



Budget repair and the size of Australia's government

**Melbourne Economic Forum
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Budget repair and the size of Australia's government

Attitudes to the best approach to budget repair are influenced by beliefs about the value of small government, and the priority of economic growth.

Many believe that Australia has relatively large government, and that the key to budget repair is smaller government that will lead to faster economic growth and a stabilised budget.

While there are many reasons to prefer smaller government, particularly promoting the scope for individuals to make choices that shape their own lives, smaller government is unlikely to solve Australia's budgetary problems. Across the OECD, there is no obvious relationship between size of government and size of government deficits.

In any case, Australia has relatively small government. Although government expenditure is currently towards the upper limit of historic expenditure, Australian government expenditure is low relative to the OECD. This is so, even if compulsory superannuation contributions are taken into account. Australian governments spend less in most categories. In particular, welfare spending is relatively low due to Australia's highly targeted welfare system.

Australian tax rates are also relatively low. Income taxes are not particularly high if one takes into account social security contributions, which have a similar incidence to income taxes.

There are likely to be continued pressures to increase the size of government. Around the world, as economies grow, governments are typically spending an increasing proportion of GDP on healthcare. In Australia, increased spending on health over the last 20 years has coincided with materially improved health outcomes.

Instead, budget repair will depend on the hard grind of both expenditure reductions and revenue increases. This will include facing up to the difficult politics of unsustainable inter-generational spending and revenue transfers. History suggests that budget repair is more likely to succeed when governments both reduce expenditure *and* increase revenue; otherwise the politics of budget repair is very difficult to manage. And the sheer scale of the federal deficit means that it is very unlikely that the gap can be bridged purely through even the bravest of expenditure reductions. Indeed the Commonwealth's plan for many years has been to repair its budget primarily through revenue increases delivered through fiscal drag.

Budget repair and the size of Australia's government

Why does size of government matter?

- Attitudes to size of government affect priorities
- Size of government and deficits

Is Australian government large?

- Relative to history
- Relative to developed countries

Is government likely to get bigger?

- Increasing spend on health as countries get richer
- Government role in health spending

What should Australia do about budget repair?

- Repair through spending reductions alone is unlikely given the size of the deficit
- Intergenerational issues are difficult
- Repair tends to be easier politically with simultaneous spending reductions and revenue increases

What is our priority?

What do you care about most?

Budget balancing

↑ Taxes

↓ Expenditure

Structural deficit won't be solved by economic growth.

Politics requires budget repair through both revenue and expenses

Companies reluctant to invest while budgets don't balance

Small government

↓ Taxes

↓ Expenditure

If government reduces taxes, it will be forced to cut expenditure.

Smaller government increases economic growth and reduces budget deficit

Economic growth (short run)

↓ Taxes

↑ Expenditure

Increasing economic growth will solve the budget issue

More services that government provides (health)

↑ Taxes

↑ Expenditure

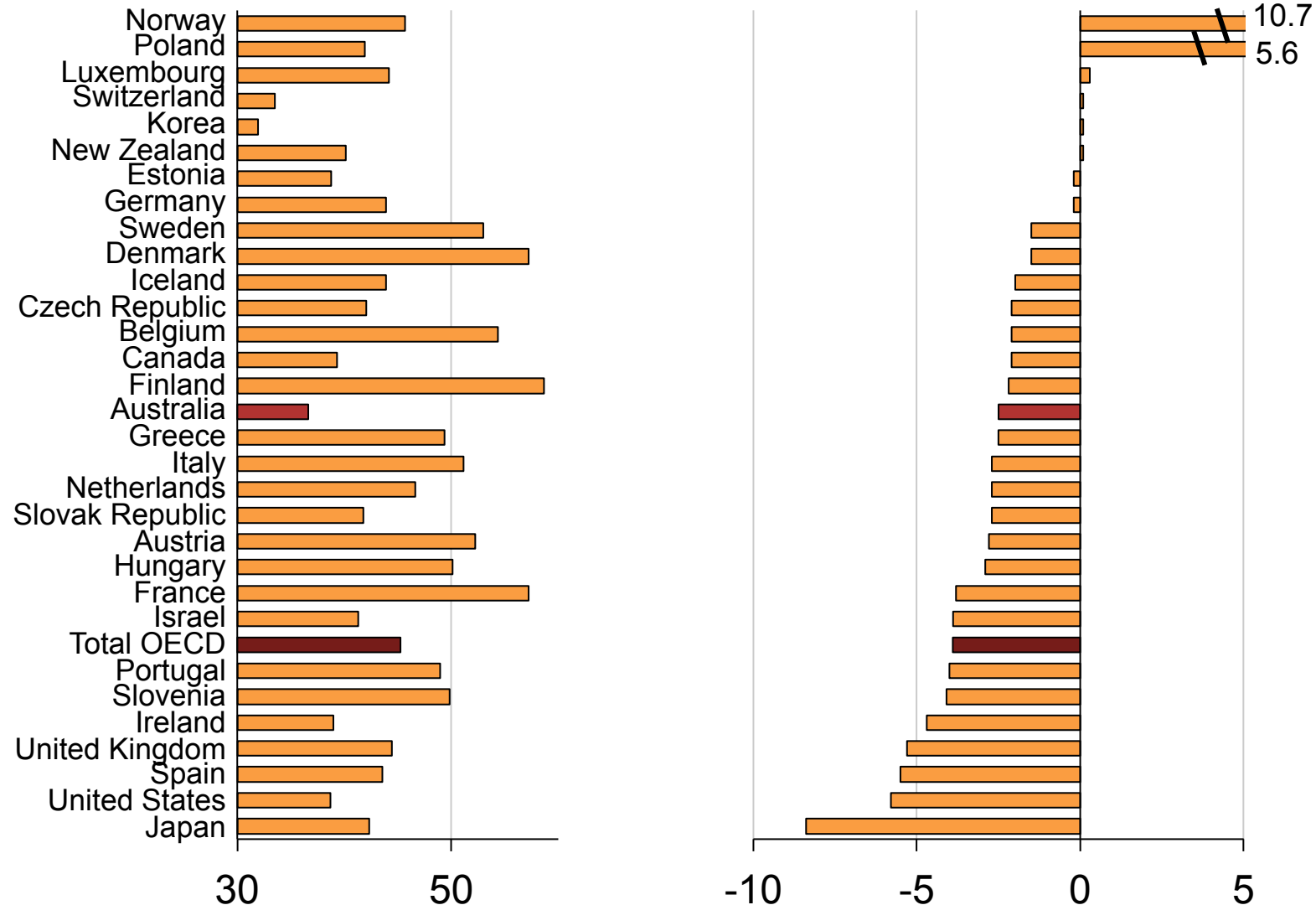
Increasing health spend as income increases

Government better at delivering many health services

Underlying assumptions

There is no relationship between size of government and fiscal balance

Government expend, % of GDP, 2014 **Budget deficit, % of GDP, 2014**



Note: Data for expenditure for Iceland, Japan, Israel, New Zealand, US, Australia and Switzerland is for 2013
Source: Grattan analysis of OECD

