances. New fiscal constraints mean there is a key role for government to play in resetting these inflated community expectations. The focus should be government establishing an environment that encourages hiring, investment and innovation.

Growing the economy

While sustained growth in the economy can do much to help repair the budget, the Business Council believes that it will not be sufficient unless the growth is unusually rapid, which is unlikely. It is possible to improve the budget balance as a share of GDP when the economy is growing above trend, but cyclical influences on the budget are unlikely to persist over time, with economic growth then reverting to trend.

Treasury and the Parliamentary Budget Office have estimated that adjusting for cyclical and temporary influences on the budget, it remains in structural deficit over the forward estimates. The medium-term budget projections assume economic growth returns to trend, so budget deficits beyond the forward estimates are largely structural, reflecting the cumulative effect of policy choices made by government.

The former government's last budget for 2022-23 showed underlying cash deficits falling to 0.7% of GDP in 2032-33, even with nominal GDP growth at trend. Returning the budget to balance will require the government to commit to active budget repair rather than relying on the cycle.

Figure: 3 – Nominal GDP and 10-year bond yield

Source: ABS and RBA.

It follows that the government should follow the guidance of both Dr Kennedy and Dr Lowe and examine revenue options as well as exert more expenditure control. Moreover, it is important to determine whether the current tax mix of the Commonwealth remains fit for purpose. For example, by global standards, Australia over taxes income and under taxes consumption and returns on capital. Our GST has a relatively low rate and narrow base relative to OECD peers.

Expenditure control will require difficult decisions to be made in order to prioritise the demands on the government's finite fiscal resources, within the current tax regime. The establishment of credible fiscal rules could help the government in this regard, alongside independent tracking of progress on sticking to these guidelines.

Lifting productivity is key

The Productivity Commission recently reported that growth in productivity in Australia over the last decade was the lowest in six decades.[2] Turning this around will require creating an environment more conducive to a business-led recovery and allowing creative decisions to be made over innovation, investment, hiring and training. Only in such an environment can Australia move to the frontier of economic activity and create the industries of the future.

Part of the problem is the apparent loss of economic dynamism in Australia. A dynamic economy is one that has flexible and competitive markets and where labour and capital are highly mobile. This gives business stronger incentives to invest and innovate. A dynamic economy is more open to the flow of people, capital and ideas from the rest of the world and is regulated in ways that lowers risk and increases certainty.

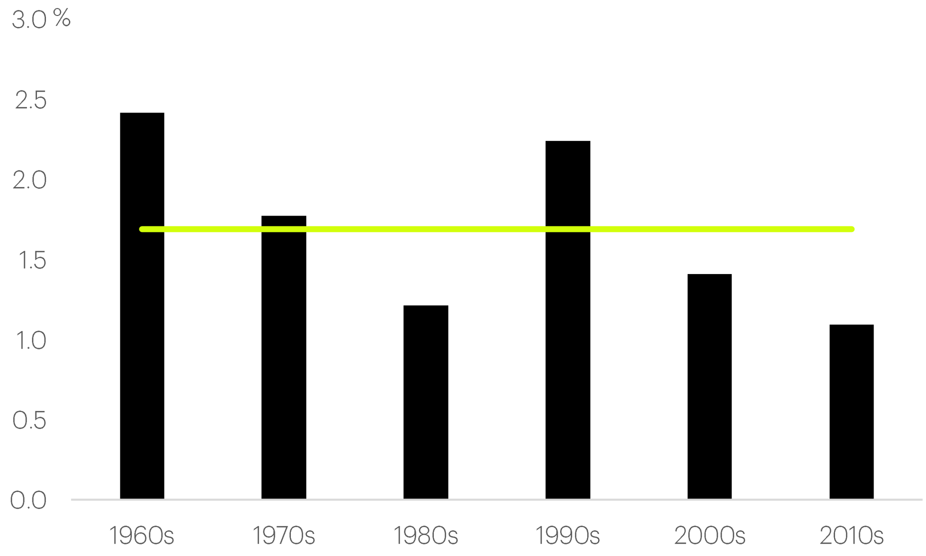
[2] Productivity Commission 2022, *5-year Productivity Inquiry: The Key to Prosperity, Interim report*, Canberra, July.

The evidence suggests that the causes of this lost dynamism are a heavy regulatory burden, rising risk aversion, increased policy uncertainty, deteriorating housing affordability, a slower rate of globalisation, falling net foreign direct investment, and a dominance of "ageing" companies here.

To a large extent, business drives dynamism in the economy through investment and innovation. Larger firms typically have higher productivity, pay higher wages and export more than smaller businesses. Businesses could contribute more to dynamism if given stronger incentives, reduced barriers to entry, greater policy certainty and a reduced regulatory and tax burden.

There is a long-established link between productivity growth and wages growth – workers with the best productivity tend to have the fastest growth in wages. The Productivity Commission found that "almost all wage growth since Federation appears to be due to labour productivity growth".[3] Faster growth in productivity also would help repair the budget by helping to grow the economy and generating higher tax collections.

Figure: 4 – Labour productivity growth by decade



Source: ABS and Penn World Table.

[3] Productivity Commission 2020, *PC Productivity Insights: Australia's long term productivity experience*, Canberra, November.

3. Economic context less supportive

The macroeconomic backdrop to the Budget is less supportive than it was in the Budget back in March. Global growth forecasts are being downgraded, equity markets have been sliding and global bond yields have been soaring. Much of the latest market volatility reflects the worsening conflict in Ukraine. There also are worsening geopolitical challenges, not least the impact of China's contested strategic objectives. Also, the US mid-term elections are approaching in November, with a growing risk of post-election legislative gridlock.

Growth forecasts for Australia also have been downgraded to reflect slower global demand for our exports and the coming domestic impact of sharply higher inflation and official interest rates. Most economists expect slower growth in household spending, in particular, in 2023.

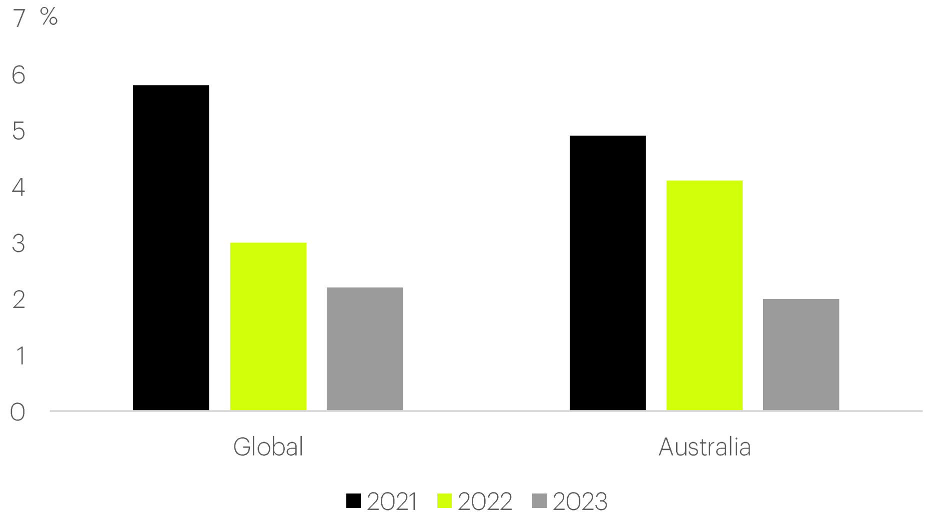
Global outlook

Growth in the global economy simultaneously is being hit by a number of factors that raise the probability of a synchronised global recession in 2023. Most economists expect that recession will be averted, but financial market pricing is indicating a high chance these economists are wrong. Among the headwinds for growth in the global economy are:

- Sharply higher energy prices because of the war in Ukraine, which has curtailed exports of gas, in particular;
- The impact of assertive increases in official interest rates as central banks attempt to curb the fastest inflation in decades;
- The lingering impacts and restrictions from the COVID pandemic; and
- Rising uncertainly in the face of geopolitical headwinds.

