GRATTAN Institute

Is there still a budget emergency?
Canberra Press Club

In his speech in reply to the 2013 budget, then Opposition Leader, now Prime Minister, Tony Abbott, declared that Australia had "a budget emergency". But there are no flashing blue lights. The Australian government budget is not in cardiac arrest on the operating table, needing a triple bypass to keep it alive. We do not have that kind of emergency. But Australian government budgets are unfit, overweight, and smoking – and now they have high blood pressure and chest pains. Most worryingly, the patient has gone into denial and is eating more cheese. I believe that reform requires a narrative that explains to Australians what happened to government budgets over the last decade, and why we need to get fit and healthy again.

Speaker: John Daley, CEO, Grattan Institute

INTRODUCTION: Today at the National Press Club, John Daley, the Chief Executive of independent think-tank The Grattan Institute, asks "Is there still a budget emergency?" With the federal government inspecting the books after winning the election and a media budget update due soon, John Daley addresses this timely topic for today's National Press Club Address.

LAURIE WILSON: Ladies and gentlemen, welcome to the National Press Club for today's National Australia Bank address. With the election now well behind us the focus turns to the task ahead with the Abbott government in managing the economy and, of course, bringing government spending under control, particularly in big spending key areas like health, the growth of which continues to outstrip economic growth. The critical question of course is just how serious are Australia's current budget problems? The problem requires some radical fiscal surgery, so it's simply a matter of a more cautious and frugal approach that's needed to shift the budget back to surplus. That's an issue that the independent policy think-tank The Grattan Institute has been closely examining. Would you please welcome the Chief Executive of The Grattan Institute, Professor John Daley.

JOHN DALEY: Thank you very much for that very kind introduction and, of course, it's a pleasure to be here. Obviously I'd like to acknowledge our sponsors the National Australia Bank; Senator Bridget McKenzie; Phil Bowen, who is the head of the Parliamentary Budget Office, obviously a very important institution in terms of looking at Australian budgets; and slightly, perhaps unusually, today I'd like to acknowledge the presence of a number of academics including Bruce Chapman, Peter Whiteford, Andrew Podger, Mark Matthews and Ben Philips. They've all written in various ways on this topic. Grattan Institute has certainly tried to build on their work, we've certainly benefited from their commentary, and I think they're all evidence of the way that good public policy ultimately does depend on Australian academia being engaged in these kind of topics and contributing to them, even if it doesn't always maximise the number of journal articles that you succeed in publishing.

Now, in his speech in reply to the 2013 budget, then Opposition leader, now Prime Minister, Tony Abbott declared that Australia has a budget emergency. But there are no flashing blue lights. The Australian government budget is not in cardiac arrest on the operating table needing a triple bypass to keep it alive. We don't have that kind of emergency, but Australian government budgets are unfit, overweight and smoking. And now they have high blood pressure and chest pains and, most worryingly I'd suggest, the patient has gone into denial and is eating more cheese. I believe that reform requires a narrative that explains to Australians what happened to government budgets over the last decade and why it is important that we get them fit and healthy again.

For much of the last decade Australian governments have lived beyond their means. Despite talk about a structural deficit, I'm not sure that everyone has absorbed exactly what that means. We probably need to spell it out a bit more clearly. Calculations of the structural deficit by the IMF, the OECD, the Australian Treasury, the Parliamentary Budget Office, Deloitte Access Economics and Grattan Institute have all approached this question with slightly different methodologies, but they've all come to the same conclusion. The Commonwealth government has an underlying deficit. After accounting for the effects of the mining boom and global financial crisis, for the last seven years this underlying deficit has generally been more than 2% of GDP. In today's dollars that's $30billion. And these budget issues have been masked by both the mining boom and the global financial crisis. We failed to realise that the income from the mining boom wouldn't last and we failed to realise that spending increases through the global financial crisis would last.

One of the problems is we often think about government expenditure as a percentage of gross domestic product and in normal times this is a perfectly good rule of thumb. If the massive run-up in the price of iron ore and coal were permanent then the Commonwealth government, its expenditure today is only a tick higher than in 2003. There is no real problem. But if iron ore and coal prices return to historic levels - and there are plenty of people who think that that's a distinct possibility - then it would be apparent that the Commonwealth government spending rose two percentage points over the last eight years. Two percentage points in eight years is a structural and material change in the nature of government spending.

Now of course, we can cross our fingers and hope that minerals prices stay higher for longer, but we can only count on that happening if we've already saved a buffer and, of course, we haven't done that. The structural shift that we've seen in Commonwealth spending has also escaped attention because of the stimulus package. It looked as though spending was falling in 2012/13, but that fall was the consequence of the stimulus package rolling off and payments being shuffled between a number of different years. Underlying spending has been rising rapidly. These problems also exist at the state level. So to take Western Australia in particular, it has spent all of the additional revenue from the mining boom on recurrent expenditure and, in addition, it has undertaken substantial capital works that mean it's now budgeting for a net government debt of $28billion by 2017. So our governments have been spending the mining revenue on the assumption that it was permanent.