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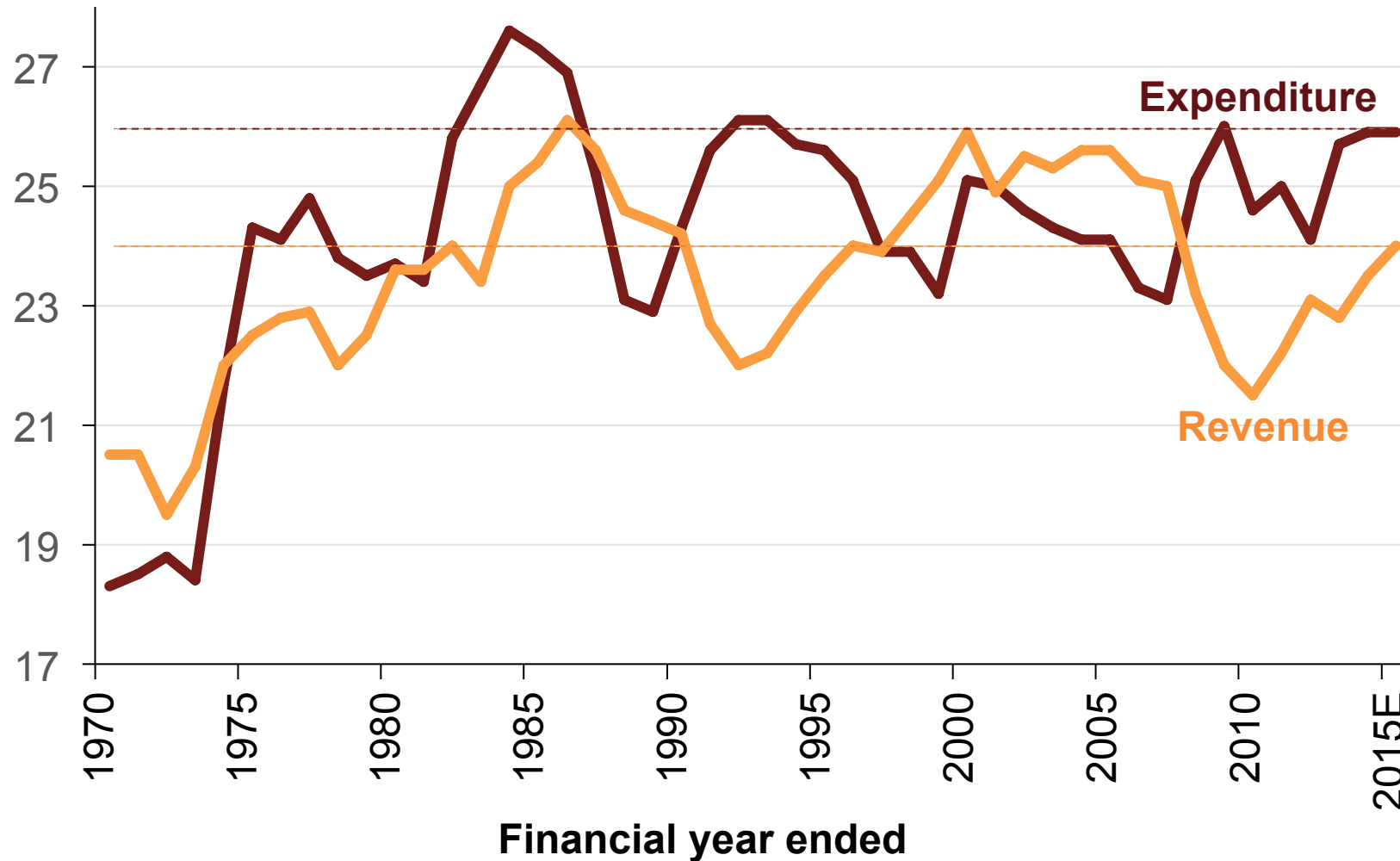
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Commonwealth expenditure is high relative to history; revenue is typical for the last 30 years

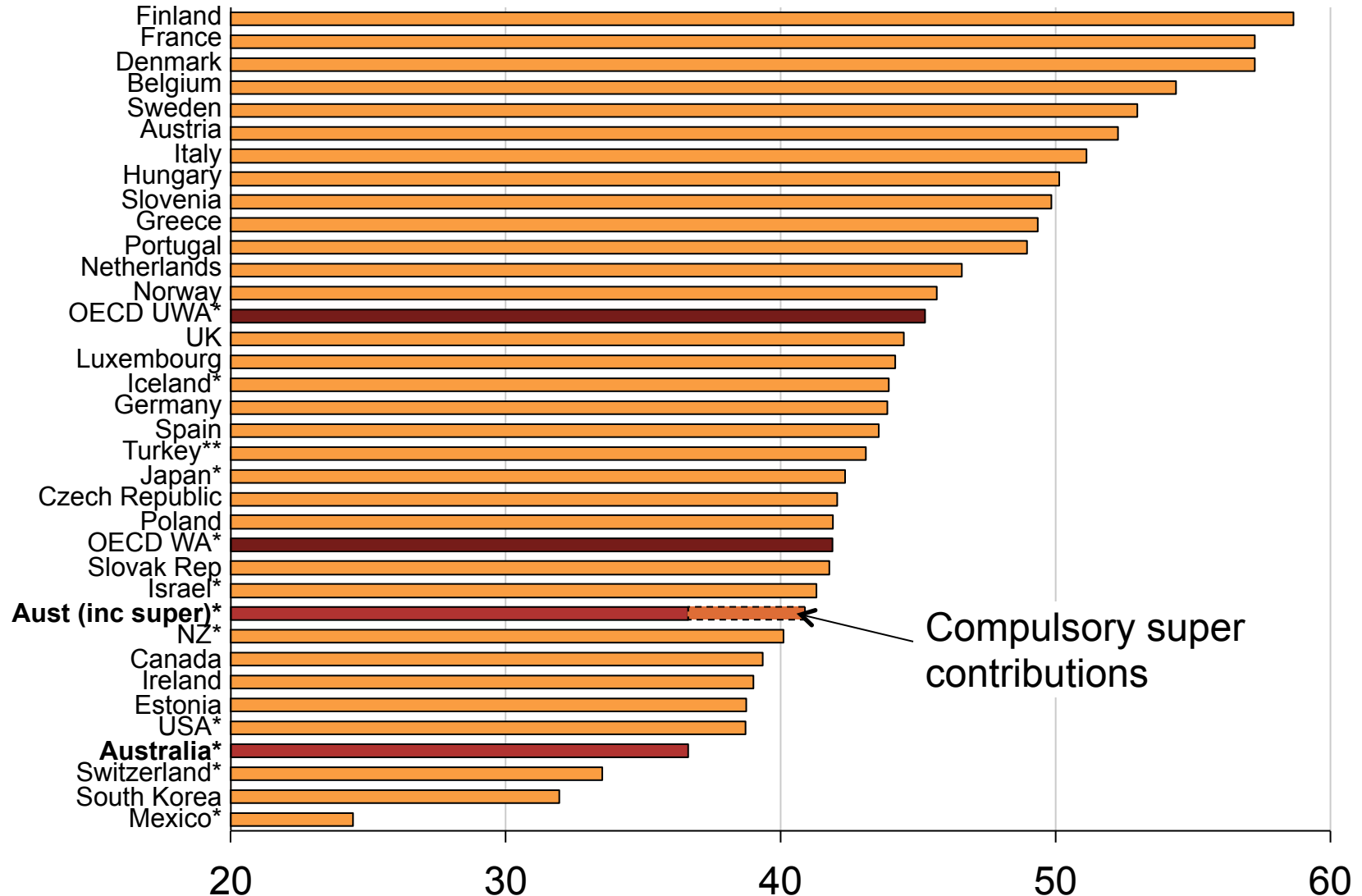
Commonwealth government expenditure and revenue, % of GDP



Note: figures for 2014-15 and 2015-16 are expected figures.
Source: Budget Papers 2014-15 and 2015-16

But Australian government expenditure is relatively small, even including super

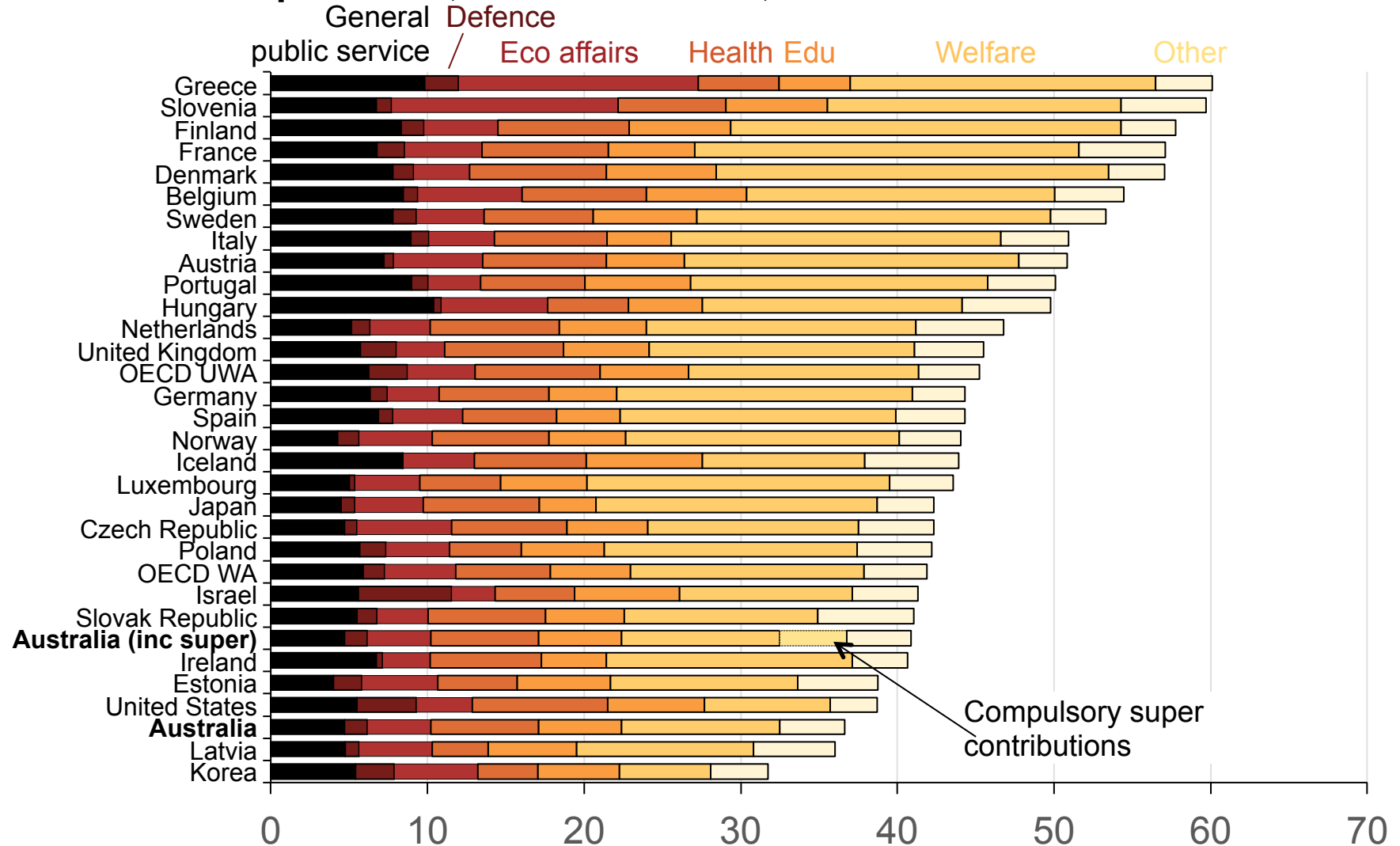
General government expenditure, OECD countries, % of GDP, 2014



Note: Data for countries marked with an asterisk are for 2013; Turkey data is for 2012
 Source: OECD <http://dx.doi.org/10.1787/888933248323>.