The Organisation for Economic Cooperation and Development (OECD) recently trimmed expected GDP growth in the global economy for 2023 to 2.2% (from 2.8%), after expected growth of 3.0% this year (held steady from previous forecasts).[4] The OECD expects recession in Germany given its high dependence on energy from Russia and sluggish growth elsewhere in Europe and the US (all sub-1% growth rates expected in 2023). The UK and Germany may already be in recession, according to some economists. The International Monetary Fund (IMF) also has announced growth downgrades.

Figure: 5 – OECD growth expectations



Source: OECD.

[4] https://www.oecd.org/economic-outlook/september-2022/

Recent turmoil in financial markets does not bode well for household and business confidence. The Federal Reserve in the US has flagged growing risks of recession as the Fed attempts to control 40-year high inflation. Chairman Powell even expressed a preference for weaker growth in the economy and higher unemployment in order to get on top of inflation. In the UK, the latest fiscal stimulus, at a time of significant fiscal imbalance, announced in late September risks fueling inflation, which could trigger even more aggressive rate hikes by the Bank of England from here. The UK pound plunged to a record low near parity with the USD in the aftermath, and bond yields soared.

Moreover, there have been unusually high levels of volatility in financial markets, which can undermine confidence. Equity markets have been sliding in response to Russia's invasion, higher government borrowing costs, rising inflation and GDP growth downgrades. The US share market has slipped around 20% in the year to date, tripping the accepted definition of a "bear" market. Bond yields, meanwhile, continue to rise, with 10-year yields recently reaching 15-year highs in the UK as investors worry about the government's plans to borrow to fund the latest income tax cuts and energy relief package.

Central banks have been raising interest rates to curb soaring inflation, which has reached multi-decade highs in the northern hemisphere. The Fed and the Bank of England have raised their base rates 300 basis points and 215 basis points respectively. This also represents five and seven straight increases, respectively, with more increases to come according to official commentary and futures market pricing. Other central banks to have raised interest rates this year are the RBNZ, the Bank of Canada, the People's Bank of China and even the European Central bank. Only the Bank of Japan has remained idle in this regard.

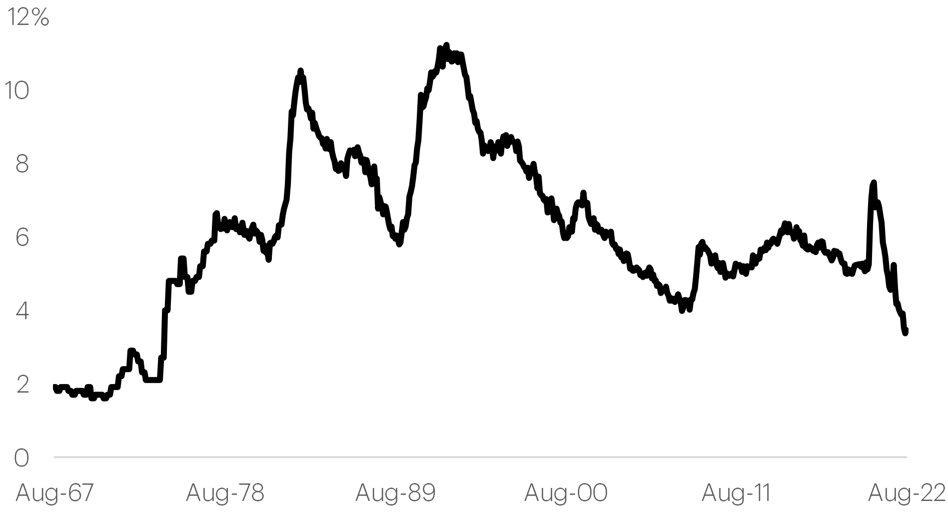
Domestic outlook

So far, so good …

Despite this worsening global backdrop, Australia's economy rebounded strongly from the impact of the COVID pandemic. The easing of restrictions last summer has seen consumer spending bounce back unexpectedly strongly, with retail spending now nearly 20% up on the same period of 2021. By contrast, confidence among households is at recession-like lows, but spending powers on. To a large extent, this reflects the release of pent-up savings accumulated during the pandemic, the benefits of the wealth gains from previous house price rises and the strong labour market.

Indeed, at 3.4% in July, the jobless rate had dwindled to the lowest level seen in nearly half a century, although there was a small rise in August. Demand for labour remains very strong, with all measures of capacity signaling that the labour market is very tight. The labour market under-utilisation rate has fallen to 9.4% – the lowest level in over 40 years.

Figure: 6 – Unemployment rate



Source: ABS.

Wages growth has started to accelerate, with private sector wage gains granted in the June quarter the highest since 2012. Yet, the rapid spike in inflation, partly owing to global influences, means most workers are experiencing deep cuts to real wages, although the average worker experienced gains in real wages over the previous five years as inflation undershot the RBA's 2-3% target zone. The tightness of the labour market means further nominal wage gains are likely, although real wages will continue to fall until inflation retreats, which looks likely during 2023.

More needs to be done to lift productivity and restore the system of enterprise bargaining. Faster productivity growth would help with broader wages growth. Moreover, those workers on enterprise agreements have been shown to have faster wages growth than workers on awards.

The external side of Australia's economy is very strong. Export volumes are booming as China, in particular, gorges on energy exports and Australia's iron ore to fuel an infrastructure boom. Commodity prices for Australia's major exports have soared, so much so that the nation's terms of trade (the ratio of export prices to import prices) recently was at a record high. Services exports are recovering now that the international border has reopened, but it will take some time for tourism and education exports (international students) to recover to pre-pandemic levels.

Business investment continues to be weak as a share of GDP. High uncertainty and the rising cost of capital has dissuaded many managers from investing. Investment in housing also is falling, albeit from recent record-highs. House prices in the capital cities are falling at the steepest rate in decades. These price falls, however, come after very rapid gains in earlier years.

Inflation in Australia has risen sharply owing to three main factors – 1) sharply higher food prices because of natural disasters, including floods 2) soaring energy prices largely because of Russia's invasion of Ukraine, but also domestic supply/demand imbalances and 3) higher dwelling construction costs, driven mainly by supply and labour shortages, freight costs and high levels of activity. There also have been the cost-push pressures from supply chain constraints, labour shortages and higher shipping and freight charges.

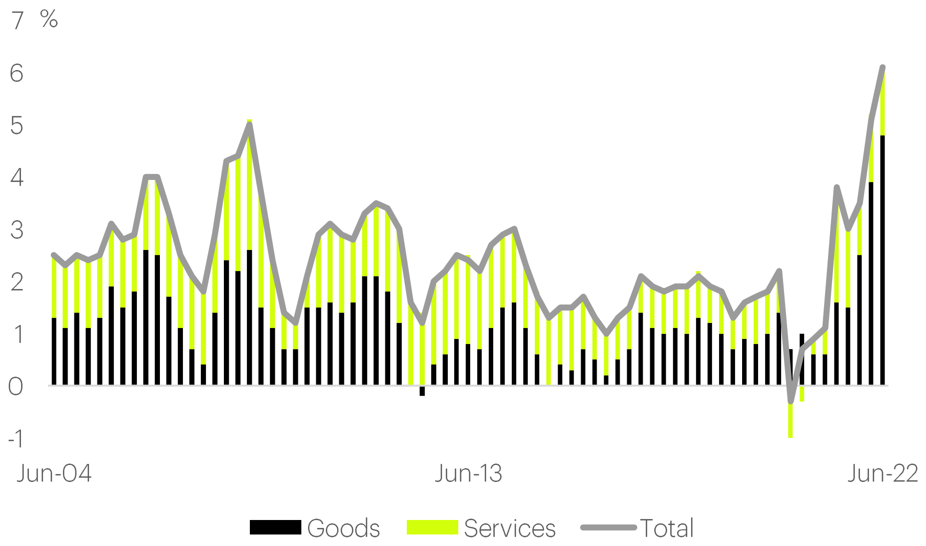
The strength of demand and soaring inflation means that Australia's Reserve Bank already has lifted interest rates six times, with more increases to come. Futures market pricing implies an RBA cash rate almost 4% by the middle of 2023, up from the current 2.6%. The RBA may be compelled to be even more aggressive if other central banks keep tightening policy. The alternative is an even weaker Australian dollar, which recently touched a 30 month low of 62.5 US cents. An even weaker AUD risks higher inflation.

