A challenge to the community and our political process – release of the Commission of Audit report

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The release of yesterday's National Commission of Audit Report highlights the challenges that the Federal Government has in maintaining a fiscally sustainable position. While there is a temptation to get caught in the detail of the recommendations, the following three commentaries take a broader perspective on the direction of proposed reforms.

Blair Comley PSM

Blair Comley has recently joined PwC as a Special Adviser in the Canberra Economics and Policy team. Blair was previously the Secretary of the Department of Resources, Energy and Tourism and prior to that of the Department of Climate Change and Energy Efficiency. A former senior Treasury official, Blair was also a member of the Secretaries Board which has a key role in overall leadership of the Australian Public Service.

The most important message of the Commission of Audit is scale of the task required to get to a Federal budget surplus of one per cent of Gross Domestic Product (GDP) in ten years' time. On the Commission's figures, the task is a budgetary improvement of around four per cent of GDP.

This task cannot be done by relying on merely improving the operation of government. As the Commission notes, only 12 per cent of Commonwealth expenses relate to directly operating government. The other 88 per cent of Commonwealth expenses is used to pay other people either directly or through the states and territories.

To successfully empower government decisions (and that is what most inquiries are mainly about) you need to convince the previously unconvinced that the change is good. Facts and analysis help, but many people are swayed more by people they trust and identify with. You rarely sway someone who can simply say 'they would say that wouldn't they!'

The most empowering inquiries often make surprising recommendations.

Many of the recommendations of the Commission are not surprising given its composition. They recommend reducing the generosity of transfer payments; reducing the growth in the minimum wage; making government more efficient; reducing industry assistance; and devolving much greater responsibility to the states. In many cases, the changes are measured and sensible responses to long-term challenges with genuine attention to the need to phase reform. But how many people will be converted by the Report? On these matters, there will be an inevitable response from the directly affected of 'they would say that.'

The surprising element of the Report is the revenue side of the Federal budget. Current tax revenue is around 21.8 per cent of GDP. The final recommendations are based on tax revenue of 24 per cent of GDP in ten years. So the report is predicated on tax collections rising by a little over two per cent of GDP. This is roughly based on having no personal income tax cuts until around 2020, allowing bracket creep to lift tax collections.

Put another way, the Report is based on around half of the fiscal adjustment task being achieved by increasing revenue. To be fair, the Commission did not have the mandate to look at the revenue side. But, if you do not like the incentive implications of higher marginal tax rates for many people (and the Commission clearly does not), then you either need to do twice as much heavy lifting on the expenses side (any appetite for even lower pensions and tighter tests?) or a fair bit of unpalatable tax reform. To put this task into context, the GST currently raises about three per cent of GDP in revenue, which means to get the equivalent revenue would need a GST rate above 15 per cent, and perhaps even as much as 20 per cent as in other countries such as the United Kingdom. If, instead you think broadening the GST is a simple fix, then you should remember that means taxing food, private school fees, out-of-pocket health expenses and increasing the GST on home borrowing expenses.

So the surprising thing is that this Report endorses increased taxation. Alternatively, it understates the challenges if you want a modest surplus without raising taxes. And, as Martin Parkinson has said recently, that is all assuming that growth continues unabated for what will be 33 years.

So will this Report empower the government to make decisions? Well, what it has done is provide a menu of options to meet a surplus target helped by a significant contribution from higher taxes. The value of the Report is that it turns abstract expenditure reductions into real proposals. Needless to say, these are controversial. But the challenge for the critics is to find alternatives when they rule things out. This will further focus the debate on tax, making the forthcoming Tax White Paper part of the main game with all the associated opportunities and risks. If we do need more revenue, then we should make sure we do it the right way, rather than by default relying on more personal income taxes and corporate taxes.

It will also flush out whether the public is convinced of the need for change. On the current Commission (and Treasury) numbers, net debt peaks at around 17 per cent of GDP. Is this a crisis? No. But it all assumes uninterrupted growth for that long 33 year period. Fiscal reform is about ensuring you have a better starting point for when the inevitable problems come and taking measured actions early rather than drastic actions later. That is a more subtle and difficult message to sell.

Roger Beale AO

Roger Beale was formerly Portfolio Secretary of the Department of Environment and Heritage and had nearly 20 years in department head level posts with the Commonwealth Government, including Transport and Communications, as a Commissioner of the Public Service Board and with Prime Minister and Cabinet. Roger was made a Member of the Order of Australia in 1995 for his contribution to national economic reform and an Officer of the Order in 2006 for his contribution to national environment policy.

The Commission of Audit has rightly and plainly stated that business as usual is not an option for Australia.

Current trends are simply not sustainable. We have to turn the fiscal ship around, and the longer we delay the harder it will be.

But the Commission does not fully capture the emerging crisis. This is because it was not asked to look at the deepening fiscal difficulties of the states. The growing gap between sluggish revenue growth and rising current expenditures and debt servicing costs is driving the states into a fiscal mire.

Simply transferring a significant slice of Commonwealth income tax revenues and spending responsibilities for high growth areas like hospitals to the states will not solve the states' underlying fiscal problems – it might deepen them.

There will be some one-off expenditure gains as Commonwealth-state duplication is reduced. But there is little empirical evidence that competition between the states in services and infrastructure, balanced by interstate competition to reduce taxes, will yield dynamic efficiency gains. History would suggest that revenue competition between the states has led to a reduction in their use of efficient taxes (including income tax which they have been offered in the past) and pushed them toward taxes which sap growth.

We cannot avoid a conversation about how to provide the states with a broader and more stable revenue base and encourage them to source their funding in a way that does less damage to growth – that means a conversation about the size and scope of GST, payroll tax and land taxes as well as any transfer of income tax.