Australian governments spend relatively less on welfare, general government and debt

Government expenditure, OECD countries, % of GDP, 2013

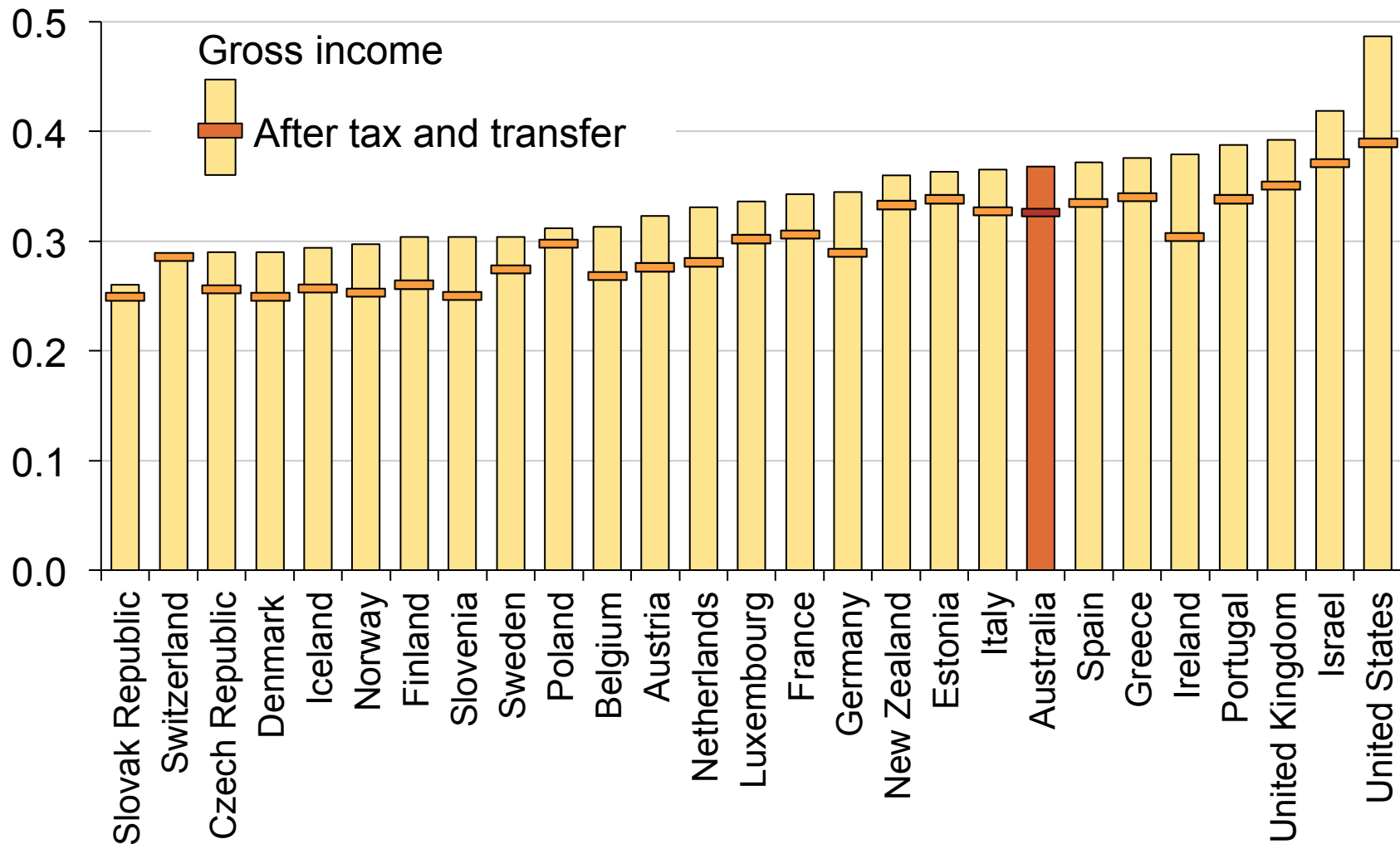


Notes: 'Other' category includes 'Public order and safety'; 'Environmental protection'; 'Housing and community amenities'; and 'Recreation, culture and religion'. 'Welfare' category is referred to in the source data as 'Social protection'.

Source: OECD <http://dx.doi.org/10.1787/888933248323>; Australian super contributions from APRA

Tax and transfer are quite progressive in Australia, but gross income is unequal

Gini coefficient (higher more unequal), OECD countries, 2012



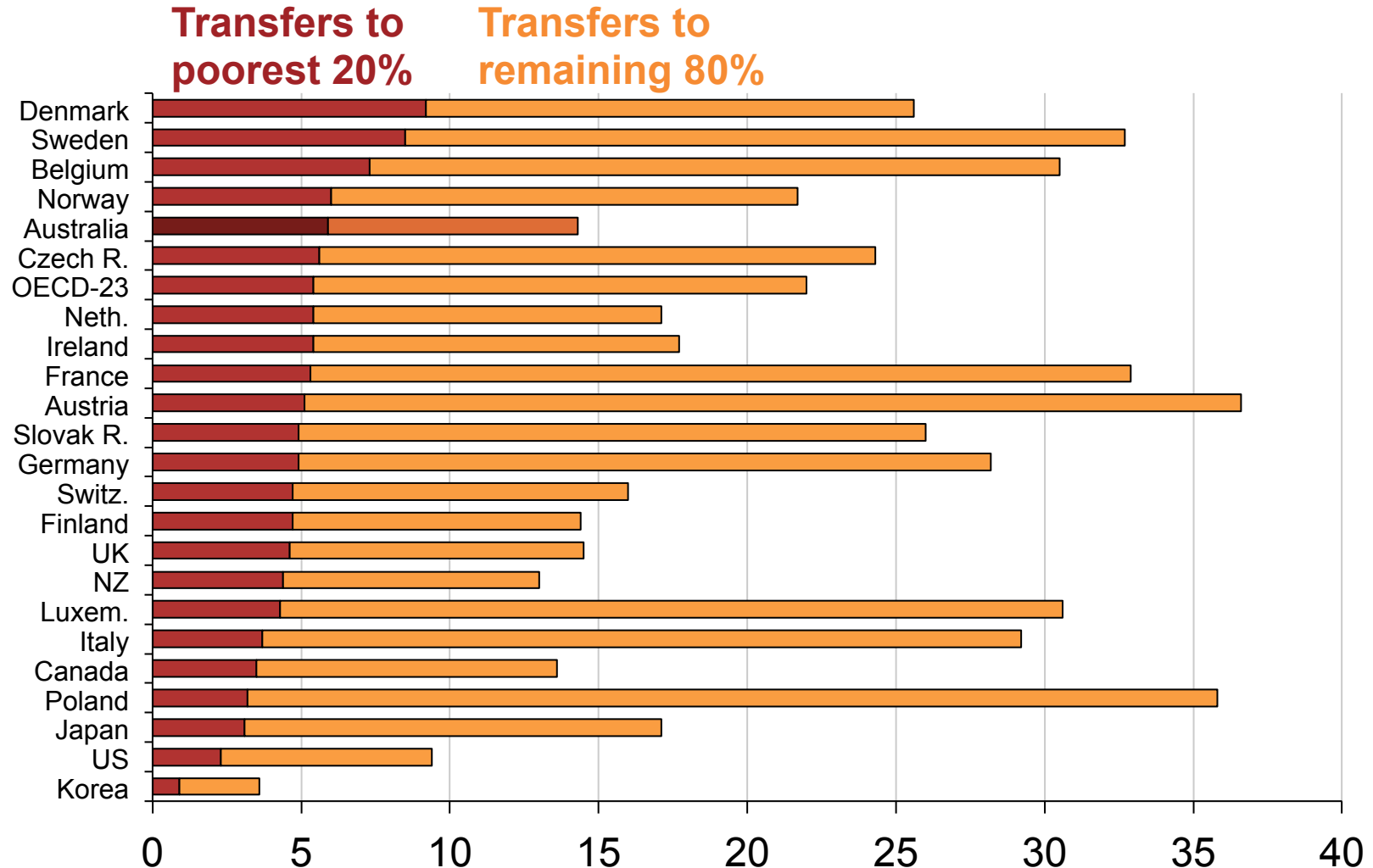
Note: Countries with no Gini estimate for gross income or disposable income in 2012 are excluded from the comparison

