TAX FORUM: THE FISCAL CONTEXT

TAX REFORM
NEXT STEPS FOR AUSTRALIA

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Overview

The Government has embarked on an ambitious tax reform agenda. It has already put in place a series of major reforms to build a stronger, fairer and simpler tax system, but there is more to be done. The Tax Forum will continue the process the Government started with the release of the Australia's Future Tax System Review last year.

The discussion of tax reform needs to be placed in the context of Australia's contemporary and future challenges. This includes an understanding of the economic and fiscal imperatives that will enable us to secure our ongoing prosperity in a global economy that will continue to change.

We all know that the tax system influences decisions made by each and every Australian individual, family and firm, and as such has a significant impact on workforce participation and productivity. Well designed tax reforms have the potential to encourage economic growth, support workforce participation and make our society fairer.

The tax system also plays a vital role in funding governments to provide a range of services that form an essential part of the high standard of living that Australians currently enjoy. Over 90 per cent of Commonwealth revenue is sourced from the tax system, and is used to fund, either directly or through the States, essential services such as health, education, social security, and defence.

Sound fiscal policy is a cornerstone of a strong economy, today and beyond. Discussion at the forum should reflect the need for ongoing fiscal discipline; both to meet the Government's fiscal strategy, but also to ensure that the budget is well placed to meet fiscal pressures in years to come. Demographic changes and increasing community demand for social services will intensify calls on government expenditure. Reforms today, both in the context of tax policy and more broadly, must recognise these challenges.

This places the onus on ensuring that the tax system provides a robust and sustainable stream of revenue going forward. It means that proposals for change need to be affordable and fully funded, not just in the next couple of years, but also into the future.

Fiscal strategy

Proposals at the tax forum need to be consistent with the Government's fiscal strategy (Box 1). The strategy is designed to ensure fiscal sustainability, while providing the necessary flexibility for the budget position to vary in line with economic conditions.

Consistent with the fiscal strategy, the Government took swift action through 2008 and 2009 to support the economy through the global financial crisis, and has set out a clear path to return to surplus.

Importantly, the strategy ensures that the budget will be returned to surplus through disciplined spending, and ensures that expenditure is directed to priority areas, such as skills and training, health and education services, and support to families.

Box 1: The Government's Fiscal Strategy

The medium-term fiscal strategy, which has remained unchanged since the Government's first budget in 2008-09, is to:

- achieve budget surpluses, on average, over the medium term;
- keep taxation as a share of GDP below the level for 2007-08 (23.5 per cent of GDP), on average; and
- improve the Government's net financial worth over the medium term.

The Government committed in the Updated Economic and Fiscal Outlook released in February 2009 to, once the economy was growing above trend, return the budget to surplus by:

- allowing the level of tax receipts to recover naturally as the economy improves, while maintaining the Government's commitment to keep taxation as a share of GDP below the 2007-08 level on average; and
- holding real growth in spending to 2 per cent a year until the budget returns to surplus.

Once the budget returns to surplus, and while the economy is growing at or above trend, the Government will maintain expenditure restraint by retaining a 2 per cent annual cap on real spending growth, on average, until surpluses are at least 1 per cent of GDP.