The structural shift in government spending has also escaped a lot of attention because of where we spent it. The big items in fact don't get much airplay when we talk about budgets. Media on the morning after the last budget focused on $1billion more or less for the school kid's bonus. Meanwhile, much larger increases in health spending went unremarked, but over the last decade health has been responsible for most of the spending increases above gross domestic product growth for both Commonwealth and state governments. Now, of course, there's a reason why governments are spending more on health. Voters want them to and you can see that in terms of the political sensitivity about waiting lists. Many people are happy to spend more of our country's increasing income on health because it increases their life span and improves their quality of life. I'd note as an interesting footnote though that private spending on health, and that includes health insurance, hasn't increased that much in the last decade. It's gone from about 5.1% of household expenditure to about 5.9%.

Now, some people believe that this substantial growth in health expenditure, much faster than GDP, has been driven by the aging of the population. Unfortunately, it's not true. Health costs have increased primarily because a 60 year-old today relative to a 60 year-old 10 years ago visits the doctor more often, has more tests, has more operations, and then takes more prescription drugs. The greater number and proportion of 60 year-olds has increased health costs a little, but most of the real increase is because we are providing more and better health services per person. Now, we are probably getting something for the money. Life expectancy for those over the age of 65 continues to increase rapidly. In 1970 most men aged 65 expected to die before they were 78. Today a man aged 65 expects to live to be over 84. It's gone from 78 to 84. Quality of life has also improved and the best illustration of this is a recent commentary by the CEO of a cruise ship operator. He said "Modern medical medicine is a gift that keeps on giving. New knees and hips, as well as heart stents – especially heart stents – are giving my customers another 10 to 20 years of travelling".

So the problem is not that our governments are wasting our money on health. The question is who's going to pay for it?

Over the last decade the answer to that question was "The mining boom paid for it". It was a pretty painless decision. There weren't any losers. But over the next decade, if health costs are going to continue increasing at the same rate, they will consume an extra two percentage points of GDP by 2023. As the effects of the mining boom unwind there will have to be some losers. Either people are not going to get the improved healthcare they want; or some other areas of government expenditure will have to be cut; or someone else is going to have to pay more tax. So a crude summary of the last decade is that the Australian governments received a windfall from the mining boom and they largely spent it on health and the large stimulus in response to the global financial crisis wasn't matched by an equally large contraction to bring government spending back to normal levels. And as a result we ran cash deficits in years that should have been in surplus. When minerals prices fall it will become all too apparent that the underlying deficits are even bigger.

Now, the problems are likely to get worse. Despite its rising cholesterol levels, Australian governments have signed up to a series of very lavish dinners. The Coalition has promised a number of signature initiatives that will ultimately have a net cost to the budget of around $10-$15billion in today's dollars by 2023. There are the costs of abolishing Carbon and Mining Taxes; there's the Corporate Tax cut, paid parental leave and large corporate levy that will collectively drag on the bottom line; and, in addition to all of that, there are the full costs of disability care and the GONSKI schooling reforms that only start to bite after 2017 - outside of the budget forward estimates - and that only really reach steady state by 2022. We're also likely to see an increase in welfare costs. Newstart payments are now at a level that leaves even the Business Council of Australia uncomfortable. So there may be more pressure to increase those sorts of welfare payments for those who are least well-off, especially if the economy turns down. We're also likely to see political pressure to continue increasing aged pension benefits faster than GDP growth, as we indeed have over the last decade.

Now, Grattan Institute's report earlier this year entitled *Budget Pressures* estimated that the cumulative pressures of health spending, signature initiatives, a fall in terms of trade, welfare spending, could reduce the budget balances of Australian governments by about 4% of GDP. So we'll be in deficit of around 4% of GDP in 2023 if we carry on as we are at the moment. That's $60billion in today's terms and it's clearly not sustainable. But for the moment, do we care? The Australian budgets are a little bit overweight, like many Australian people. Can't we just take a few cholesterol-lowering drugs and carry on? Relative to those severely obese European countries, surely we don't have very much to worry about? Now, it's true that Australian governments are a lot less than governments elsewhere. We're not in the emergency ward crawling from one debt reconstruction to another with government slashing the social safety net and the economy shrinking at the same time. But surely the lesson we want to take away from countries overseas is that we do not want to be in the position that they are in today?

And then of course there's the most important argument for budgetary reform, which is that increase in government debt effectively means that future generations have to pay for the spending of current generations and we see this nicely illustrated in Queensland. The increase in debt of the last Queensland government led to annual interest payments of about $1.5billion. That's not a big deal for the Commonwealth, but it is quite a big deal for the Queensland government and it substantially constrained their budget. In addition, relatively little of the increase in annual spending we've seen over the last decade is going to benefit future generations that much, particularly in terms of increasing economic growth. Most of the increase, as I said, we have spent on health and whilst that health spending increases participation a little bit, most of its effect is to help people live longer and happier retirements. Now, that's absolutely a good thing, but the tough question is why should future generations pay for it?