The Commission's preoccupation with transferring a share of Commonwealth income tax revenue is likely to deepen, not reduce, our reliance on income taxes and corporate taxes. Speculation regarding plans for an income tax 'deficit surcharge' and the proposed levy on certain large companies to fund Paid Parental Leave are small, but further, steps away from a tax system that will boost growth. Hopefully they are not signs of things to come.

It is difficult to criticise the Commission's focus on the big and growing areas of Commonwealth spending as the key areas to be addressed. The broad thrust of its recommendations is right.

The challenge to the government, and the community, is now to work through the Commission's recommendations asking in relation to each:

- Will it lift growth and real incomes – which means will it lift productivity, participation and business investment?
- Will it lift workforce participation of women with children? What will be the net effect on effective marginal tax rates of the withdrawal of benefits and tighter means testing of childcare support?
- Will it lift workforce participation by older workers? Will unskilled workers be able to extend their working lives as readily as the highly educated? Are complementary strategies beyond changes to pension and superannuation entitlements needed for the less skilled?
- Will it provide the states with a more stable revenue base that more nearly matches their responsibilities? Will it support the move to a more efficient tax mix?
- Are the costs of adjustment fairly distributed over the community
- And will it contribute to building a better life for our disadvantaged and low income earners?

But the biggest challenge for government is how to bring together a package of expenditure restraint, tax changes and Commonwealth-state reform which the community will understand and endorse.

Steve Beet

Steve Beet is a Partner within the PwC UK National Government Services team specialising in the introduction of new commercial models and new business structures for the delivery of public services. Steve recently concluded a one year secondment to the UK Cabinet Office as CFO of the government's pathfinder mutual joint venture, MyCSP, during its set up and commercial negotiation. He has broad experience of change and commercialisation experience across a range of public sector and social enterprise organisations.

As someone who has spent the last 5 years working closely with the Efficiency and Reform Group (ERG) in the Cabinet Office in the UK, as they drove through the UK austerity programme, I am delighted to find myself in Australia at the start of what I see as a similar, but in no way identical journey. I had the privilege of listening to Tony Abbott at Monday night's Sydney Institute event and have since met with officials in both Canberra and Sydney. I spent last night reviewing the Commission's Report (due to the wonders of jet lag.)

I suspect that the next 3 weeks, with the imminent budget statement, and the reaction it will no doubt receive from the media and commentators, will set the course for the Australian economy for the next few years.

I see many parallels, in the preamble to the Commission's Report, with the position inherited by the coalition government in the UK in May 2010.

The inventory of challenges, due to underlying indexation of benefits, an ageing population and the related increase this creates in the demand for public services, and the desire not to place a significant additional tax burden on taxpayers, create a 'perfect storm'. A situation that requires firm, decisive action, under strong leadership, where many 'sacred cows' may need to be challenged.

The inventory of policy recommendations are familiar; means testing, co-payment arrangements, eligibility reviews and incentives for citizens to take preventative action themselves. The structural recommendations also resonate; rationalising the number of public bodies, devolving decision making and clarity of roles across bodies.

There are however significant differences between the Australian position today and the UK in 2010. The size of the deficit in the UK was daunting and led to some immediate actions, such as the imposition of severe central spending controls and cancellation of programmes and initiatives. Many commentators recognised the need to send a signal to the UK economy but this needs to be done with care to avoid putting service continuity at risk or storing up problems for the future.

The underlying business economy in Australia appears sound and I note Dr Martin Parkinson's recent recommendation that the glass is seen as 'half full'. There appears to be general alignment on what should be done and an acceptance amongst those in receipt of public services, and those providing them, that change is needed.

However, I do see some areas where the lessons from the UK may be worth a moment's reflection. My top five would be as follows:

1. The report recognises that, within the principles of good government, there may be occasions where a national interest calls for a cooperative and national response. However, within the recommendations, aside from the need to clarify the respective roles of Commonwealth and State, there is little on how collaboration may be beneficial. Within the UK we have launched a major programme to bring together the buying power of all public sector spend to drive out a better deal for the taxpayer in how suppliers are managed. This is an area that may be worth consideration.
2. In addition, there is mention of shared services providing an opportunity for efficiency. I suspect that this could be driven much deeper in defining a policy of rigorous standardisation in the back office by considering partnering with the private sector to leverage assets that already exist, thus freeing up what funding there is for the front line.
3. The Commission's Report mentions privatisation and outsourcing as options that should be considered in how services are delivered. Our learning from the UK would add a third option alongside in-house and out-source, being joint ventures, where the expertise and capital from the private sector can be accessed without the loss of control and fear of exploitation that comes with normal outsourcing debates.

4. I am genuinely surprised by the low level of ambition in the rationalisation of the public sector workforce. A 5 per cent target reduction appears modest, given the size of the fiscal challenge. Within the UK, the challenge has been much higher. As one UK public service leader commented "after years of 5 per cent year on year reductions, it is simpler to tackle a 20 per cent challenge than the next 5 per cent. It requires us to do different things rather than just do things differently".
5. I am equally surprised by the short list of 10 potential public entities to be considered for privatisation. There must be further opportunities to leverage public sector capabilities and intellectual property to generate a positive inbound capital flow from the private sector. Maybe this exists at a state level.

There is clearly no absence of ideas and recommendations, whether from the Commission or other experts. What will be essential is that those in power seize the initiative and take action. Many of the drivers of the fiscal challenge are irreversible and, therefore, a correction is needed. The experience from the UK is that this is painful and demanding. We are now emerging from a difficult 4 years but prospects are now positive. I hope that, by drawing on the lessons of others, and taking rapid action the period of distress in Australia can be minimised.

Let's Talk

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