Pressures on the fiscal situation

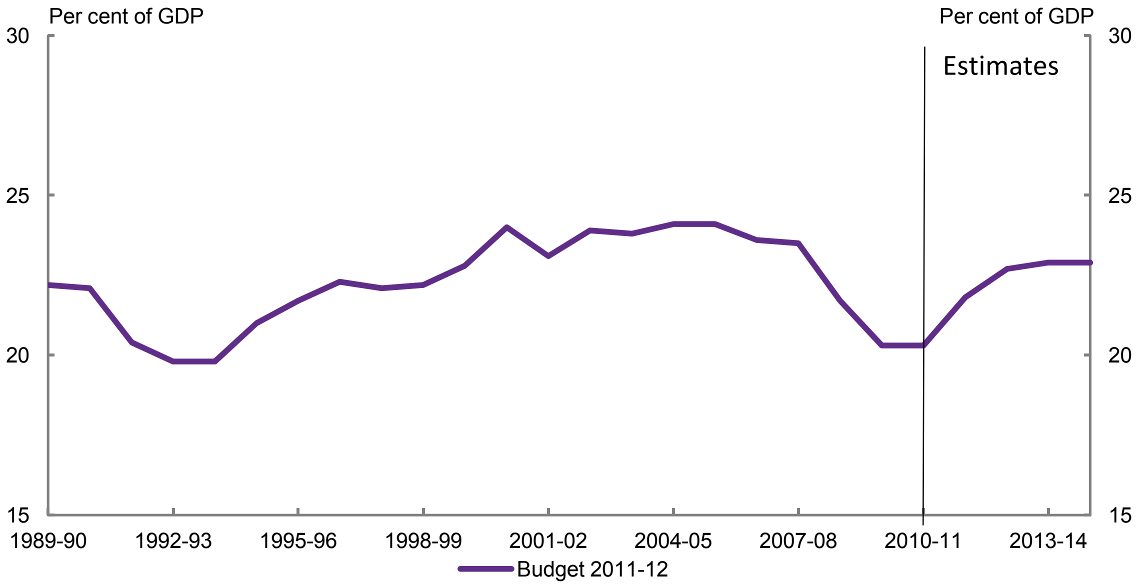
Like most other advanced economies, Australia faces emerging and long-term pressures on the government budget, including from population ageing. Australia is better placed than most other advanced economies, but these pressures are significant. The Government has acted to reduce some of these pressures but continued attention by government and the community is needed if public finances are to remain sustainable.

Medium-term outlook

A softer economy stemming from the impact of the recent natural disasters and the strong dollar, as well as the legacy effects of the global financial crisis that have reduced tax receipts and heightened risks to the international growth outlook, are contributing to the challenging budget environment.

While tax as a share of GDP is recovering, it remains well below the level that existed in 2007-08.

Chart 1. Tax to GDP ratio (Budget 2011-12)



Notwithstanding the near-term challenges, the Government remains determined to return the budget to surplus in 2012-13. The fiscal consolidation will create space for the private sector to respond to the strong demand for Australia's commodity exports. It will also further strengthen public finances and support Australia's capacity to respond to unanticipated shocks, at a time when there are significant risks to the international outlook.

Continued adherence to the Government's fiscal strategy will strengthen the budget position (Charts 2 and 3), and ensure our public finances remain amongst the strongest in the developed world — the expected peak in net debt as a share of GDP is less than one tenth of the average net debt position of the major advanced economies in 2011.

Chart 2. Underlying Cash Balance (Budget 2011-12)

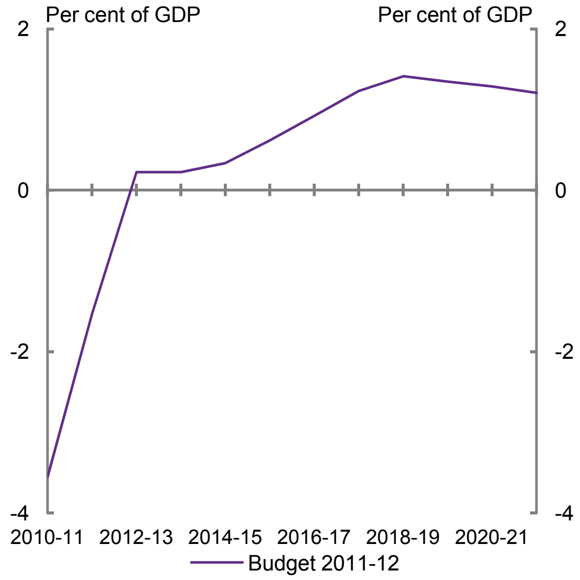
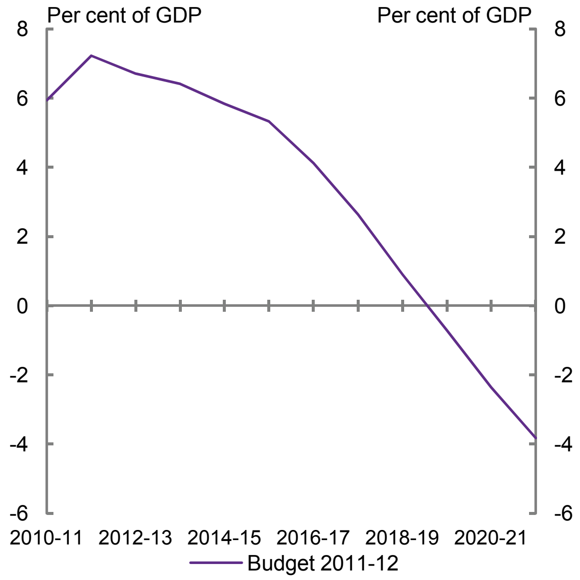


Chart 3. Net Debt (Budget 2011-12)



In accordance with the Government's fiscal strategy, the projections reflect the natural increase in tax receipts associated with a strengthening economy until receipts reach the tax to GDP level of 2007-08. Spending is projected by modelling the impact of demographic and other drivers on existing programs, whilst holding the real growth in overall spending to 2 per cent until the surplus reaches 1 per cent of GDP.