Now, Australian governments of course are promising to do a little better, but their doctor would probably be worried that the patient isn't actually going to change its behaviour. The last Commonwealth budget planned a real cost growth for 2013/14 of 4.3% and then very generously promised, on behalf of the next government, that spending growth in the next three years is only going to be 1.8% per year. Now, to hit that target of 1.8% the Abbott government is going to have to be a lot more frugal than its predecessors. From its starting point before the global financial crisis to the last budget that it delivered for 2013/14, by which time the global financial crisis should have been pretty thoroughly washed out of the numbers, cumulative spending growth under the Rudd-Gillard governments was 3.7% per year. The Howard government averaged 3.2% for its first three terms and then 3.6% in its final term.

Then there are worrying signs that our patient, Australian budgets, is in denial. In recent months both sides of politics have downplayed the urgency of Australia's budget issues. Maybe chastened by the experience of the last government, the new Commonwealth government has not yet committed to a date by when the budget will be in surplus. In addition, the prospects of slower economic growth and rising unemployment have led some to urge a return to Keynesian stimulus and, of course, there are some storm clouds on the economic horizon. GDP growth has slowed to 2.5%. Unemployment has increased from 5.1% a bit over a year ago to 5.8% in August. But I think that we should worry about a tendency to look for any excuse to put off eating better and exercising more until next year. There's always going to be reasons to put off the hard political work of actual budget repair. And this is a global trend. Governments everywhere are keen to promise budgetary virtue, a little less keen to deliver it. Budget choices are hard. No-one likes a short term reduction in economic growth. The benefits of lower interest payments are inevitably promises about the future and promises about the future are things that people tend to value less.

And that's why Australia's historic public aversion to public debt may not be the economically first best answer, but from a political economy perspective it's a pretty good second best answer. Because unless governments are under constant political pressure and constant electoral pressure to avoid debt, they will always try to find reasons to spend tomorrow's tax dollars today. That is, until they hit the hard limits of financial market tolerance and borrowing becomes either high cost or impossible. Reaching those limits is very clearly a third best answer. In any case, the current situation may in fact be as good as our economy gets for a very long time. GDP growth is still 2.5%. That may be the long term growth rate for a very long time.

Some economists, like Tyler Cowan and Steven King from HSBC are suggesting economic growth is going to be slower in developed countries for the next few decades given there is no obvious wave of productivity-enhancing platforms and aging is starting to reduce participation rates. And similarly, while our unemployment rate is 5.8%, and that's high relative to the last decade of the mining boom, it's a lot less than the 7.7% average of the previous decade. And it's worth remembering that these economic results in terms of GDP growth of 2.5%, unemployment at 5.8%, were achieved in the last year in which nominal Commonwealth spending did fall by $3.8billion. That's in nominal terms, so the real fall was substantially larger. Now obviously that statistic benefits from various amounts of money being shuffled between years, but even so it's a significant change.

Secondly of course, Keynesian theory would advocate spending in the bottom half of the cycle but saving the top half and, as I've suggested, I think we may well in fact still be in the top half. Our economic situation may well be as good as it's going to be for quite some time. Finally of course, we've got an insurance policy. If budget repair results in a significant increase in unemployment then Australia's Central Bank, unlike its counterparts in most of the rest of the developed world, still has some room to cut interest rates to stimulate the economy.

So what should we do?

We might need some different solutions to those of our recent past. Budget reforms in living memory have had to make hard decisions about recurrent spending to bring our budgets back into balance, but they eliminated the backlog of debt largely by selling assets. So the Howard government, for example, reduced debt by about $58billion between 1997 and 2002 and it sold about $40billion of assets in that time, including Telstra, Qantas, Commonwealth Bank and a number of airports. Between 1992 and 2000 the Kennett government in Victoria reduced its debt by about $37billion and it sold about $45billion of assets, particularly its electricity and gas assets. It's not obvious that today the Commonwealth government has sellable assets worth that kind of money.

The good news is that if you look further afield governments elsewhere have dug themselves out of substantial deficit positions, indeed much larger debt positions than Australia has today, and they've done it by making tough decisions. There's a recent International Monetary Fund survey of budget repair which found that the major driver of success was indeed the hard work of making decisions that improved the structural budget balance on average by about 3% of GDP. It can be done. And just as sustained deficits can rapidly lead to large debt positions, sustained surpluses can erode even larger debts in a decade.

But there are a few things that are not going to work.

The same International Monetary Fund paper found that most of these countries did not solve their debt problems and their deficit issues simply by growing out of trouble; they needed to actually engage in structural reform. Along similar lines, some people hope that spending on infrastructure will lead to longer term economic growth that will help the budget bottom line or at least increase the denominator and therefore reduce the debt to GDP ratio. If that's going to be true, our infrastructure spending is going to have to be a lot better than the last five years. If we just look at roads and railways, government spending on constructing infrastructure is a larger percentage of GDP than at any time since the Australian Bureau of Statistics started to collect records in 1987. And it's not clear to me that the five year surge in infrastructure spending on roads and railways that we've seen has been matched by any surge in productivity, nor is there any magic in the private sector taking infrastructure spending off the government's balance sheet. I'd suggest that many of these schemes are in fact just an exotic, and usually expensive, investment banking way in which governments ultimately promise to pay away future tax revenues. It has all the same vices of running up debt. You are promising tomorrow's tax revenues.