… but the "narrow path" is hard to find

There are, however, signs that the outlook for Australia's economy is darkening. Recession next year remains unlikely, but the risks of a monetary policy overshoot both here and overseas mean the risk of an extended period of economic weakness is rising. Most consumers are yet to feel the impact of the RBA's rate hikes, but this is coming, and there is a large repayment shock coming for those borrowers rolling off lower fixed mortgage rates during 2023. Consumers also are yet to respond to negative wealth effects from the recent falls in house prices.

RBA Governor Lowe has said that he is aiming for the "narrow path" that would simultaneously curb inflation and deliver a soft landing for the economy. In the past, though, delivering a soft landing has been beyond the capabilities – or luck – of most policy makers.

Figure: 7 – CPI inflation



Source: ABS.

Commodity prices already have fallen significantly from their peaks, which means there is a negative income wave washing over the economy. The Reserve Bank forecasts that the unemployment rate probably will rise in 2023, after a further dip in the near term. The OECD downgraded Australia's expected growth rate for 2023 to just 2.0%, less than half the 4.1% rate of expansion forecast for 2022.

A key risk is that inflation could prove to be more persistent than already feared. The RBA forecasts inflation of nearly 8% by the end of 2022, up from a 21 year high of 6.1% in the year to June 2022.[5] Worsening conflict in Ukraine could see even higher energy prices, and there also is the risk of food prices spikes if the weather forecasters are correct about another La Niña scenario forming off Australia's east coast. This typically brings above-average rains and flooding. More persistent inflation would require even higher official interest rates.

Inflation also could be more persistent if the labour movement succeeds with its apparent aim of restoring a system of multi-employer bargaining to workplaces. Such arrangements could deliver higher nominal wages in the near term, but history tells us that the ultimate outcome would be higher inflation and unemployment. Governor Lowe has asked that flexibility be maintained in the bargaining system.[6] Productivity gains are best achieved at the enterprise level, yet multi-employer bargaining could sever the long-established link between wages and output per hour worked.

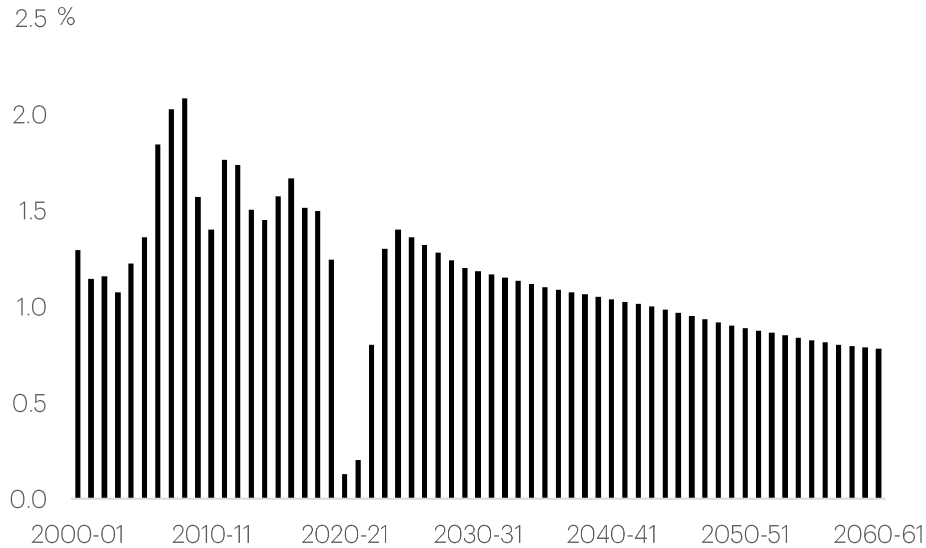
[5] https://www.rba.gov.au/publications/smp/2022/aug/economic-outlook.html
[6] https://www.abc.net.au/news/2022-09-08/reserve-bank-philip-lowe-anika-foundation-speech/101418278

Long term economic challenges

Australia has many advantages, not least our abundant natural resources and proximity to large populations in rapidly growing and developing economies in Asia. Around 80% of our exports of goods and services go to Asian economies. There is a growing middle class in Asia that will continue to demand products produced with Australian energy, in particular. We also are uniquely placed to capitalise on the decades-long process of decarbonisation and climate change abatement, given our long hours of sunshine and related opportunities in wind, hydrogen and solar power generation.

That said, Australia's economy also faces significant long-term challenges in capitalising on these advantages. These will make it more difficult for Australia to sustain the rates of economic growth delivered in previous decades. The government's own Intergenerational Report (IGR) from 2021 predicts average GDP growth of 2.6% a year over the next 40 years, down from 3% a year over the previous 40 years before the pandemic.

Figure: 8 – Population growth



Source: ABS and IGR 2021.

These long-term challenges include:

- The population is ageing, which means lower labour force participation over time and rising health costs. Overseas migration can help, here, but is limited by the new cap on the annual intake;
- Productivity growth was the lowest last decade in 60-years, with Treasury expected to revise down expected productivity growth over coming decades to 1.2% (from the currently assumed 1.5%);
- Decarbonisation and other climate change abatement threatens Australia's exports of fossil fuels, with iron ore, coal and natural gas accounting for 53% of our exports in 2021-22. The drag here, of course, could be offset by development of renewable energy resources; and
- Further dislocations caused by energy supply challenges, which is likely to see persistently higher energy prices in the years ahead.

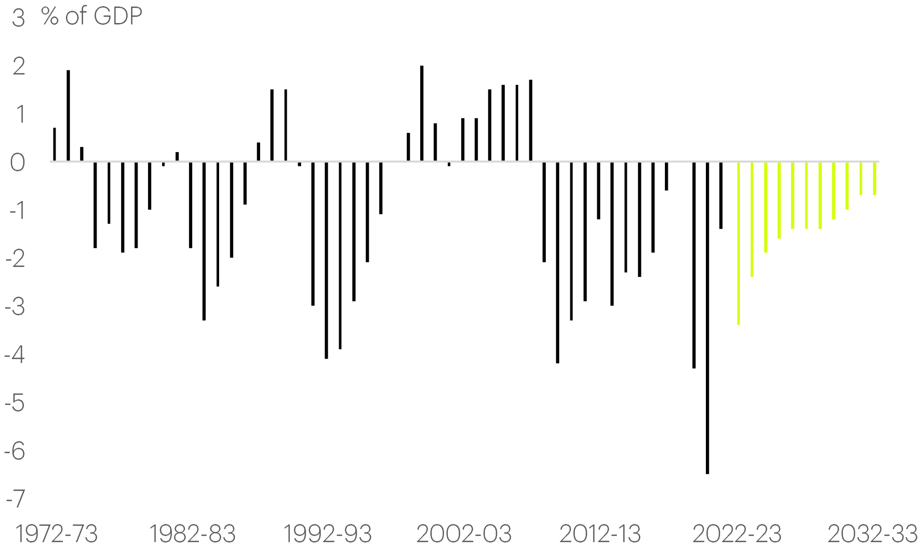
It is essential that Australia's economy be flexible and nimble in order to overcome these long-term challenges. Australia will have to move towards the global frontier more quickly by developing genuine industries of the future that will create jobs and sustain the living standards of Australians. This means creating an environment conducive to creative, business-led growth, hiring and innovation.