The projections for spending capture significant policy reforms made by this Government, including an increase in the Government's share of public hospital funding, major investments in schools, an increase in the Superannuation Guarantee to help meet the challenges of an ageing population, and age pension reform to provide greater financial security to pensioners.

The Government is delivering these reforms in a manner consistent with the fiscal strategy by making difficult savings decisions. Many of the savings put in place by the Government in recent budgets will deliver continuing benefits to the budget bottom line, improving the sustainability of Government finances. These savings include those in the areas of health services, family payments, the qualifying age for the Age Pension, and tightening tax expenditures like the dependent spouse tax offset.

In order to ensure this positive medium-term fiscal outlook is realised, the Government will need to continue to restrain spending and fund new priorities through savings. It also requires the maintenance of a strong revenue base, including through restraining tax expenditures. The task will become increasingly more challenging once spending pressures from ageing increase.

Drivers of spending growth

As indicated in the 2010 Intergenerational Report (IGR2010), without action to curtail spending growth the overall level of government spending under existing programs would, over the medium to long term, become unsustainable.

Key findings from IGR2010 include:

- between 2010 and 2050 the number of people 65-84 will double and the number of people 85 and over will quadruple;

- by 2050 only 2.7 people of traditional working age are projected for every person aged 65 and over, compared with 5 people in 2010;

- real GDP growth per person is projected to fall from 1.9 per cent a year over the last 40 years to 1.5 per cent per a year over the coming 40 years; and

- total Commonwealth government spending is projected to increase by almost 5 percentage points of GDP over the next 40 years.

Fewer people of working age to support an increasing number of older Australians, slower economic growth, and an increase in age-related spending will create substantial fiscal pressures. Without policy change, spending is projected to exceed revenue by 2¾ per cent of GDP by 2049-50. This is an improved result relative to the 3¼ per cent of GDP fiscal gap (spending greater than revenue) projected in the previous IGR, largely owing to the benefits of the Government's fiscal strategy and a more gradual pace of ageing than previously expected.

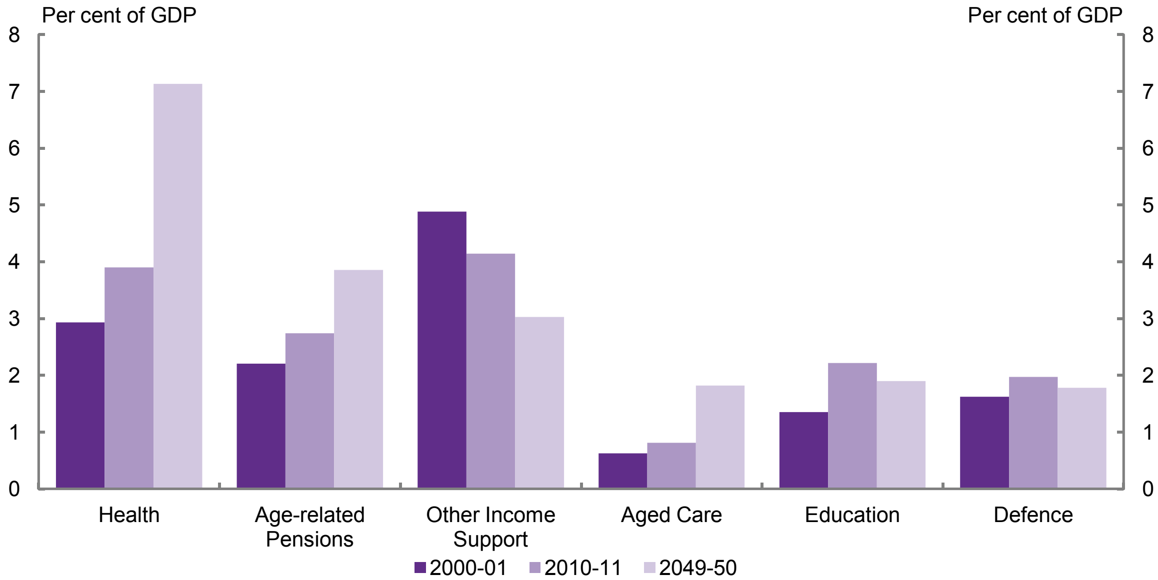
These are challenges affecting advanced countries around the world. Australia's sound public finances and strong fiscal framework places it in a better position than most other countries. Nonetheless, significant challenges remain.