Now of course, things are different if the loan is to be repaid only from additional infrastructure-linked revenues such as tolls but, given the experience of toll roads from Clem 7 in Brisbane to the Lane Cove Tunnel in Sydney, that is the precise risk that the private sector is now very reluctant to take on. The search for savings is not going to be easy. The Rudd-Gillard governments have squeezed the public sector through a series of deficiency dividends; middle class welfare has been quietly constrained as benefits have been retargeted towards genuinely poorer families. Indeed, despite the common perception that Australia has vast swathes of middle class welfare, it's very hard to find recipients under the age of 60. Family Tax Benefit A, the School Kids Bonus and the Baby Bonus are now all targeted at less wealthy families. Family Tax Benefit B is a little more generous, but only about half-a-billion goes to families that do not collect Family Tax Benefit A. As Peter Whiteford has demonstrated, Australia in fact has the most tightly targeted welfare system in the world. We are relatively generous in providing transfer payments to those in the bottom 20% and we are extremely frugal in providing few benefits to people in the top 80%. So I don't think that there's going to be easy wins in welfare.

Similarly, the Australian health system is already one of the most efficient in the world. We spend around the average for the OECD in what we spend on health per person, but we have substantially higher life expectancies than almost every other country. Substantial reductions in health expenditure may well be possible, but they're going to require Australia to invent new solutions and that's unlikely to happen quickly. Nor do I think there's likely to be substantial savings in slashing Commonwealth departments. We've heard a lot, for example, about the Commonwealth Health Department, but staffing the Commonwealth Health Department only costs us about $600million per year and those staff may not run any hospitals, but they are ultimately responsible for Medicare, Pharmaceutical Benefits Systems and so on that pay out close to $30billion per year, so I'm glad that someone at least is looking after them.

So what are our choices?

Well, we can spend less on health by not providing all the services that are available today. We can look at untouchables, like superannuation payments. We can talk about untouchables like aged pensions. We can talk about increasing taxes. I'm guessing that none of these is going to be wildly popular, but the choices aren't going to get any easier. One of the few choices that both increases economic growth in the medium term and helps the budget position is to increase the age at which people can access their superannuation or their aged pension. That reform is not going to close a budget deficit of 4% of GDP by itself, but it would certainly be substantial and it would certainly help.

But in terms of whether Australia can deal with its budgetary situation, I would suggest the acid test is whether the Treasure Joe Hockey's first budget contains substantial net improvements to the structural budget balance. There are very few governments that have succeeded in improving their budgets after several years of avoiding hard decisions. To build political momentum for hard decisions governments need to admit loudly, repeatedly and in public that they've got a problem and that everybody needs to bear some of the burden of the difficult decisions. And if you don't do that it's all but impossible to build credibility later on to make those hard decisions.

So in conclusion, Australian government budgets aren't blue on the operating theatre table, but they are in serious trouble. All the warning signs are there and as yet there are few signs that governments are serious about reforming their behaviour. In a sense, one of the problems is that budgetary reform is never urgent. Putting it off for another year only adds a little bit to the waistline, but the cumulative effect of putting off the difficult decisions is that you make the risks greater every year and the ultimate and inevitable task of regaining fitness is ever tougher. In the sense that there's a compelling case for immediate action but the patient is yet to get serious about the hard work of reform, we've still got a budget emergency and it's probably time we did something about it. Thank you.

LAURIE WILSON: Thank you very much John Daley. Before I go to questions I should mention that a copy of that speech will be available on your website, The Grattan Institute, complete with some very impressive graphs as well, possibly available now, but certainly later this afternoon. So our first question today.

AUDIENCE: I wanted to ask you – and probably stretching your metaphor to breaking point – not about the doctor in the room talking to the patient, but the doctors outside the room having a chat about what the doctor inside the room should do; that's private sector and academic economists, all of whom – and this may be a wild assumption – are relatively well off and relatively well paid. When you put out your prescriptions for what the government should do, should you include a "how they should do it" as well, the bit where the economics meets the political reality? It's easy to say governments should take tough decisions, but much harder to do. And, while I'm on this subject, do you know if private sector and academic economists go back over the forecasts they've given to people like me in the media and just double-check that they were actually right?

JOHN DALEY: Well, two questions there. Do we have an obligation to talk about what government should actually do in a substantive sense? I think the answer to that question is ultimately yes and, indeed, we at Grattan Institute are working on that. I've outlined a few things in terms of where you might need to go. You'll have noticed that I described all of them as politically very difficult and that's because I think we've run out of easy choices. Most of the things that will make a serious difference to our budget bottom line are going to be hard from here.

In terms of going back on forecasts, I'm not sure whether private sector forecasters always do that. I know that the Reserve Bank of Australia definitely did engage in that exercise of looking at the accuracy of forecasts or otherwise, particularly of course looking at gross domestic product forecasts a year out. They came to the conclusion that Reserve Bank and Treasury forecasts were actually very, very slightly worse than the consensus of private sector forecasters, but I think it would be fair to say the difference wasn't material. The really frightening thing was that they figured out if they simply picked the long run band for GDP growth and then basically used a random number generator – so essentially they shot darts at a dartboard – they would in fact have done better. So I think it's fair to say it's just a really tough thing to get right in forecasts.