This version corrects an error for Australia in the original version published in December 2015

Source: <http://stats.oecd.org/Index.aspx?DataSetCode=IDD>

Australia has a particularly targeted welfare system

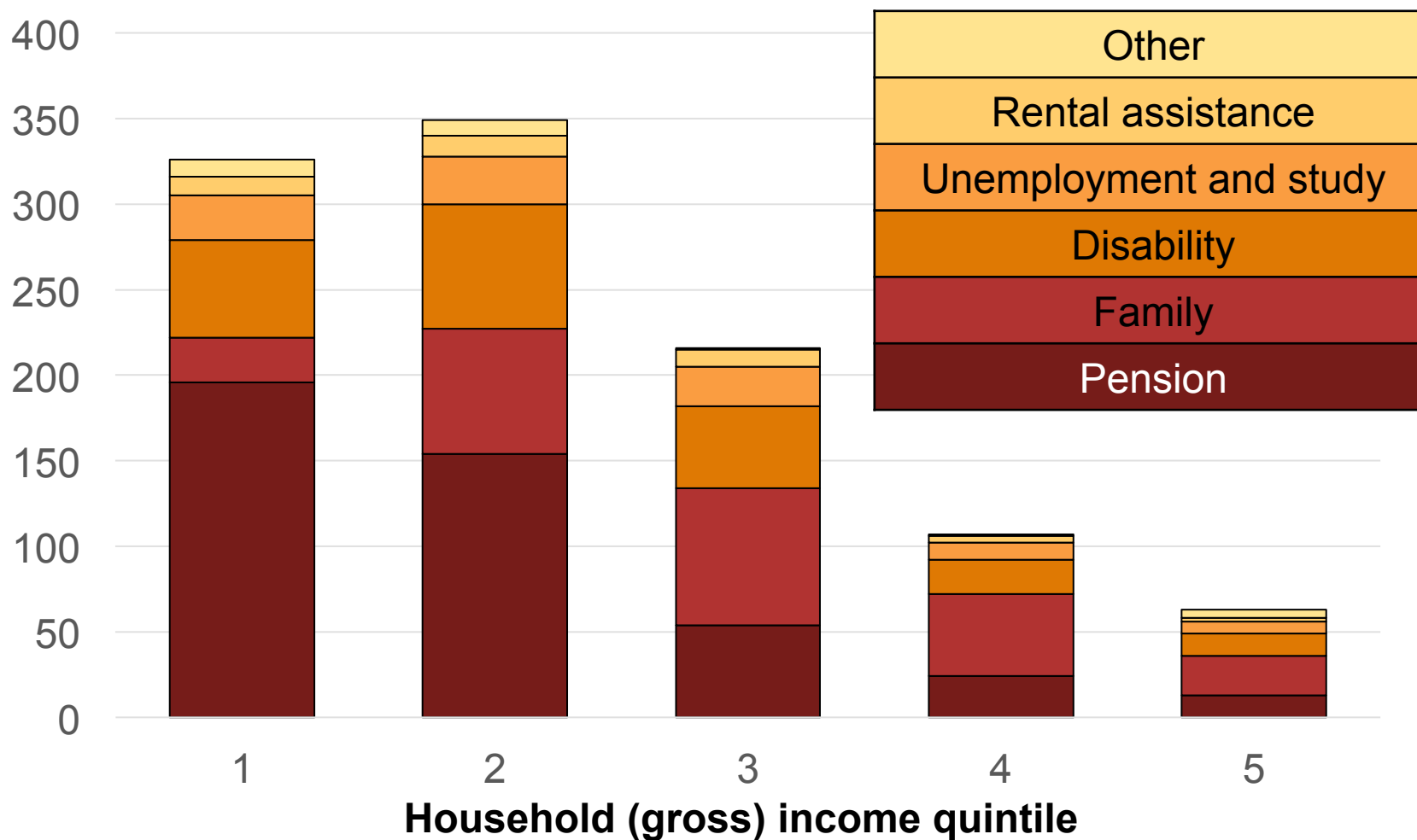
Public payments to households as a proportion of population disposable income, mid-2000s



Note: incomes are equivalised
Source: Grattan analysis of Whiteford (2010)

Australia's welfare system is well targeted

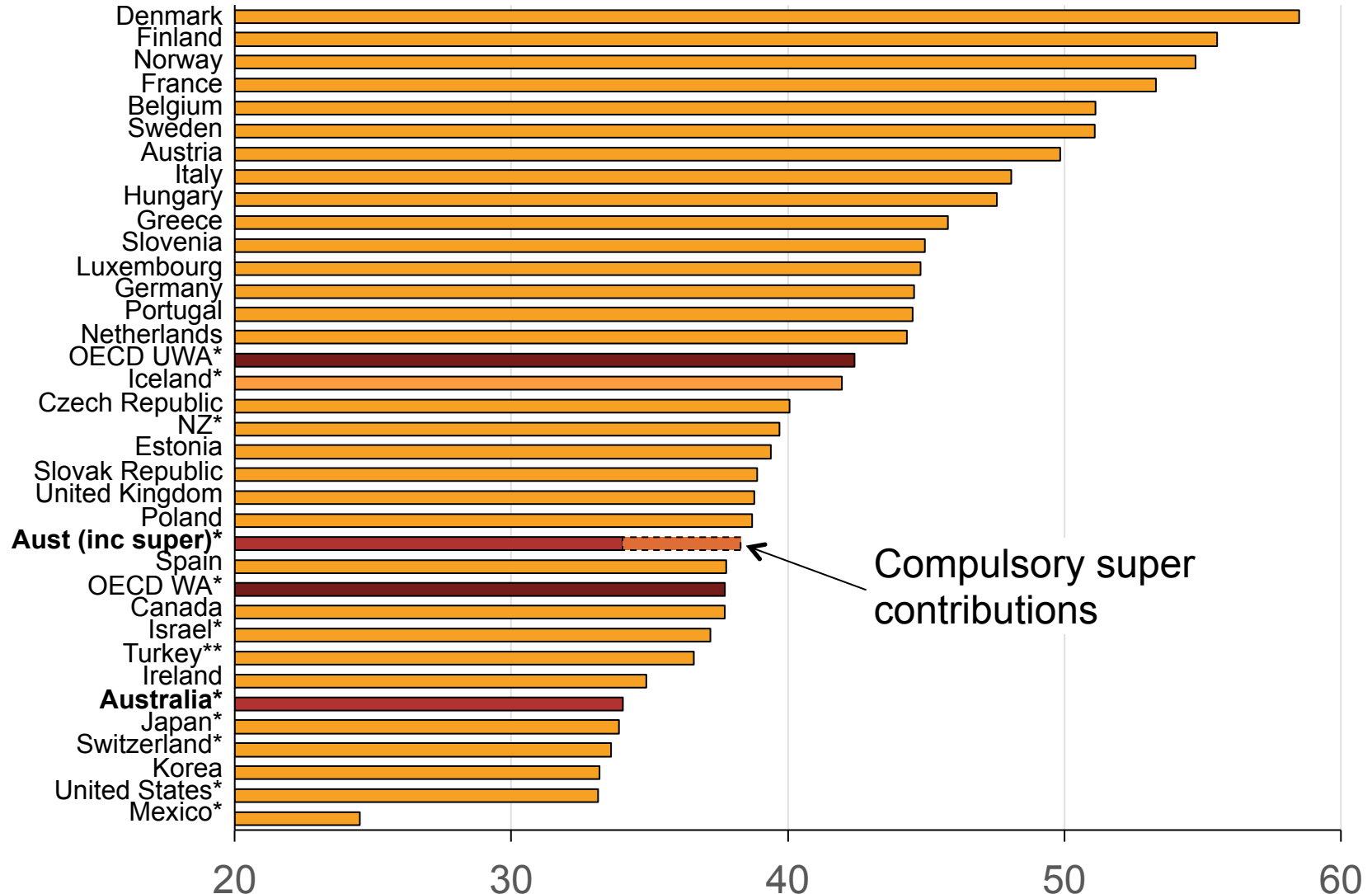
Average welfare payments per week by household gross income quintile, \$2013-14



Notes: Pension includes Age and Veteran's Affairs Pension. Family payments include Family Tax Benefits and Parenting Payments.
Source: ABS (2015); Grattan analysis.