With an ageing population, productivity-enhancing reforms and measures to increase participation are key to boosting economic growth and reducing future fiscal pressures. Policies have been adopted that help in this regard, including those in the 2011-12 Budget to provide better and more targeted skills and training, improve private sector opportunities to invest in infrastructure, and strengthen incentives and invest in services to support participation. Tax reform can continue to play a significant role in boosting economic growth and living standards by lifting productivity and participation further.

Measures to slow growth in spending will also be important. A large part of this spending growth reflects population ageing, but growth in the average cost of services provided to recipients and overall population growth are also important drivers. State Governments face a similar set of spending pressures, particularly in areas where funding responsibilities are provided by different tiers of government, especially in relation to health, aged care and education expenditures.

In relation to Commonwealth spending, key areas that have already seen significant growth and risen as a proportion of GDP are social security and welfare, healthcare, education and defence (Box 2). In 2011-12, spending in these four areas accounts for around two-thirds of total government expenditure. Expenditure on healthcare, age pensions and aged care in particular will continue to increase as a proportion of GDP if current policies remain unchanged (Chart 4).

Chart 4. Expenditure in selected areas (2000-01 to 2049-50)



Source: Department of Finance and Deregulation and Intergenerational Report 2010, Canberra.

Box 2: Growing spending pressures

Social Security and Welfare

Social security and welfare is the largest area of government spending, accounting for around one third of Commonwealth government expenditure. It includes several major programs that have seen strong spending growth in real terms over the past decade, including the age pension, aged care, Disability Support Pension, Family Tax Benefit and Child Care Fee Assistance. This growth reflects increases in the number of beneficiaries due both to population growth and to the changing age composition of the population. It also reflects the indexation of benefit payments and increases in the cost of services provided. Spending in many programs is projected to increase strongly over the next 40 years, and this will have significant implications for budget sustainability.

Under existing policy, spending on the age pension, the largest single program (and the second largest Commonwealth expenditure program after revenue assistance to the States and Territories), is estimated to increase from around 2.7 per cent of GDP currently to around 3.9 per cent of GDP by 2049-50. This reflects the expected strong growth in the population aged 65 years and over, and the indexing of pension rates to average male earnings.

Aged care spending has grown strongly over the last decade and with an ageing population will continue to grow strongly. Government measures have helped contain growth in this area of spending, including the capping of funding at 88 residential places per thousand people aged 70 years and older. Aged care is expected to be the fastest growing area of government expenditure under current policy settings, increasing from 0.8 per cent of GDP to around 1.8 per cent in 2049-50.

Spending on the Disability Support Pension (DSP) has grown strongly over the past decade, reflecting substantial growth in the number of beneficiaries combined with indexation of the benefit rates by male average earnings growth. Real growth in DSP spending may continue to exceed real GDP growth over the medium term, although the Government's steps to moderate the number of people moving onto DSP and its wider participation agenda will play an important role in slowing that growth in spending.

Box 2: Growing spending pressures (continued)

Social Security and Welfare (continued)

Other large spending programs, such as the Family Tax Benefit and Income Support to Carers account for a significant level and share of spending and their ongoing funding represents a challenge for government in the context of growing spending pressures and priorities elsewhere.

Health

Spending on healthcare is a significant component of government expenditure, accounting for around 16.4 per cent of total expenditure in 2011-12. It has grown significantly over the past ten years, more than doubling in nominal terms from $27.6 billion in 2001-02 to $59.8 billion in 2011-12.

Major health programs contributing to this growth include the Medical Benefits Scheme, the Pharmaceutical Benefits Scheme (PBS), payments to the States and Territories under the Australian Health Care Agreements and the National Health Reform Agreement (NHRA), and the Private Health Insurance Rebate. Spending on these programs has risen around 7 per cent or 8 per cent per annum over the past decade, and is expected to continue to increase at broadly similar rates over the medium term.