What we can say though is that budgets are in a sense much, much easier to forecast. We more or less know what the spending will be and if you look at the record of estimating expenditure it's actually pretty good. In terms of estimating revenues, that's a lot harder because it does depend a lot more on what happens to economic growth and that's why I think governments find it difficult.

AUDIENCE: Thanks very much John, I really enjoyed the speech. Getting to the issue of political economy and political will, the next stage in that process has surely got to be the Commission of Audit which Joe Hockey is expected to announce within weeks. What are your thoughts on what it should look at; what its priorities might be; how wide the terms of reference should be; and do you have any thoughts on how long it should last? I think one of the ideas at the moment is that it might do an interim report that can then feed into the May budget, but should it have a longer timeframe as well to keep on the job in terms of looking for structural change?

JOHN DALEY: I suspect it does need to have a longer remit than simply the next budget. Apart from anything else, an awful lot of the next budget will be locked away by effectively about February 2014 and that doesn't give them very long to come up with much and I suspect a longer process than that will probably find more. As I hope is implicit in my remarks, I think it is important that the next budget – and whether it comes through the Commission of Audit or whether it comes just through Treasury and other government departments doing what they do for a living – it's important that that next budget does really start to embark on the work of structural reform a lot more seriously than we've seen for a while. So yes, I do think that the commission of audit should probably both look at the short run and the long run. And of course, one of the functions of those Commissions of Audit is that they essentially provide cover for the politically tough decisions.

One thing I would suggest about that kind of Commission of Audit is yes, you doubtless want to give it a broad scope, but I suspect what will be very helpful is, rather than coming back with 200 recommendations, coming back with half-a-dozen and saying "If you're serious, you need to pick at least three of these". As I said, you can come up with a lot of budget measures which are worth half-a-billion here, half-a-billion there; they're not going to make that much difference when you've got the kind of problems we've got. You ultimately do need to start to pick off some of the things that are worth more like $5billion or $10billion. By definition, they are all politically really, really hard and I think something that very much lays out for the Australian people, "Look, all the choices here are unpleasant and we are going to need to share the burden and pick off some of those unpleasant changes" is going to be an important thing to do from a political economy point of view. If you look back at the lessons of the Kennett government, they were very good at explaining loudly and at length "This is the problem we've got, it's a very serious problem and everyone is going to have to share the burden".

And I think one of the dangers of Commissions of Audit is that we shuffle off the problem to a group of three doubtless very learned people and don't acknowledge that this is ultimately a political problem that our politicians must own and must be seen to own. If we look at the lessons of the '80's and '90's reforms, I would suggest the lessons are that our politicians owned the reform; they took responsibility for explaining to the Australian people what the problems were and why that mattered; and they did that, as Paul Keating said very famously, "Until every pet shop Galah was talking about it". And that is the kind of thing that you need to do if you're going to build momentum for tough reform.

AUDIENCE: Good news John, I've just had a tweet from Joe Hockey in Washington who's been listening to you and he's offering you a consultancy to tell him exactly what changes he should make. And you must have thought about this, I mean, yes, the pensions and superannuation age, if we take that it seems to me a very big one and very obvious medium term reform, but you must have other ideas in your own sense, acknowledging that it is a political choice. Can you tell us what other things you think we should do?

JOHN DALEY: We are busy working on those and I think it would be premature of me to talk about them until we've got the numbers absolutely nailed down, but it's absolutely the right question. I'm encouraged to hear that the Treasurer is worrying about those things. I'm going to disappoint him; Grattan Institute doesn't do consulting work for any government precisely because it's important for our independence to be able to tell them things that they don't always want to hear.

AUDIENCE: You spoke earlier in your speech a lot about health and about how basically the increase in health spending swallowed up all the increase in revenue from the mining boom. I go back to three-and-a-half years ago when Kevin Rudd was talking about health reform and one of the things he warned about was that health spending would basically swamp state government's budgets. By, I think, 2050 all the states then, all their spending would technically be on health. I wonder if we can have budget reform without having some sort of, I guess, constitutional reform and we look at responsibilities between the states and the Commonwealth, we get out of this situation where things like health, education and now disability are effectively shared between the two tiers of government, if that is going to have to be part of this puzzle as well?

JOHN DALEY: I'm sure that the shuffling of responsibilities between states and Commonwealth in a variety of these areas doesn't help, but I think the really interesting thing about health is that we've put almost all of our energy into that precise question around what's the relative responsibility of the Commonwealth and the states. And the much more fundamental problem is this: imagine that you were tomorrow the Prime Minister of Australia and that the states had transferred to you 100% of responsibility for health - your Health Department does now run all of the hospitals - what would you do that would substantially reduce health expenditure? And we're also going to assume, to make your life really easy, that you've declared martial law and you don't have to face an election for the next 10 years, so there are no political constraints either. What would you do to reform our health system in such a way that it result in more or less the same outcomes at substantially lower cost? And the answer is we don't know.