Australian government revenues are about average if you include super

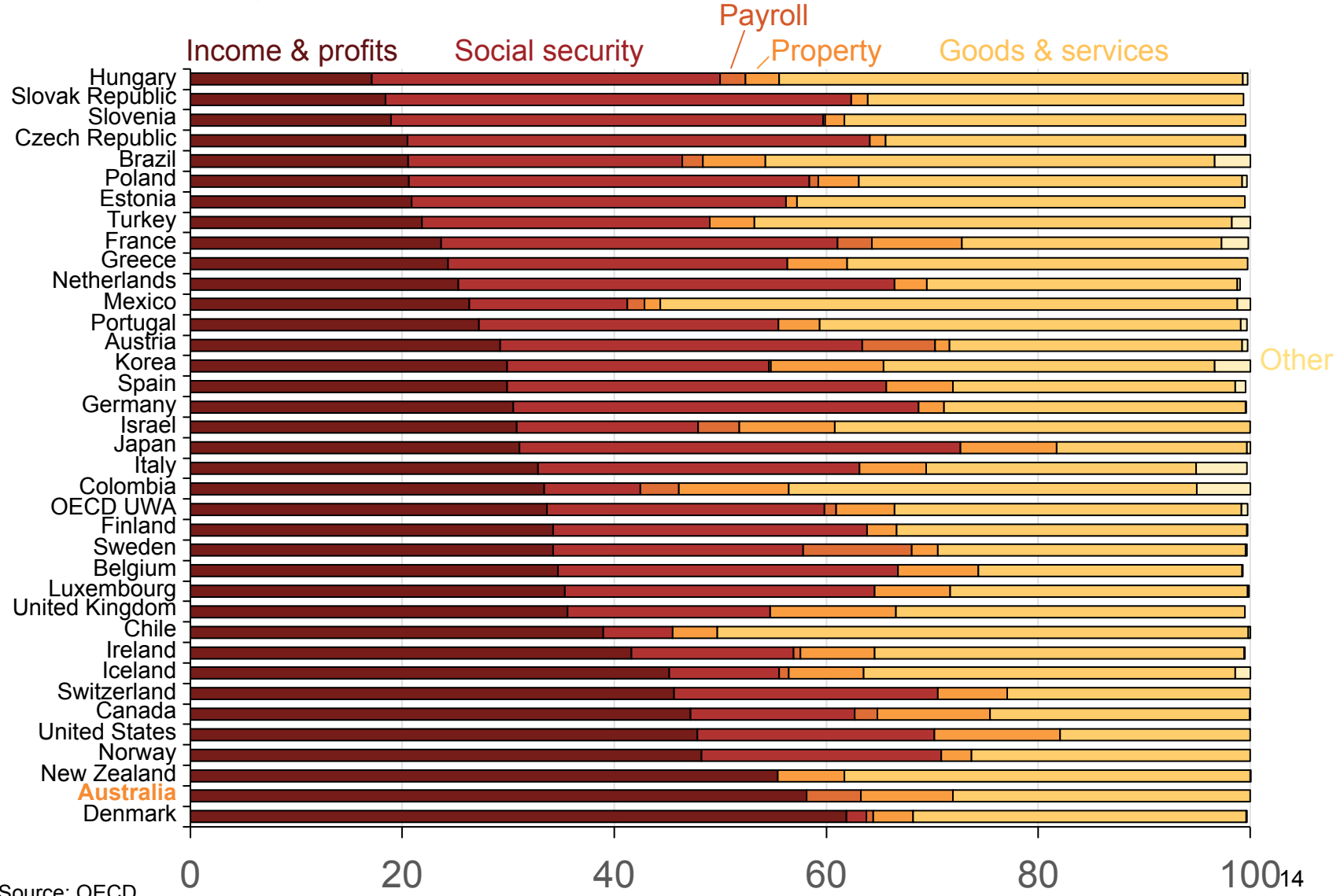
General government revenue, OECD countries, % of GDP, 2014



Data for countries marked with an asterisk are for 2013; Turkey data are for 2012
Source: OECD <http://dx.doi.org/10.1787/888933248215>.

Australia is uncommonly reliant on income tax, but much lower social security taxes

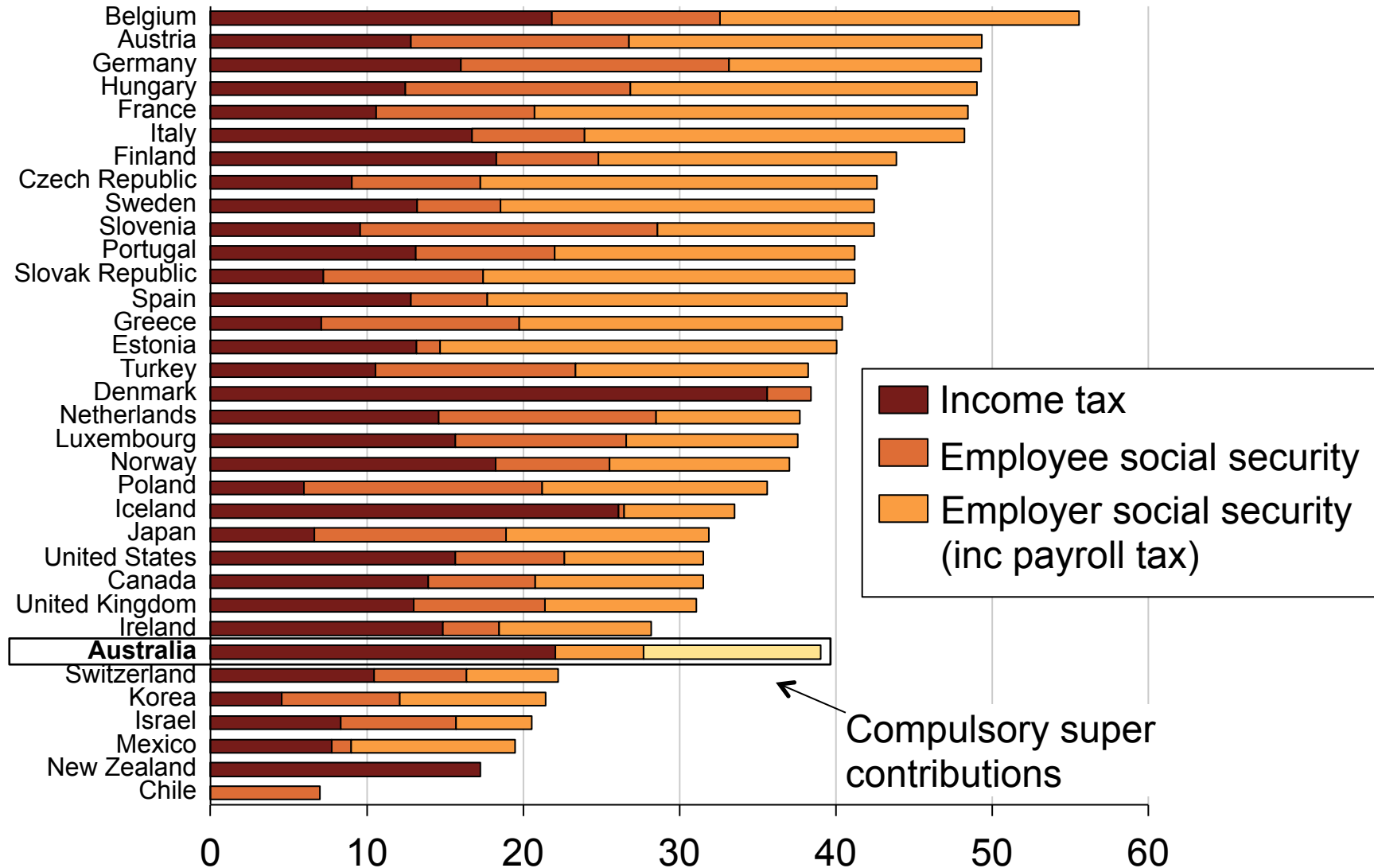
Tax mix, OECD, % of total taxation, 2012



Source: OECD

Australian labour taxes are relatively low if social security contributions are included