4. Fiscal context – better starting point

The Budget has improved substantially since the projections were released by the previous government in the last Budget back in March. The Business Council welcomes the near $50 billion improvement in the underlying cash balance announced by the Treasurer last month, but share his concerns that these gains will not be sustained. The improvement thus far was shared almost equally across the revenue and spending sides of the ledger, but further unexpected revenue gains, in particular, will be harder won in the period ahead.

- The record commodity prices that drove up company tax collections already have retreated owing to a supply response from producers and softer demand as world growth slows.
- The unemployment rate is likely to rise from here as growth in Australia's economy slows. This means slower growth in personal tax collections, notwithstanding the expectation of faster wages growth.
- On the spending side, there will be greater demands on government coffers, including to fund transfer payments as unemployment rises, deferred payments associated with pandemic relief that was not paid in the last fiscal year and additional spending commitments.

Figure: 9 – Budget balance as a share of GDP



Source: Final Budget Outcome 2021-22 and Budget 2022-23.

There appears to be widespread community acceptance for the government to provide more and better quality social services. There also appears to be acceptance that this provision of services should be funded by taxpayers. This desire for a greater role for government spreads across service delivery portfolios from health, to aged care, childcare, support for the vulnerable and indigenous Australians, among others.

Australians rightly expect this money will be spent well and that governments will be efficient and effective. Value for money does not mean fewer services. Rather, it means making sure services are delivered efficiently and effectively, without duplication. Another core challenge alongside this is to fund these additional demands in a way that eases the drag of taxation on the economy and enhances equity and efficiency. The Henry Tax Review back in 2010 found that there is no general case for hypothecated tax raising – a policy favoured recently by some state governments.[7] Rather, these funding demands should be met from general revenue.

Under-taxing capital and consumption … overtaxing income

As the Henry tax review also found, Australia's tax system has an over-reliance on taxing income (households and corporates) and under-taxing returns on capital. This bias creates powerful disincentives for affected employees

[7] Treasury. 2010. Henry Review: Australia's Future Tax System. Canberra: Commonwealth of Australia.

to work more hours and can encourage investment in relatively unproductive assets. The economy would benefit if more investment was directed to income-generating assets and productivity enhancing national infrastructure.

The Henry tax review also found that taxes on income tend to do more economic damage than taxes on consumption. This raises the issues for consideration around Australia's goods and services tax regime. Australia's rate of GST is low by global standards and the base to which the tax applies is narrow. The Business Council is not advocating changes to the GST regime in this budget, but welcomes a conversation about constructive changes to Australia's tax mix that should include a discussion of the GST, both rate and base.

Structural budget imbalance

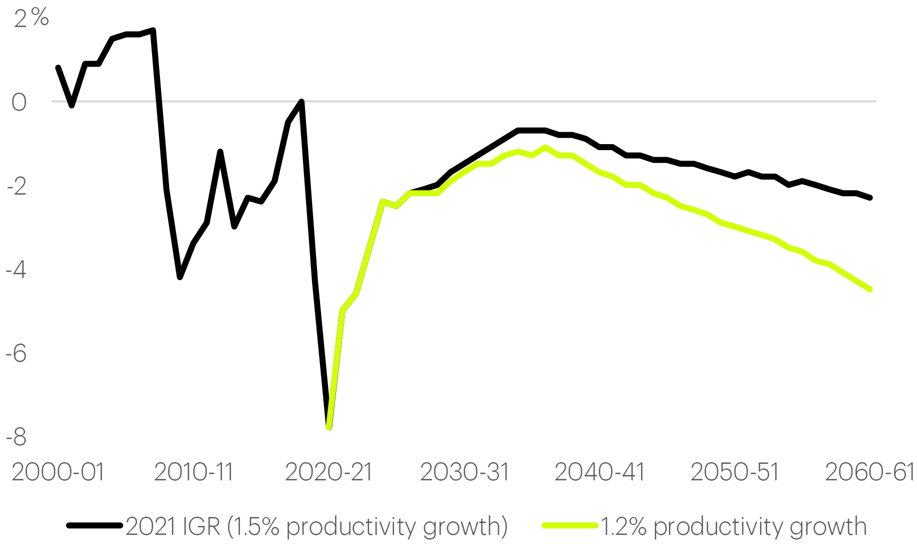
The last Budget back in March forecast budget deficits over the forward estimates, despite Treasury expectations of decent growth in the economy. This highlights the structural imbalance baked into the Budget, with the level of tax collected insufficient to fund the degree of service delivery expected. Something has to give – there needs to be a reset of fiscal policy. As Treasury Secretary Dr Steven Kennedy highlighted in his speech back in June, the tax mix and the level of tax collected needs to change or expenditure needs to be controlled more effectively.[8]

The long-run pressures on the budget will become worse from here, not better, which brings into focus the difficult decisions needed to ensure fiscal sustainability. The demands on the budget from growing expenditures in health, aged care, and disability services will become more acute as the population ages. Also, ballooning debt means the interest payments on debt will continue to rise. The Treasurer recently foreshadowed a $24 billion rise in projected interest costs per year within a decade.[9]

Moreover, some of the changes to industrial relations being debated could result in significant increases in the funding requirements in "funded" sectors like aged care. Increasing access to multi-employer bargaining in the funded sectors of the workforce, for example, would require a significant rise in government funding, given a large share of the funding for these sectors comes from the Commonwealth.

The expected downgrade to Treasury's assumptions about productivity growth should not be underestimated. The expected reduction to 1.2% (the 20-year average) from the previous 1.5% (the 30-year average) would have a profound impact on Australia's average growth rate and revenue raising ability over the coming decades.

Figure: 10 – Budget balance under different productivity growth assumptions



Source: IGR 2021.

[8] https://treasury.gov.au/speech/address-australian-business-economists-0
[9] The Hon Jim Chalmers MP, Doorstop, Parliament House, Canberra, Monday 26 September 2022

5. A credible, long-term fiscal strategy

The Business Council's understanding is that the Budget will be framed taking account of *three* main elements:

1) funding the government's election commitments, including expanded childcare arrangements,

2) accounting for the agreed outcomes from the recent Jobs and Skills Summit; and

3) parameter changes, including any new assumptions on population growth, interest rates, expected GDP growth and inflation.

The Business Council calls on the government to produce a medium-term fiscal strategy that outlines the government's priorities. A credible plan for fiscal sustainability over time should be a key part of this strategy, in order to rebuild the nation's depleted buffers. Governments quickly run out of fiscal "runway" without sufficient room to respond when something goes wrong, like the COVID pandemic. The long-term strategy must balance fiscal sustainability, management of debt, and growth in the economy – the three must work in tandem.

Fiscal buffers are essential resources to be deployed by governments at times of crisis in the future. As examples, the federal government spent around $50 billion at the time (around 4% of GDP) offsetting the damaging effects of the global financial crisis (GFC) more than a decade ago and more than $300 billion (over 14% of GDP) providing fiscal support during the pandemic. There will be other crises coming our way in an increasingly uncertain world of weakening economic growth, rerising inflation and interest rates, and strained geopolitics.

Business needs certainty over long term fiscal plans

The Business Council welcomed the comments from Treasury Secretary Dr Steven Kennedy back in June when he said the process of budget repair needed to be active not passive (that is, relying merely on growth in the economy).[10] Dr Kennedy mentioned the need to look at both the revenue and spending sides of the budget in the context that the parameters of the budget would not repair themselves without bolder action.

Similarly, it was instructive that RBA Governor Phil Lowe discussed the importance of prudent fiscal policy when testifying to Parliament in September.[11] Dr Lowe stressed the importance of restoring the buffers needed to respond to future economic downturns.

In this context, the Business Council is calling for the government to establish a credible fiscal framework. This ideally would be in the form of a 10-year plan for returning the budget to surplus. The plan should include details on how the government plans to fund the growing societal demands for service delivery, particularly in aged care and health, and rising interest costs.

Fiscal rules to control government spending

The Business Council advocates for a series of fiscal rules to help drive efficiencies in government spending. These rules will not reduce the level of services available to Australians – indeed, they provide for an increase in spending per person after inflation. These rules should be adopted against the background of growing the economy – the GDP denominator in key rule ratios.