That's my point about the Australian health system, for all its faults, actually being very close to the international frontier. We don't actually spend that much on health relative to the rest of the world and we get very, very good outcomes. This is a very good country to get sick and that's why it's a tough problem and that's why I would suggest, look, some of the Commonwealth-state things can't possibly be helping, but I suspect the root cause and the really tough reform is thinking through what do we do in terms of the way that we manage and fund our health system that will give us substantially better results? And the catch is, we are going to have to make that up as a country, there is no model internationally that's doing much better than we are and, of course, making things up is always slow and difficult.

AUDIENCE: You touched on the tax side in your options but didn't dwell on it. I'm wondering how extensive you think tax reform should be and do you think that federal and state governments do need to bite the bullet and look at changes in the rate and breadth of the GST?

JOHN DALEY: If you look at the history of past reconstructions of budgets and repairs, almost invariably they involve both reducing spending and increasing taxation and I think that there are fundamental political economy reasons for that. If you are trying to ask the community to take a bunch of tough decisions it's important from a political rhetoric point of view to be able to say everyone is bearing some pain, and essentially there's a bunch of people who will only bear some pain if they're paying some increased taxes. So yes, I think tax reform does have to be on the table.

Secondly, what's the timeframe for that? I've talked about why I think that spending reform needs to be shorter term, at least start in the shorter term. In terms of tax reform, it's invariably a slower process. It's worth remembering that getting a GST up and running from the Asprey Report in 1973 took 27 years until 2000. It's not something that usually happens quickly. And secondly, it's something that's very difficult to propose from Opposition. I don't think there is any Opposition in Australia that has been elected promising substantial tax reform, but there are plenty of governments that have been re-elected proposing substantial tax reform. And again, it's because with all of the resources of government it's actually possible to do the work. And so I think that the Abbott government's position of saying, whilst they were in Opposition, "We will be looking at tax reform and we're going to work it out and we're going to take something to the next election" is in fact exactly the right political strategy. It's difficult to see substantial tax reform getting up any other way.

In terms of that tax reform, it is difficult to see that the GST is not part of the answer. It is an extremely efficient tax; it's extremely difficult to avoid on a large scale; precisely because it taxes consumption, it doesn't do much to discourage people from working or from investing and for that reason, relative to other taxes, it has much less drag on the economy. In terms of whether we look at rate or coverage, I think the answer to that is quite probably both. There are a number of categories which are quite substantial that are excluded. Private spending on education and health in particular are currently exempt as well as fresh food and there are plenty of good reasons to say if you're going to have tax reform and you want to increase taxes then it may well be that the least bad option is to look at expanding the coverage of the GST.

AUDIENCE: We've heard quite a few metaphors and analogies today and you seem to have all the hallmarks to make a great politician one day. To put you on the spot, if you had to make a decision in terms of you were travelling on the Titanic and the tax system is a little bit like the deckchairs: on the one hand you had the option to reshuffle the deckchairs or to perhaps re-engineer the Titanic. Which way would you go?

JOHN DALEY: Obviously re-engineering the Titanic as it's sailing is always pretty tricky, to stretch that metaphor. I think that tax reform, if we're going to be serious about it, by definition is about a bit of re-engineering and I wouldn't be at all surprised if the best answer to our situation, if we are going to do things like increase the GST, is to simultaneously look at a plethora of relatively small taxes that collect relatively little and look at essentially doing away with them; and also to look at the balance between Commonwealth and state taxes and see whether there's anything we can do; and also to look at, given that GST at least currently notionally all gets paid to the states, whether there's a trade-off and whether we can use this as part of a grand bargain that encourages the states to reform some of their taxes.

So to look at very specific examples, payroll taxes are far from uniform around the states and we've seen them essentially competing on both rates and thresholds against each other and I'm not sure that that's ultimately in the national interest. We've seen the ACT essentially shift from a stamp duty to a land tax. There's any quantity of economic theory to suggest that that is a very good shift that should be encouraged and perhaps we might see reform on that. Yes, absolutely, in an ideal world you would see not just shuffling of deckchairs, but you would start to see re-engineering of our tax system. And if we're going to go through a proper process over three years' worth of government in which we think about the options and we take something significant to the next election, I'd like to think it involved a reasonable quantity of engineering.

LAURIE WILSON: If I can just pick up on that point, and you mentioned the Asprey Report - I'm sure there'll be a few people in the room who remember that, I do from my university days certainly. In fact, as I recall it the government essentially rejected that and went with the Mathews Report which was about addressing bracket creep. But my recollection of that report was that it essentially said that the impact of taxes was largely flat across the board and recommended severing reliance on consumption tax and flat income taxes, in other words a significant simplification. So when you talk about re-engineering, do you think that there is the potential for a genuine simplification of our tax system?

JOHN DALEY: I suspect that they're probably two different issues in this sense, that when you look at our income tax the complexity or otherwise of the rates doesn't actually – I mean, we're now down to, what, four thresholds. Actually, that's not the complicated part of filling in your income tax return. It's all the other bits and pieces, exactly what do you claim, what do you not claim, how do you treat all sorts of bits and pieces; that's what drives the complexity. If you're serious about tax reform in terms of promoting economic growth and getting rid of deadweight costs, it's all of that stuff you need to worry about I would suggest as opposed to the number of thresholds which in the scheme of things is pretty easy to administer.