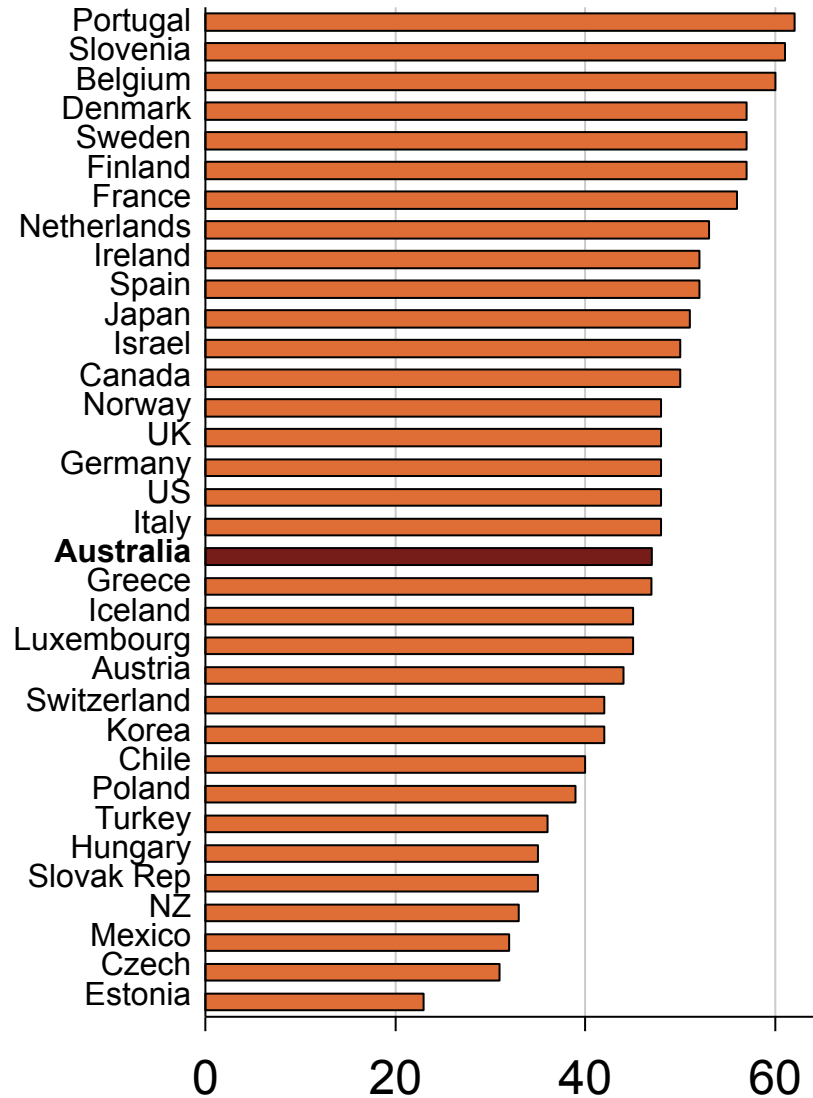
Taxes on labour costs, OECD countries, % of gross wages, 2014



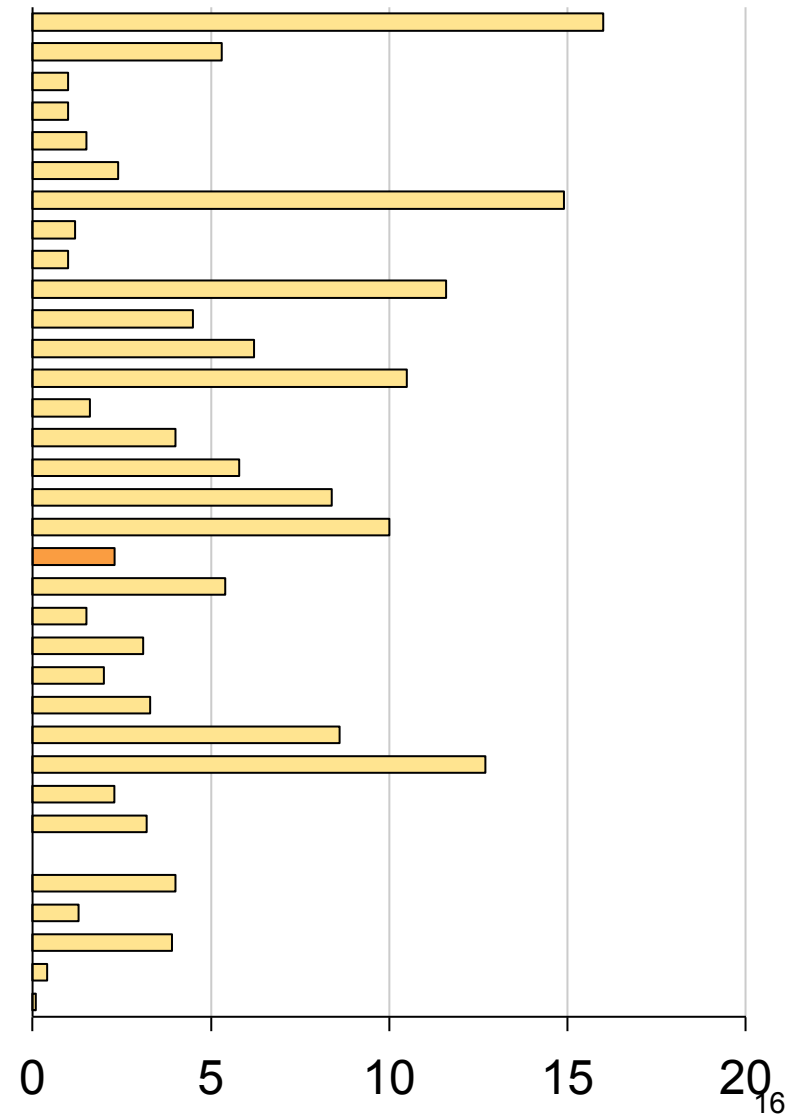
Source: OECD, *Taxing Wages 2015*

Australia's top marginal tax rate is unremarkable, although the threshold is relatively low

Top marginal tax rate, percent



Top marginal threshold, AWE multiple



Source: Treasury, *Re:think*; Grattan analysis

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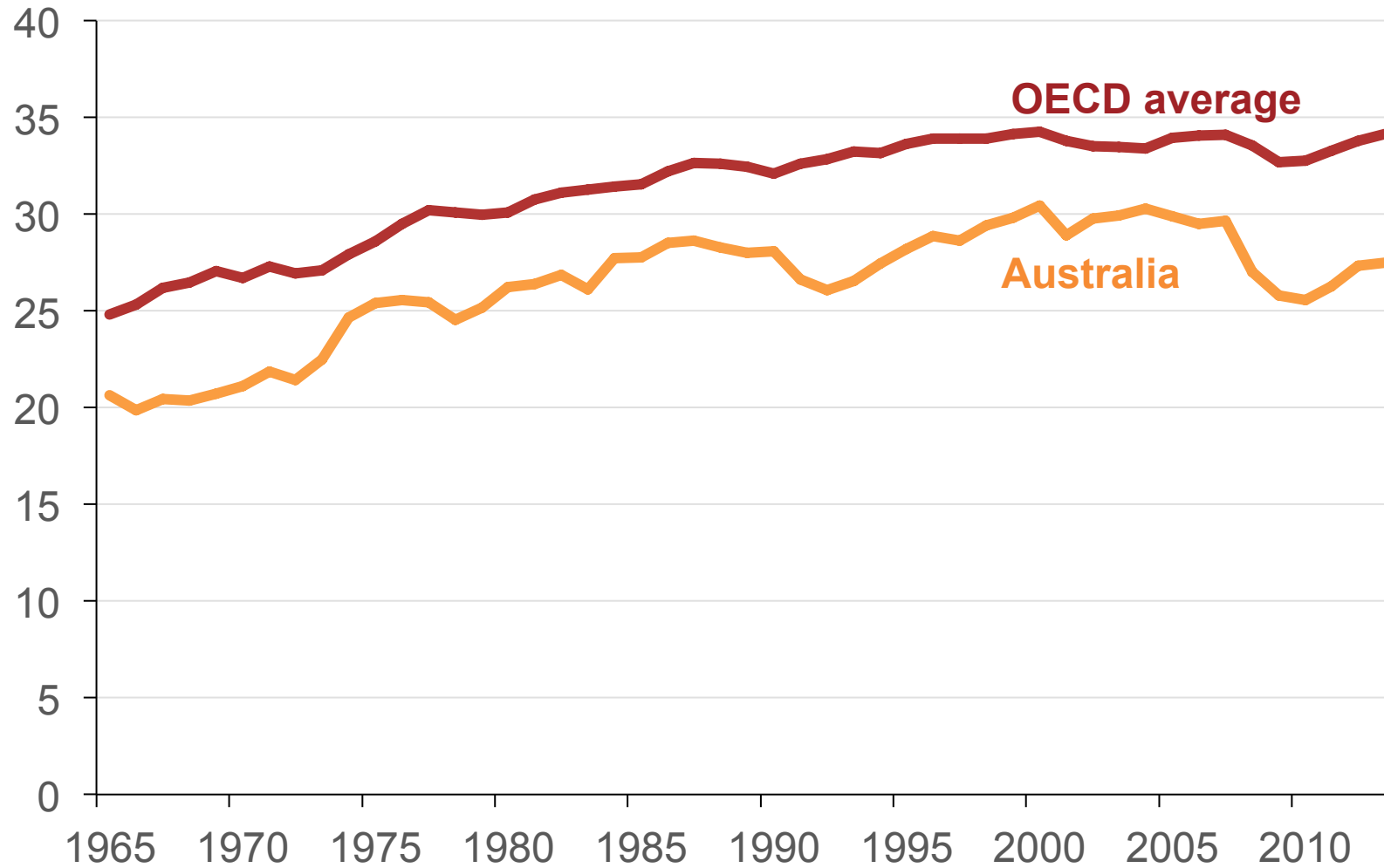
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Government has tended to grow larger across the OECD