Fiscal rules ultimately are about ensuring taxpayer dollars are not wasted and taxes are kept as low as possible, while still providing quality services and a social safety net. They act as fiscal guardrails that will help bring the debt under control and maintain discipline in the spending of taxpayers' money.

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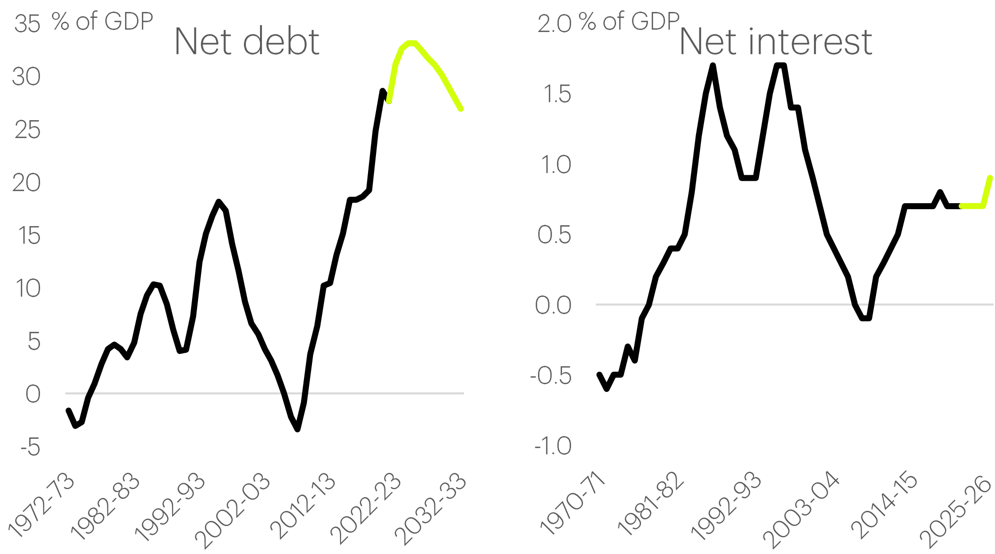
[10] Dr Steven Kennedy PSM, Address to the Australian Business Economists, Post-Budget economic briefing – opportunities and risks, 8 June 2022.

[11] https://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;db=COMMITTEES;id=committees%2Fcommrep%2F26038%2F0001;query=Id%3A%22committees%2Fcommrep%2F26038%2F0000%22

Without fiscal rules, long term budget goals can be more easily deferred or fiscal discipline can be inconsistent. Put simply, the long run fiscal gap will grow wider without action until it requires a painful adjustment through a combination of cuts to services and higher taxes.

Figure: 11 – Public debt projections and interest expense



Source: Budget 2022-23.

The Business Council recommends the following fiscal rules to ensure spending does not drift to a higher share of GDP, bringing with it increased debt and interest costs. The economy needs to grow more quickly than the 2.6% annual growth rate assumed over the forward estimates to help deliver fiscal sustainability. These rules will help with the numerator in these key ratios, while the government and business also focus on growing the economy.

1. A tax-to-GDP cap of 23.9% of GDP. This effectively hands back bracket creep, places discipline on governments and restricts spending from continually expanding more rapidly than the economy. While the 23.9% level may be argued as arbitrary and can easily be broken, it does not impose an overly restrictive constraint on tax collections by historic standards and has only been reached in five of the past 50 years. It's critical to grow the economy at the same time and not let the ratio simply drift up over time.
2. Capping real expenditure growth at an annual rate of 2%. This would force discipline on the budget decision making process while still allowing for growth in real spending per person. There are significant funding pressures in areas such as health, aged care, the NDIS and defence, but they must be funded in a sustainable and efficient way. It is critical that governments drive performance improvements in major areas of service delivery which can improve outcomes for the community in a cost-effective way.
3. Setting a target for gross debt. High levels of debt bring with them high interest servicing costs. Interest payments have become one of the government's biggest expenditure items, and this will increase as interest rates rise and divert funds from critical services. To illustrate, the Treasurer has noted the annual cost of servicing debt in 2032-33 has increased from $41 billion since the March Budget to around $65 billion.[12] Governments therefore need a plan to target reductions in gross debt.

Adherence to these fiscal rules can help deliver strong and sustainable surpluses over the decade. Real spending is expected to grow faster than 2% a year beyond the forward estimates period, meaning fiscal discipline is crucial. Taking early decisions from now can minimise the disruption from changes and help put the budget back on a sustainable footing, while still increasing real spending per person.

A set of clear fiscal rules should be monitored by an independent authority, such as the Parliamentary Budget Office, and include public reporting of adherence to the rules. This will help to ensure they achieve their purpose and provide assurance to the public that best practice is followed. Integrity of government processes is

[12] The Hon Jim Chalmers MP, Parliament House, Canberra, Monday 26 September 2022.

important to building trust in government. In this light, it is important that there is transparency around the government's finances and how tax dollars are spent.

Pathways to growing the economy

The Business Council supports initiatives to help grow the economy and contribute to budget sustainability over the medium term. Lifting productivity growth will play an important role in longer term fiscal repair by facilitating sustainable growth in the economy. The Business Council expects Treasury to downgrade the long-term assumption on productivity to 1.2% in the Budget, from the 1.5% assumed previously. This downgrade reflects the 20-year average growth of productivity, rather than the previous 30-year average, but makes the task of budget repair more difficult. The impact of this sort of downgrade by 2060-61 would be profound:

- $13,300 lower GDP per person;
- An almost doubling of the budget deficit, or around $50 billion higher in today's dollars; and
- more than 65% higher net debt, or around $520 billion higher in today's dollars.

Boosting economic dynamism will encourage business investment, innovation and hiring. A dynamic economy is one that has flexible and competitive markets and where labour and capital are highly mobile. This gives business stronger incentives to invest and innovate. A dynamic economy is more open to the flow of people, capital and ideas from the rest of the world and is regulated in ways that lowers risk and increases certainty.

To a large extent, business drives dynamism in the economy through investment and innovation. Larger firms typically have higher productivity, pay higher wages and export more than smaller businesses. Businesses could contribute more to dynamism if given stronger incentives, reduced barriers to entry, greater policy certainty and a reduced regulatory burden.

The causes of Australia's dynamism bring to the forefront possible solutions, some of which already are being advocated by the Business Council of Australia. Not all problems can be solved by changes to Commonwealth policy; many policy levers are the domain of the states and territories. This raises the need for a coordinated approach to restore Australia's economic dynamism, perhaps outside the existing institutional frameworks like National Cabinet.

There are a number of pathways to help drive growth in the economy:

- Ensuring the tax system is efficient, not overly distorting economic activity and is providing the right incentives to work and hire. A more efficient tax system incentivises industry to innovate and develop the skills of the workforce;
- Reducing red tape and the regulatory burden to make it easier to do business;
- Improving training and skills over the working life of an employee to ensure business have the resources need to build industries of the future;
- Boosting the annual migration intake, particularly for skilled migrants; and
- Implementing better coordination, selection and evaluation of planned government nation-building infrastructure to ensure completed projects boost productivity.

A tax system that is fit for purpose

The Australian economy faces immediate and long-term challenges and uncertainties, from its ageing population, shifting global geopolitical and economic forces, digital technologies, changing business models, changes to the nature of work and the climate transition. Ultimately, the tax system must be fit-for-purpose to take on these challenges. As it stands, there are too many distortions and insufficient incentives to invest and save.

This means addressing issues such as:

- the over-reliance on direct taxation, particularly from top income earners, a few key industries and bracket creep;
- the mismatch between federal and state taxes and spending;
- the volatile and inefficient state tax base (notably stamp duties);
- a globally uncompetitive tax rate for companies with turnover above $50 million, and
- fragmented payroll tax regimes.