In terms of the GST, I mean, I think that the current evidence would be that either increasing its rate or broadening its scope would be very mildly regressive. It would have, on a percentage basis, a greater impact on people with lower incomes rather than people with higher incomes, bearing in mind that there are some people with higher incomes that don't pay much tax and when there's a GST it's very difficult for them not to pay the tax. But in terms of that regression I think Ken Henry was absolutely right to say that there are two questions here: one is what does the ideal tax regime look like and the other is what does the ideal welfare system look like? And it may well be that if you reform the GST that has to be accompanied by changes to the welfare system that essentially increase benefits for the people who are worst off. That was part of the package last time, I am guessing it will have to be part of any package next time around. It won't consume anything like 100% of the GST revenue, but it will consume some of it.

AUDIENCE: Thanks for your address. I'll take you back to an earlier question and the tweet which had just been received from Joe Hockey. I won't read you out the tweet that I got from Colin Barnett, but he's got a few thoughts about things that you had to stay about structural deficits and irresponsibility in approach to budget management. But I just want to encourage you to go a little bit further. So far you've let us know that GST is not indeed a bad thing to look at, you've also chanced your arm on a few other things. If I were to tell you we're going to invite you back here sometime again between now and the incoming government's first budget and that the subject of your address will be "Basic principles that you just can't escape from guys" if we're going to address the issue of enduring and recurring budget deficits, could you tease out a little bit further for us what those principles would be?

JOHN DALEY: Thank you, that's a great question. Yes, I think we can talk about how you think about this. Firstly, you're looking for budget reforms which are big enough to care. We spend a lot of time, as I said, agonising about middle class welfare. As I said, for people under the age of 60 it's now down to a billion or two a year. In the scheme of a budget deficit that we're looking at in a decade's time of $60billion the right answer to that question is who cares? So number one, you want to look for the reforms that are big enough to truly make a difference.

Secondly, you're obviously going to have to evaluate those reforms in terms of asking how confident are we that we would in fact get a budgetary kicker out of it; what are the social costs of it; what are the economic costs of it, bearing in mind that sometimes the economic impact may in fact be positive and a good example of that is if you increase the age at which you get access to your superannuation that will both be positive for the budget and in fact positive for the economy; and then you're going to want to look at any distributional aspects, so to what extent is this a budget measure that particularly falls on people in the bottom 20%, people who are worst off in our community?

So I think that those are the kinds of things that you are going to want to evaluate measures on and then, as I suggested earlier, you're going to want to try and prioritise. Political capital is always limited.

By definition, the things that are big enough to make a difference are going to be really hard so figuring out what are the couple of things that are big enough to make a difference, the collateral impacts aren't too bad, and then prioritising them to do something about it is important.

I just wanted to respond to Colin Barnett's tweet. For those of you who haven't followed Western Australia very closely, one of the things that we've done as Grattan Institute as part of this budget work is compare the budgets of the four largest states and, I will confess, we were somewhat surprised by what we found. If you look at spending per capita of our four largest states and if you look at revenue per capita in our four largest states, revenue per capita in Western Australia is about 20% higher than in New South Wales and Victoria and that's primarily because of royalty revenue. So for all of the complaining about GST, the bottom line is that the West Australian government has got 20% more to spend per resident and, indeed, spend it does, 20% more per resident than New South Wales and Victoria.

And, of course, it's worth remembering that in fact the geography of Western Australia is not that different to the geography of Victoria. It's basically a very large capital with most of the people living in it, or pretty close to it, and then some relatively far-flung regions with relatively little of the population. And when you look at the spending of the Western Australian government it is 20% higher or substantially higher in pretty much every category. It is difficult to escape the conclusion that essentially spending in Western Australia is higher because it can be and I think that there is a very substantial budgetary issue there. As I said earlier, they are essentially spending 100% of their mining revenue and some. They're also then spending on the capital side and running up a bill of about $28billion. That is clearly not sustainable.

LAURIE WILSON: Some proportion of that though would have been back into the regions wouldn't it? I mean, they do have a significant contribution through the Royalties for Regions, which may or may not be justified.

JOHN DALEY: That's absolutely right. I mean, a chunk of it is to regions, albeit that money is, certainly on a per capita basis, despite all of the rhetoric, in fact very much skewed towards the Wheatbelt and the bottom line is that no amount of spending money on the Wheatbelt is going to result in a substantial increase in population. We've been trying to do that as Australian governments for well over 100 years, spend money on regions remote from capitals and hope that it will result in population and economic growth. Hasn't worked for the last, in fact, 200 years since Australia was colonised and I'd be surprised if it works now. So yes, some of it is Royalties for Regions and it may well not have been particularly well spent, but a lot of it is, as I said, it's just spending in health, in education, in child protection and everything else.

AUDIENCE: Professor, before the election, at that very platform, I asked John Houston why he thought discussion at his apparently unlosable election had moved from very detailed policy to the outright populism that we have now and he said it was because nobody wanted to be the next John Houston. The perceptions that people have that they're heavily taxed and that they're generally badly off will take a long time to shift. How long do you think it will take to remove the perceptions that are necessary to get the sort of reforms you're talking about?