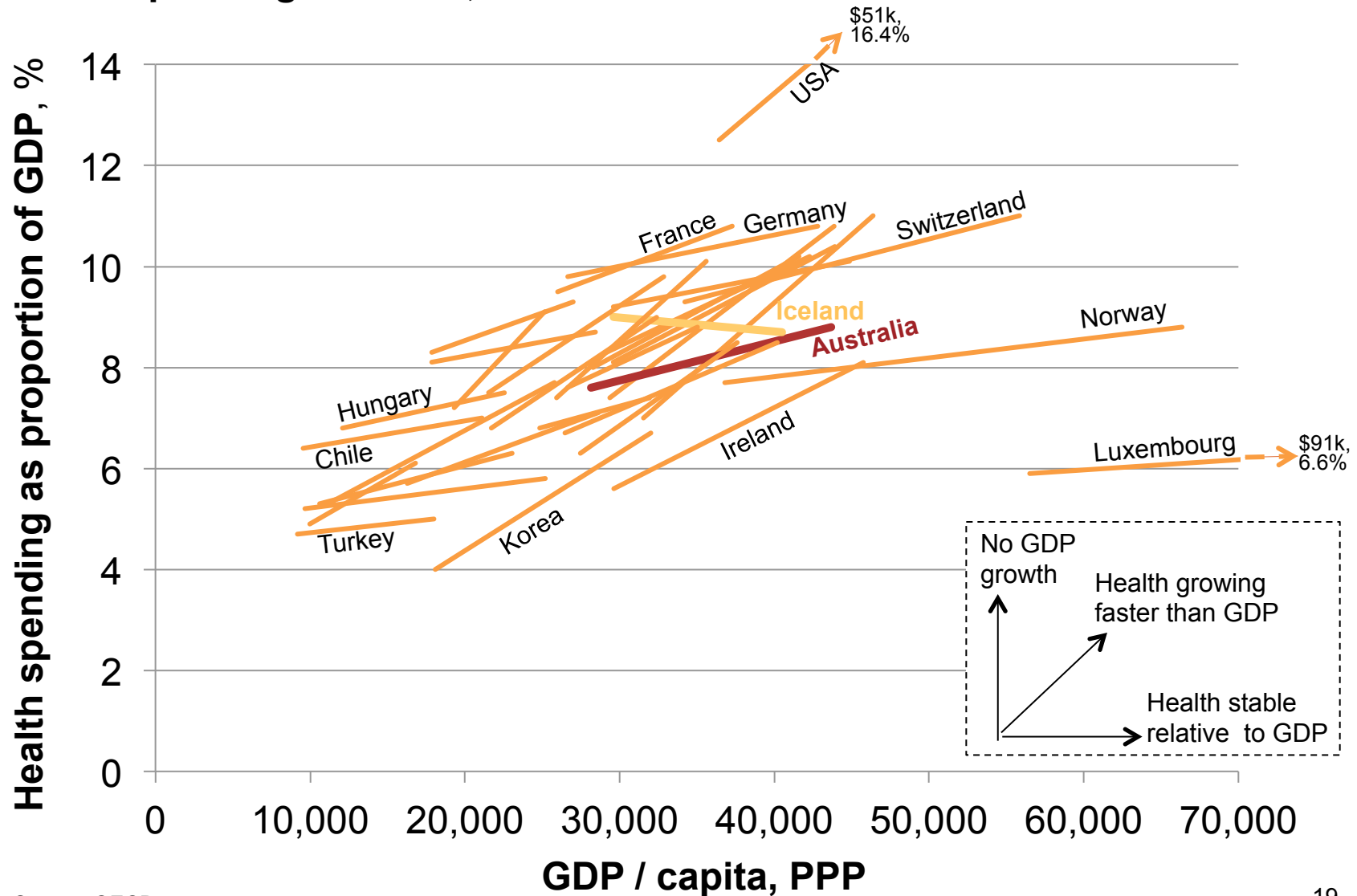
Government revenue as % of GDP over time



Source: OECD

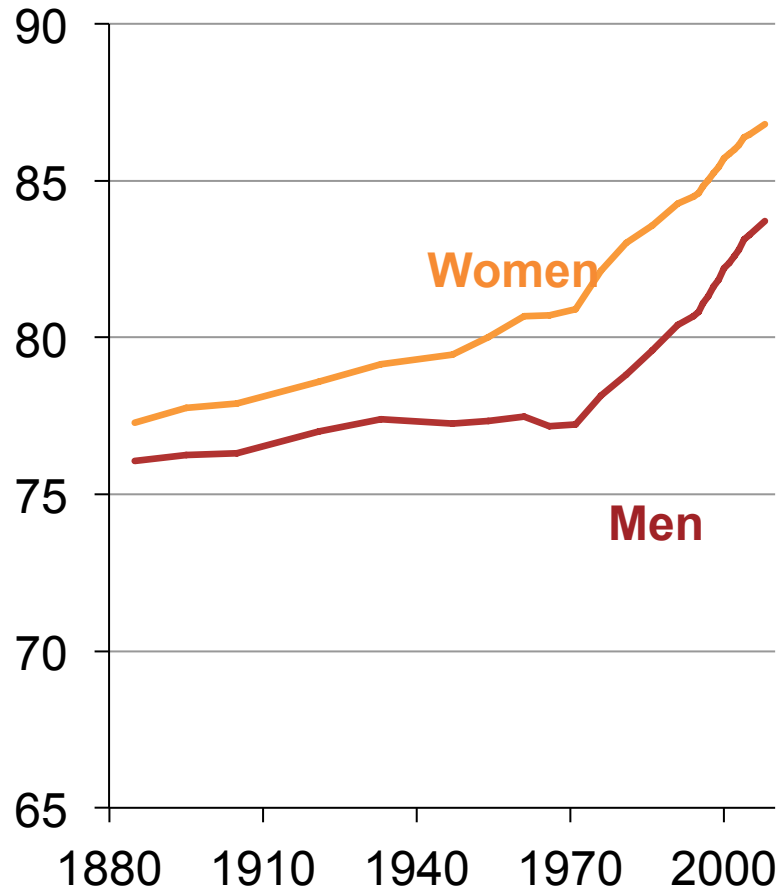
As all OECD countries got richer, they spent more on health (except Iceland)

Health spending and GDP, 2000 to 2012



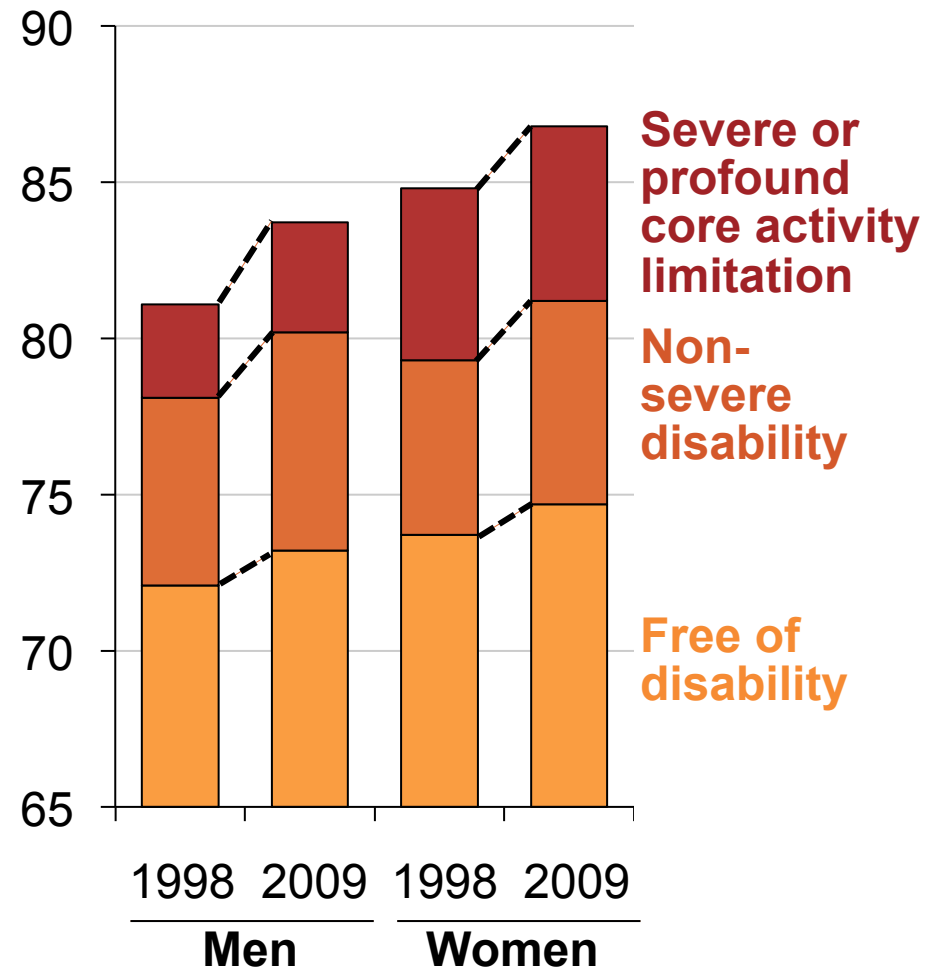
As health spending increased, life expectancy improved