The Business Council continues to call for:

- improved work incentives, especially around the tax/transfer interface for low-income earners;
- a more competitive tax system for all businesses in the global contest for investment;
- better harmonised state taxes, such as payroll tax bases; and
- more neutral tax treatment of savings income, such as capital gains, rental income and interest on savings deposits.

The Business Council has long advocated for comprehensive tax reform. Australia needs to move to a more modern, sensible mix of taxes that will provide better incentives to work and invest, best promote the wellbeing of the Australian community and support job creation. It is not about any one tax, but the combination of taxes, and setting an overall tax mix that is most able to achieve the goal of growing the economy and creating jobs, while funding vital government services across the federation. Reform can be incremental, starting with successive elements of the personal tax system, followed by reform of Commonwealth-State relations and the business tax regime. A well-functioning federation underpins efficient delivery of government services and better community outcomes for each dollar spent.

Importance of ensuring fiscal sustainability

It is important that the Budget is on a credible path back to surplus and that the nation's long term fiscal position is sustainable. There are a number of reasons why the budget should be on a path back to surplus:

- We need fiscal buffers in case of unexpected developments, like another pandemic. Australia had been running a sizeable budget deficit, although was coming to close to turning that around when COVID hit, and the fiscal support measures provided during the pandemic made that unachievable and have left an even more difficult challenge to now reach a surplus.
- Financial markets look more favourably on fiscal stimulus being provided from a position of a sustainable budget, as the new leadership in the UK has just discovered.
- Running budget deficits means borrowing from the future to fund current spending priorities. This increases the burden on future generations at a time when there will be a growing need to fund rising costs of an ageing population, which likely brings with it declining workforce participation.
- To control growth in debt and rising interest costs. The government's interest bill will exceed $60 billion annually within a decade thanks to the projected rise in the stock of debt and higher interest rates. This is the equivalent of more than 3 West Connex projects, around 90 hospitals, and the cost of numerous other examples of nation-building infrastructure that otherwise would be built. A rising interest bill also means there is less funding available for the provision of government services.

Figure: 12 – 10-year Commonwealth bond yields

Source: RBA.

- Australia's level of debt is low compared with a number of other countries and we also are more exposed to the global economic cycle and commodity prices than most other countries. This has of course been to Australia's advantage, but it also means that the Australian economy can be subject to a wider range of shocks than most other developed economies. Therefore, a lower level of debt provides critical capacity to respond to any negative shocks.
- Maintenance of AAA credit rating – Australia remains a member of the small pool of nations boasting a AAA credit rating, alongside Canada, Denmark, Germany, Netherlands, Norway, Singapore, Sweden, Switzerland and the United States. Maintenance of the highest rating available is critical for retaining financial strength and maintaining investor confidence. It also helps keep in check the cost of government borrowing as well as borrowing costs for banks. Australia remains dependent on foreign capital, which would be more difficult to attract without the top credit rating.

Microeconomic reform – removing obstacles to growth

The Business Council recently published a detailed blueprint for achieving the necessary micro economic reforms called "Releasing the Handbrakes on Growth" that included common sense reform "wins". [13]

The Australian economy is emerging from the pandemic better than almost any other nation. With our people, natural resources and numerous advantages, the nation is in the box seat to forge its own future with better jobs, better access to skills, higher wages and higher living standards. But before we can truly take control of our destiny on the frontier, Australia needs to contend with a dramatically changed outlook.

Until we can overcome these obstacles and unleash the full potential of the economy, we will be forced to tread water. Our ability to modernise the economy and move forward will be hamstrung. This will mean removing the barriers to recovery as a fundamental step to laying the foundations for long term and sustained economic growth. It means shifting to a cleaner and more competitive economy, with increased diversity and shored up supply chains. All this will deliver higher real wages and ease cost of living pressures.

We can start to address the structural barriers in the economy by:

- Dealing with acute labour shortages, supply chains and building confidence;
- Continuing the commitment to our migration program to ensure we attract individuals with new and emerging skills;

[13] BCA, *Releasing the handbrakes on growth*, July 2022.

- Investing in **our people** to develop the capability for success;
- Supporting **new industries** to modernise and diversify the economy;
- Becoming a world leading **digital economy** by 2030;
- Maintaining an **open economy** that is more competitive on the world stage;
- Improving the **infrastructure** delivery system;
- Driving improvements in **planning approvals** to support increased housing supply and major projects;
- Reducing frictions in doing business through **consistent and modern regulations;**
- Tackling **tax reform** for more competitive and sustainable finances;
- Reforming **government services** to improve productivity in the public sector and manage funding pressures in key programs, and
- Repairing the **workplace relations** system to better support the labour market.

There are major, game-changing reforms across each of these areas that can lock in the recovery and secure our economic future. They will require a change in mindset to recognise the urgency of driving change. It is clear we can no longer afford to keep putting off difficult decisions. The hard and detailed work that underpins them must continue, but we are realistic these major reforms will take time

At the same time, then, we can pursue a microeconomic reform agenda with smaller, practical steps on the path towards substantial reform. These steps can produce quick wins and substantial cumulative benefits by reducing the frictions in our economy, increasing the flexibility and adaptability of households and businesses, removing unnecessary barriers, making it easier to do business, improving Australia's competitiveness and dealing with the supply side issues stalling the economy.

Importantly, we shouldn't take our eye off the little things because, put together, little changes count. There are several microeconomic levers we can pull immediately to make a difference. Let's not forget the measures that drove the previous big era of productivity – which delivered higher wages and living standards – included National Competition Policy reforms. Benefiting the economy to the tune of at least $57 billion in today's dollars, these reforms took a decade to implement and required the effort of all levels of government, covering close to 1,800 pieces of legislation. The benefits also flowed to people's pay packets.

Immediate fiscal priorities

The immediate priority must be to support businesses in managing the COVID-19 recovery, while helping to drive future growth. Only if we lift our investment performance and drive new industry opportunities will we achieve the productivity outcomes needed to improve our fiscal outcomes. Business investment currently is at a 30-year low as a share of GDP, and could dwindle further. This could be supported by addressing the business tax system via policies such as:

- **Extend immediate expensing** beyond next year's expiry. Investment is forecast to significantly slow when the measure expires, with Australia left with an uncompetitive corporate tax system that will hamper our ability to compete in the global race for capital. These incentives via immediate expensing were introduced during the pandemic as a temporary measure and were seen to have worked well. Their success means the Business Council advocates they be made a permanent part of the system to incentivise investment. There also should be more incentives for business to invest in clean technology.
- **extend the Skills and Training Boost and Technology Investment Boost** to 30 June 2025 to provide more time for businesses to plan, make their investments and deliver suitable training. Many businesses continue to report acute shortages of labour and other skill mismatches as significant constraints on them operating their businesses.

- implement the patent box tax which is designed to encourage investment in the innovation and technologies of the future, and enable Australia to compete for that research and subsequent commercialisation. It aligns with the types of policies that can generate the economic dynamism that is currently lacking and acknowledges Australia has a strong research foundation but needs to shift the dial on research translation and commercialisation.

What not to include in the budget

The Business Council is not advocating for other specific policy measures in this submission. The BCA's submission ahead of the next Budget in May 2023 will include such detailed recommendations. The Business Council, however, recognises the government is under pressure to fund additional programs, all of which seem worthy to their advocates.