JOHN DALEY: I think that we can move perceptions over a year or two. I think you're absolutely right to point to the problems in terms of Australians believing that they're worse off, and I don't think that we've done a particularly good job of explaining that average household income in Australia has gone up, real income has gone up by about 35% over the last decade. Now, that's, certainly in the developed world, one of the best increases anywhere. The bottom line is that Australians have gone over the last decade from being quite well off to being amongst the richest people in the world. Now, I understand why it's politically very unfashionable to say that, but that is what has happened and we do need to start explaining to people that they are doing pretty well, but nevertheless the good times are not going to last and a few things are going to have to change.

As I suggested earlier, if you look at the track record both of the Howard governments and of the Kennett governments, they did succeed in getting tough reform to happen and they succeeded by talking about it particularly when they were in government. I think one of the things we can learn from the Houston experience is that talking about tough reform in detail in Opposition is very difficult. The real politic is the government of the day will always have the resources of Treasury and Prime Minister and Cabinet and a series of other departments, literally hundreds of people in policy areas, to basically sit there, take whatever has been prepared and rip it to pieces. And on the other hand, Oppositions, if they've got a dozen people working on this they're probably doing pretty well. So they're hopelessly out-gunned.

Now, the reverse is true when you're in government. You have all those resources of Treasury, Prime Minister and Cabinet and so on at your disposal to work out what you want to do and why it's a good idea and exactly why the balance comes out alright, and Oppositions have got relatively few resources to pull it apart. And so that's why I would suggest that the message of Houston and fight back is yes, preparing a detailed plan while you're in Opposition and publishing it is perhaps not very politically wise, but planning a detailed plan when you're in government and then talking about it at length, explaining the problem before you try and explain the solution is very important, is doable.

And if you look at the long run track record of Australian governments over 30 or 40 years it is actually a very proud track record in which we have done a number of hard, difficult political reforms that have made a big difference to the country. We've gone from being a kind of okay country in 1970 to being one of the best in the world. Some of that was the mining boom, but some of it was frankly we did pretty well in terms of making tough political decisions. I don't think it's impossible for us to do that again as a country. I think we're a grown-up country, I think we can have those conversations, but I think it is important that our politicians do the planning and then accept that it's their responsibility to talk about these are the tough problems we face; these are the difficult trade-offs we face; and this is why what we're planning on doing is the best of all possible worlds in the situation we find ourselves in.

AUDIENCE: John, you talked earlier about the spending programs that are now in the budget – well, sorry, they're not technically in the budget, but they're there beyond 2017: disability care; Better Schools; and a bunch of other things. Now, at the moment the incoming government has committed to four years of spending on Better Schools but not beyond then. Do you have any thoughts about whether it's actually worth the big investment beyond 2017 in the Better Schools program? What are your thoughts on whether the nation does get the productivity gain that's meant to come from that huge school investment or is it actually worth thinking about not going ahead with that?

JOHN DALEY: I think it depends crucially on where that money is spent. If you look at the track record over the last couple of decades, we have very substantially increased in real terms per student how much we spend and, to be blunt, we have not seen any substantial improvement in results coming from that. Now, if you look at the work that my colleague Ben Jensen has done, if we spend that money improving the quality of initial teacher education, improving the extent to which teachers get feedback on their performance in the classroom on a very, very regular basis and use that to improve how they go about teaching, there is a fighting chance it will be money well spent and a fighting chance that we will see substantial improvements. If, on the other hand, we spend it frankly on reducing class sizes then the track record is that that will have very little impact on outcomes and it will be money wasted and we'd be better off not spending it.

Of course, the much bigger thing that's outside the forward estimates which, as I understand it, the Coalition government is committed to, is the disability reform and almost all of the increase in spending is outside of the forward estimates periods. I think that that is going to be an important reform. There are obviously many good reasons to want to do it, but it's also something about which we are going to need to be very, very careful. At its heart it's a scheme in which the government is going to provide private operators with money to provide services to relatively vulnerable people.

Now, if you look at the lessons of the home insulation scheme, if you look at the lessons beautifully written up in a recent book called "The Blunders of Our Governments" in the United Kingdom where they provided training accounts that would essentially pay for training for individuals; where you have governments providing payments to private operators to provide services to vulnerable third parties the bottom line is you need to be very careful about the quality and frankly fraud that can go on. I would not suggest for a moment that most people in disability services today are shonks, indeed I wouldn't suggest that any of them are, but the bottom line is that if you have a large scale government scheme of that nature, as we saw with home insulation, you will attract people who are either fraudsters or not that fussed about the quality of what they deliver. And designing those schemes so that you prevent that from happening is not easy.

Now, I'm not suggesting for a moment that we can't do it. I am just suggesting though it will be difficult and it's one of the things it will be quite difficult to get right in pilots. Pilots don't attract shonks so you don't really test that part of the system. It's when you go to full roll-out that you attract people who think that this is a big bucket of government money out of which they can get rich. And that is, I suspect, going to be one of the very substantial challenges for disability care and, of course, if it gets out of control either we'll wind up with a scheme that we have to shut or we'll wind up with a scheme that costs us a great deal more than we are currently planning on.

END OF RECORDING