Demand for health services continues to rise due to population growth and ageing. Older age cohorts require a relatively high level of health care services and have much greater access than younger cohorts to concessional payments, for example through access to the age pension and, for non-pensioners, through access rules for the Seniors Health Card. Population ageing means there is an increasing proportion of the population in these older age cohorts.

Increasing costs associated with more technologically advanced procedures and drugs increase the per capita cost of healthcare. The growth in PBS costs also reflects the growing number of pharmaceuticals added to the scheme. These cost (non-demographic) factors are more significant in expenditure growth than demographic factors.

Under the NHRA, the Government will increase its share of public hospital funding by meeting the cost of 45 per cent of efficient growth from 2014-15, increasing to 50 per cent from 2017-18. As part of this new Agreement, the Government has guaranteed at least $16.4 billion in efficient growth funding for public hospitals over the period 2014-15 to 2019-20.

Population growth, ageing and growth in health insurance premiums will increase spending on the Private Health Insurance Rebate. If the Government’s legislation to introduce means-testing is not passed by Parliament and implemented, cumulative spending on this program would be around $100 billion higher in real terms by 2049-50.

The IGR2010 indicates that real spending on healthcare per person could triple from its 2009-10 levels by the middle of this century. A rising share of healthcare services in national GDP is a worldwide trend, as incomes increase and populations age: governments everywhere have to make choices as to how the increase is shared between individuals and the public purse.

Education

Education is another significant component of government expenditure. Spending on education has more than doubled over the past ten years and now accounts for 8.2 per cent of total spending.

Box 2: Growing spending pressures (continued)

Education (continued)

The major contribution to spending growth in education over the next ten years is expected to come from assistance to government and non government schools. Indexation of assistance levels is based on a measure of average cost growth in government schools and has averaged around 6 per cent per annum, while population growth amongst 5 to 18 year olds over the next ten years is expected to be nearly double the rate of the past ten years.

Uncapping student university places to provide a higher education system that is more responsive to student demand would be expected to see strong growth in current and expected student numbers, as well as the flow-on impacts to student income support of these changes.

Defence

Defence currently accounts for 5.8 per cent of total government spending. Growth in defence spending in real terms has broadly kept pace with GDP growth over the past ten years. The Government's plan is to maintain growth in the defence base level of funding in real terms averaging 3 per cent per annum until 2017-18 and then at 2.2 per cent a year until 2029-30. However, in line with standing practice, the funding levels beyond 2011-12 do not include funding for defence operations, which is determined on an annual basis. Operations aside, the major sources of continued real growth in defence spending are personnel costs and the planned program of major equipment acquisitions.

Emerging spending pressures

Community expectations that the quality and quantity of government services will continue to grow are an additional source of spending pressure. For example, growing expectations around reform of the aged care system and wide-ranging changes to disability support arrangements could involve significant costs to government.

The August 2011 Productivity Commission report on aged care highlighted the significant challenges Australia faces in providing aged care services for older Australians. In order to address these weaknesses, substantial changes have been proposed, many of which may require changes to funding arrangements.

The Productivity Commission has similarly found that the current disability support system is 'inequitable, underfunded, fragmented and inefficient'. The Commission proposes a National Disability Insurance Scheme, with the Government to meet the additional funding that this would require. The Productivity Commission estimates put the cost to the Commonwealth at up to $6.5 billion per annum in addition to existing funding once the scheme is fully operational.

The provision of community services is another source of pressure on government spending. Fair Work Australia (FWA) is considering an application for award wage increases in the Social and Community Services (SACS) sector on the grounds of gender undervaluation. The Government has made a commitment to meet its responsibilities and provide fair and appropriate supplementation to help support a phased-in wage awarded by FWA.

The Government is acutely aware of community needs in these areas. However, reform will need to occur in a manner that is fiscally sustainable.

Summary

The tax forum offers an invaluable opportunity for participants to shape the Australian tax landscape and through it make our economy stronger, society fairer and the tax system simpler.

It must also be remembered that the tax system funds the services we rely on, and for sustainable delivery, we need a strong and sustainable tax system.

In that context, there are potential pressures on current revenue bases particularly from increased international mobility of capital, also labour and the rising importance of intangibles such as intellectual property (both as inputs to production and final consumption goods).

In view of the significant fiscal challenges that lie ahead, contributors need to consider how their proposals can be implemented in a manner that is fiscally sustainable.

This requires proposals to be fully funded, not just in the next couple of years, but also into the future.