A number of revenue-raising options and tax expenditures have been suggested, but the Business Council hopes the government takes heed of the following suggestions:

- Stick with the three-stage Personal Income Tax Plan, which will simplify the tax system and remove disincentives that discourage workers from entering the workforce, working extra hours, or getting a new job. It achieves this while maintaining a progressive and fair tax system overall. The Plan does not fully eliminate bracket creep, which requires constant recalibration or indexation of tax thresholds and disproportionately and unfairly hurts lower- and middle-income earners. However, the changes are a positive step and provide the foundation for broader reform by closely aligning to Recommendation 2 of the Australia's Future Tax System Review. Furthermore, the income tax changes are legislated, expected and promised by the government, so should be delivered as planned in 2024. The Business Council has long advocated for reform of the personal tax system alongside reform of the complex system Commonwealth-State relations and the business tax regime. The legislated personal tax cuts achieve three core aims of – simplification, boosting incentives and handing back bracket creep, which is a lazy way to repair the budget. Many of the arguments against proceeding with the three-stage plan are predominantly around spending money on different priorities – not budget repair or fiscal discipline. They also provide a means of supporting economic growth at what is likely to be a time of uncertain economic challenges in 2024 and when inflation is expected to subside.
- No ad hoc tax increases that would undermine investor confidence, particularly given businesses with the largest balance sheets have been the recent target of ad hoc tax increases, additional compliance measures, increased reporting requirements, and additional/higher penalties. Taken together, such actions are increasing risk and chilling decisions to invest in Australia, for example with a pause on some new coal investments in Queensland following the recent ad hoc increase in coal royalties.[14] Businesses understandably are unsure about what will happen next with a prospect that a 'one-off' revenue raising measure becomes the norm as a quick budget fix. This is not conducive to a rekindling of confidence and 'animal spirits'. Ad hoc tax increases are also not a solution to inefficient spending – and inevitably impair the income growth that drives the revenue for essential services.
  - No super profits tax – suggestions to tax the so-called super profits of miners, in particular, in response to recent record high commodity prices should be resisted. Higher commodity prices contributed to $14 billion higher company tax revenues in the recent 2021-22 Final Budget Outcome – with further upgrades likely in the upcoming Budget. The so-called excess profits will not be sustained now that commodity prices are falling. A structural "solution" should not be imposed on a cyclical boost to prices and profits. Profits derived from record-high energy prices cries out for energy sector reform, not a new tax. After all, Australia's energy companies will be at the forefront of the process of decarbonisation that still has a long way to run. Also, taxing profits generated from past investment decisions with a 'one off' tax raises a level of sovereign risk that is unwelcome and raises risk premiums for future projects.

[14] https://www.abc.net.au/news/rural/2022-08-17/bhp-coal-queensland-blackwater-south-mine-royalty-rises/101340898

Mining companies in Australia paid a total of $43 billion in company tax and royalties to governments in fiscal year 2020-21.[15]

- Do not bring forward childcare subsidy changes, particularly given immediate workforce shortages and the substantial time required to implement changes. This is such an important reform, with potential large benefits to workforce participation, yet there is insufficient time for the changes to be implemented earlier than currently planned. National Skills Commission data show total job vacancies have almost doubled compared with pre-COVID. By comparison, job vacancies have almost tripled for child carers and more than doubled for childcare centre managers. This reflects many thousands of people leaving the profession, partly owing to rates of pay, along with a dwindling pool of workers sourced from inward migration.
- Caution on further cost of living measures in the short term – as the Treasurer has indicated, there already are measures in the budget to help offset the rising cost of living, so any further response should be carefully targeted at lower income households. There is a risk of tension between fiscal and monetary policy where broader budget measures could lead to even more inflation and higher interest rates – placing further pressure on households. The Business Council's *Releasing the handbrakes on growth* paper discusses a range of reforms that can help clear bottlenecks and blockages, improve growth, and help ease cost of living pressures without putting pressure on the budget.

[15] https://www.minerals.org.au/news/mining-industry-contributed-record-43-billion-company-tax-and-royalties-financial-year-2020-21

6. Expenditure – discipline needed

Expenditure rules are an important element in the suite of fiscal policy rules that can be used to discipline new government spending commitments, improve the quality of new and existing spending and underpin long-run budget sustainability. Maintaining discipline on the expenditure side of the budget will be important giving growing demands on the budget from existing policy commitments. New spending commitments will need to be carefully prioritised and existing commitments subjected to scrutiny to ensure they are delivering value for money.

PBO expectations of spending growth

According to a Parliamentary Budget Office analysis, by 2030-31, the age pension, defence, NDIS, aged care, the Medicare Benefits Schedule, public hospitals and schools, along with interest payments, will consume almost half the federal budget. These projections on a no-policy change basis are likely to under-estimate future growth in relation to existing spending commitments and their demands on the budget.

The government should prioritise reform of the government services sector, including in health and the NDIS, to improve productivity in the public sector and manage funding pressures. Projected growth in spending in these areas means the potential for savings is huge via enhanced productivity to make spending more sustainable. The Productivity Commission's 2017 productivity review, *Shifting the Dial*, made a series of recommendation to improve delivery of government services.

The Business Council is advocating for better service design, including greater use of technology, to control costs in service delivery. The Business Council is not arguing for cost cutting. The focus should be on creating a more consumer-centric model of delivery that produces better outcomes for users and is sustainable over the long term. Otherwise, ever-growing amounts of government spending would be chasing an inefficient model of service delivery and higher cost programs. This clearly is not sustainable.

The fiscal response to the COVID-19 pandemic has seen a change in perspective because new spending commitments were made to look small in comparison to pandemic-related measures, but this reduction in expenditure restraint has contributed to a deterioration in the fiscal outlook.

An important task for the new government will be to reinstate a mindset of fiscal restraint. This is best done through adoption of explicit fiscal rules as part of the fiscal strategy statements mandated by the Charter of Budget Honesty.

Table 1: Payments by key program area, 2018-19 and 2031-32

Payments	Nominal payments ($b)		Per cent of GDP		Change in percentage points of GDP	Annual real growth (%)	Share of total payments (%)
	2018-19	2031-32	2018-19	2031-32	2018-19 to 2031-32		2031-32
GST transfers to states	66	119	3.4	3.5	0.1	2.4	13.2
Age pension	47	80	2.4	2.3	0.0	2.0	8.9
Defence	38	79	1.9	2.3	0.4	3.5	8.8
National Disability Insurance Scheme	11	59	0.6	1.7	1.2	11.1	6.6
Aged care	20	50	1.0	1.5	0.4	4.7	5.5
Medicare Benefits Schedule	24	48	1.2	1.4	0.2	3.1	5.4
Public hospitals	22	46	1.1	1.3	0.2	3.6	5.1
Interest payments	19	38	1.0	1.1	0.1	3.1	4.2
Schools	20	37	1.0	1.1	0.1	2.6	4.1
Disability support pension	17	23	0.9	0.7	-0.2	0.3	2.6
Pharmaceutical Benefits Scheme	13	22	0.7	0.6	0.0	1.9	2.5
Income support for unemployed	11	19	0.6	0.6	0.0	2.1	2.1
Family tax benefit	18	18	0.9	0.5	-0.4	-2.2	2.0
Child care	7	16	0.4	0.5	0.1	4.1	1.8
Carer income support	9	16	0.5	0.5	0.0	2.5	1.8
Government superannuation	7	14	0.4	0.4	0.0	2.5	1.5
Fuel Tax Credit Scheme	7	14	0.4	0.4	0.0	2.8	1.5
Road and rail infrastructure	6	12	0.3	0.4	0.0	3.1	1.4
Commonwealth Grants Scheme	7	10	0.4	0.3	-0.1	0.2	1.1
Private Health Insurance Rebate	6	9	0.3	0.3	-0.1	0.5	1.0
Parenting payments	5	8	0.3	0.2	-0.1	0.5	0.8
Official Development Assistance	4	5	0.2	0.2	-0.1	-0.2	0.6
Veterans support	6	4	0.3	0.1	-0.2	-5.0	0.5
Total modelled payments	391	746	20.0	21.8	1.7	2.8	82.9
Total payments	478	899	24.5	26.2	1.8	2.7	100.0

Source: Parliamentary Budget Office (2021), Beyond the budget 2021-22: Fiscal outlook and projections.

Expenditure rules used successfully in the past

Expenditure rules have been used successfully by governments in the past to maintain fiscal discipline. The government's 'trilogy' of fiscal commitments in its 1985-86 Budget included a commitment to cap the expenditure share of GDP over the life of the then parliament.

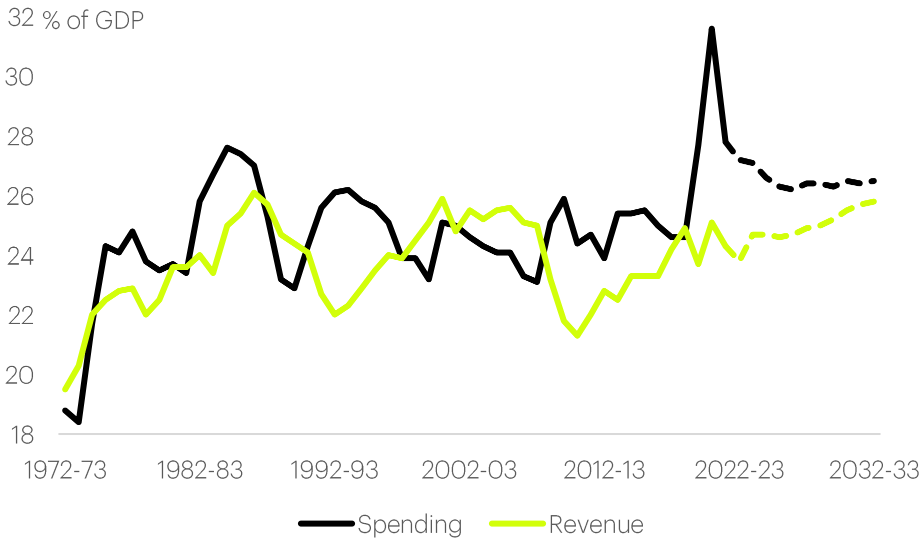
Under the trilogy, expenditure fell an average of 1.7% in real terms between 1986-87 and 1988-89, returning the budget to surplus in 1987-88, while the expenditure share of GDP fell from around 27% of GDP in 1985-86 to just below 23% in 1989-90. The expenditure share of GDP has never been lower since.

The 2009-10 Budget committed to limit real spending growth to no more than 2% per annum until the budget returned to surplus, although this commitment was qualified in the 2011-12 Budget to apply to periods when the economy was growing above trend. The 2% real spending cap was reaffirmed in every subsequent budget until the change in government in 2013 and complemented the tax cap introduced in the 2011-12 Budget, which limited the tax share of GDP to its 2007-08 level (then 23.5%).

Between 2009-10 and 2013-14, real growth in payments averaged 2.1%, and was below the 2% cap in 2010-11 and 2012-13, when growth in payments fell 0.4% and 3.2% respectively.

The 2022-23 Budget showed federal government payments averaging 26.5% of GDP over the ten-year projection period to 2032-33. By comparison, tax revenue is projected to average 23.3% of GDP, while overall revenue is expected to average 25.1% of GDP, leaving an underlying budget deficit of 1.4% of GDP on average over the projection period.

Figure: 13 – Revenue and expenditure as a share of GDP



Source: Budget 2022-23.

A cap on real growth in expenditure

If the tax cap is to be maintained, then the expenditure share of GDP will also need to be limited. This is best done through a real expenditure cap. A 2% real spending cap could be applied starting with the October budget and holding for the budget projection period. The spending cap should be viewed as a framework to drive improvements in the quality of government spending, so that new spending commitments are only entered into when they have been appropriately prioritised.

In order to help meet the spending cap, the government should implement a functional efficiency review across the full range of Commonwealth expenditure to achieve savings and ensure that expenditure is appropriately prioritised. Fiscal discipline can also be reinforced through a renewed focus on reforming the fiscal relationship between the Commonwealth and the states with a view to eliminating duplication and ensuring federal payments to the states are driving efficiencies at both a Commonwealth and state level.

7. Improving the federal IGR

Understanding the long-term outlook of the economy and federal, state and territory budgets, and the major risks Australia faces, puts current policy decisions in a crucial long-term context. It can help our governments make decisions which set Australia up to succeed in the decades to come.

Intergenerational reports (IGRs) by the federal, NSW and Tasmanian governments have built our understanding of the longer-term spending and economic pressures Australia faces, particularly from an ageing population. Fiscal transparency also has indirect benefits. The IMF has found that there is a relationship between fiscal transparency and how a country is perceived in global markets including credit ratings and foreign investment.[16]

IGRs have never been more important, as all levels of government are facing significant challenges over the coming decades. With total public debt now exceeding $1 trillion, the issue of how the debt is paid down, and by who, raises important issues, particularly around intergenerational equity.

The Business Council welcomes the decision to produce an Intergenerational Report (IGR) once every parliamentary term. This provides a platform from which to reflect on other ways to improve how all Australian governments report on their long-term fiscal outlook and learn from best practice around the world so that IGRs continue to serve the Australian community well in the decades to come.

A comprehensive IGR that better considers the sustainability of the various taxes across the federation can help to identify the priorities for long-term tax reform. It will also help to keep track of personal tax and the effects of bracket creep.

Independent analysis

- Intergenerational reports should be independent and non-partisan. The Parliamentary Budget Office is the most suitable authority to undertake the task.
  - This is the gold standard worldwide. In the UK, Canada and the US, the long-term fiscal sustainability reports are produced by independent authorities. In New Zealand, it is a document of the Treasury, not of the government.

Broader analysis of long-term risks and issues

- Expand the scope of the IGR to include deeper analysis around climate change, off-balance sheet equity investment in infrastructure, chronic disease and the intergenerational equity implications of different fiscal scenarios.
  - To date, IGRs have focussed primarily on the impact of an ageing population on economic growth and government spending. This analysis should continue, but there is also a case for future IGRs to more thoroughly examine other long-term policy challenges and risks.
- The IGR should contain more thorough analysis on the pressures, risks, adequacy and sustainability of the various taxes across the federation.
  - This could help identify priority areas for tax reform.

Improving accessibility and transparency

- IGRs should include long-term projections under both 'currently legislated' and 'proposed' government policies. The reasons for any large differences should be clearly explained.

[16] IMF, *Fiscal Transparency, Accountability, and Risk*, 2012.

- The community should be able to easily assess the merits of the government's and parliament's fiscal choices. Information, clearly and accurately presented, provides a sound basis for our democratic choices.

- Conduct sensitivity and scenario analysis on the main economic, demographic and policy assumptions.
  - For example, setting out population and migration scenarios could usefully inform current and future settings in the migration program.
  - While there inescapably is a large degree of uncertainty when making long-term economic projections, detailed analysis of the main risks and assumptions can help to manage this risk.
- Compare the latest projections with past IGRs and actual outcomes and explain the cause of any substantive differences.
- Publish the full set of assumptions and data to aid transparency, contestability and scrutiny of the work.
  - Australia should follow the example of New Zealand's Treasury, which makes its long-term fiscal model and assumptions publicly available.

All states should produce an IGR

- State PBOs or Treasuries should produce independent IGRs guided by international best-practice.
  - This will support all governments in long term planning and enable a complete picture of long-term fiscal pressures across the Federation.
- All recommendations to improve the federal IGR should also be considered by state governments.

Creating a national IGR

- An assessment of Australia's long-term fiscal sustainability should include all levels of government to give a full picture of Australia's fiscal outlook and highlight any cost-shifting between tiers of government.
  - On the advice of PBOs and relevant state and territory experts, first ministers should agree to a national framework which will form the basis of all IGRs in Australia. This framework would then underpin each jurisdiction's independent IGR so that the long-term budget position of the whole nation can be brought together.
  - Given the complexity of federal financial relations and the political and policy tensions that can emerge among governments, understanding and assessing the fiscal state of the federation as a whole is essential. Delivering better services for Australians will ultimately require federal and state governments to work together to prepare long-term national reforms and plans.
- Alternatively, the federal PBO could estimate federal and state fiscal outlooks using ABS Government Finance Statistics, guided by experts with state government experience.
- Another option would be to coordinate the production and regular update of a national IGR via National Cabinet.

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