Life expectancy at 65 years of age



Source: Grattan Institute analysis of ABS (2008) cat no 3105.0.65.001 Table 7.6

Expected life quality for 65-year-old years

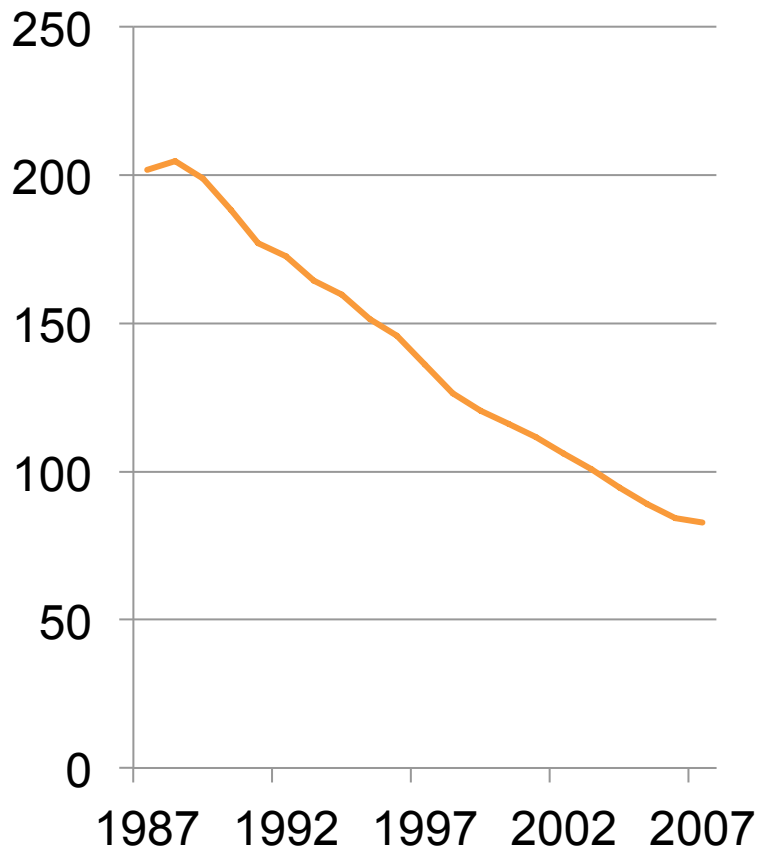


Source: AIHW (2012), Figure 13

As health spending increased, health improved

Amenable mortality

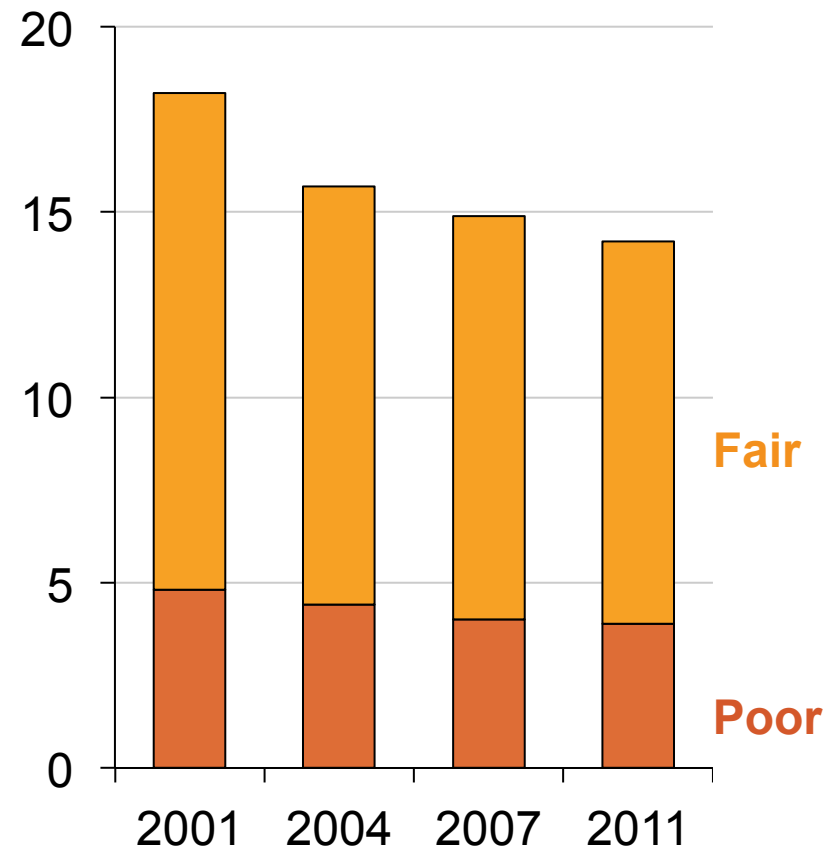
deaths per 100,000 population



Source: AIHW

Self-reported health status

Percentage of population in lowest two categories ("fair" or "poor")



Source: ABS

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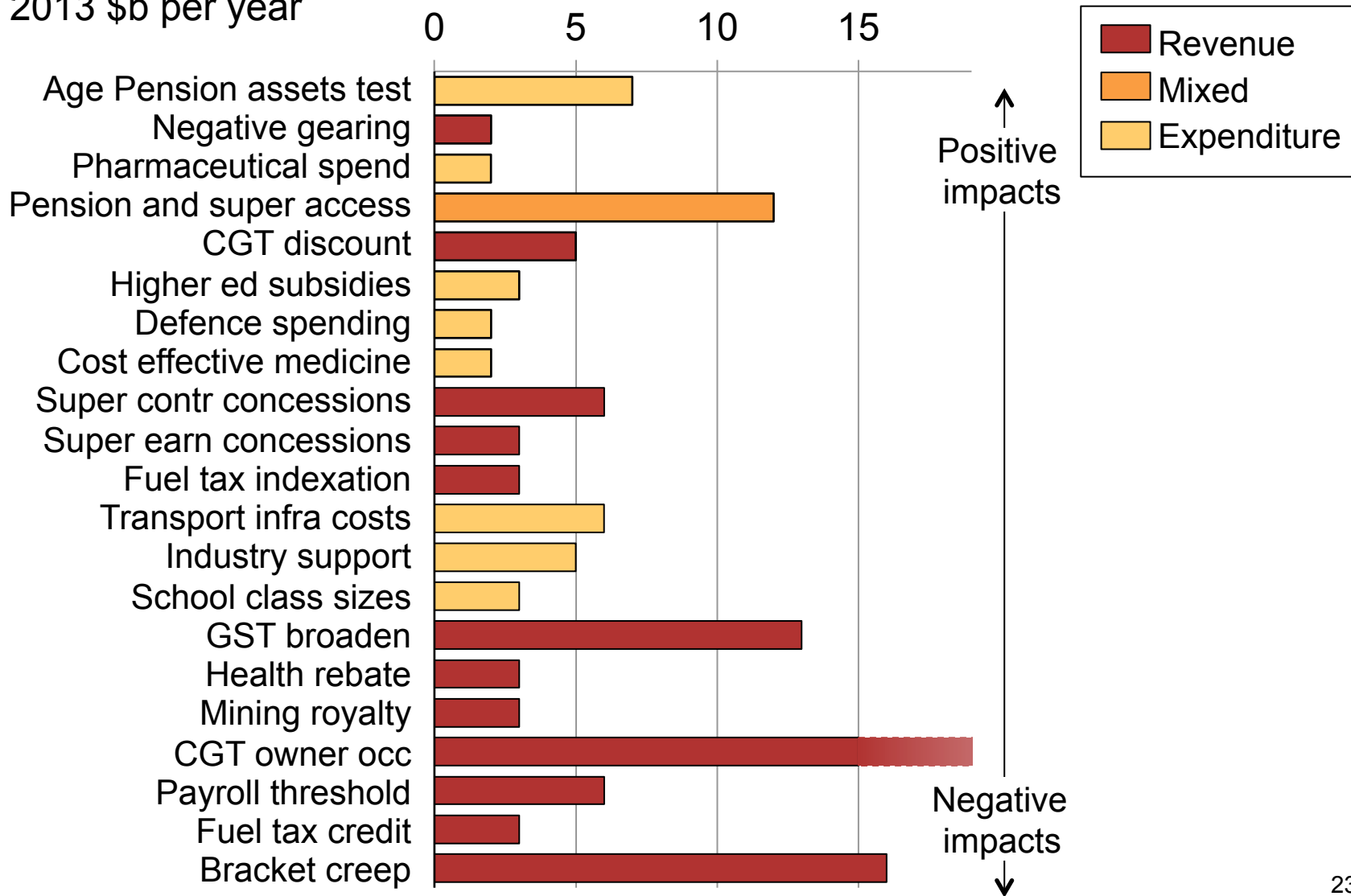
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Filling a budget hole of \$40b without revenue increases is implausible

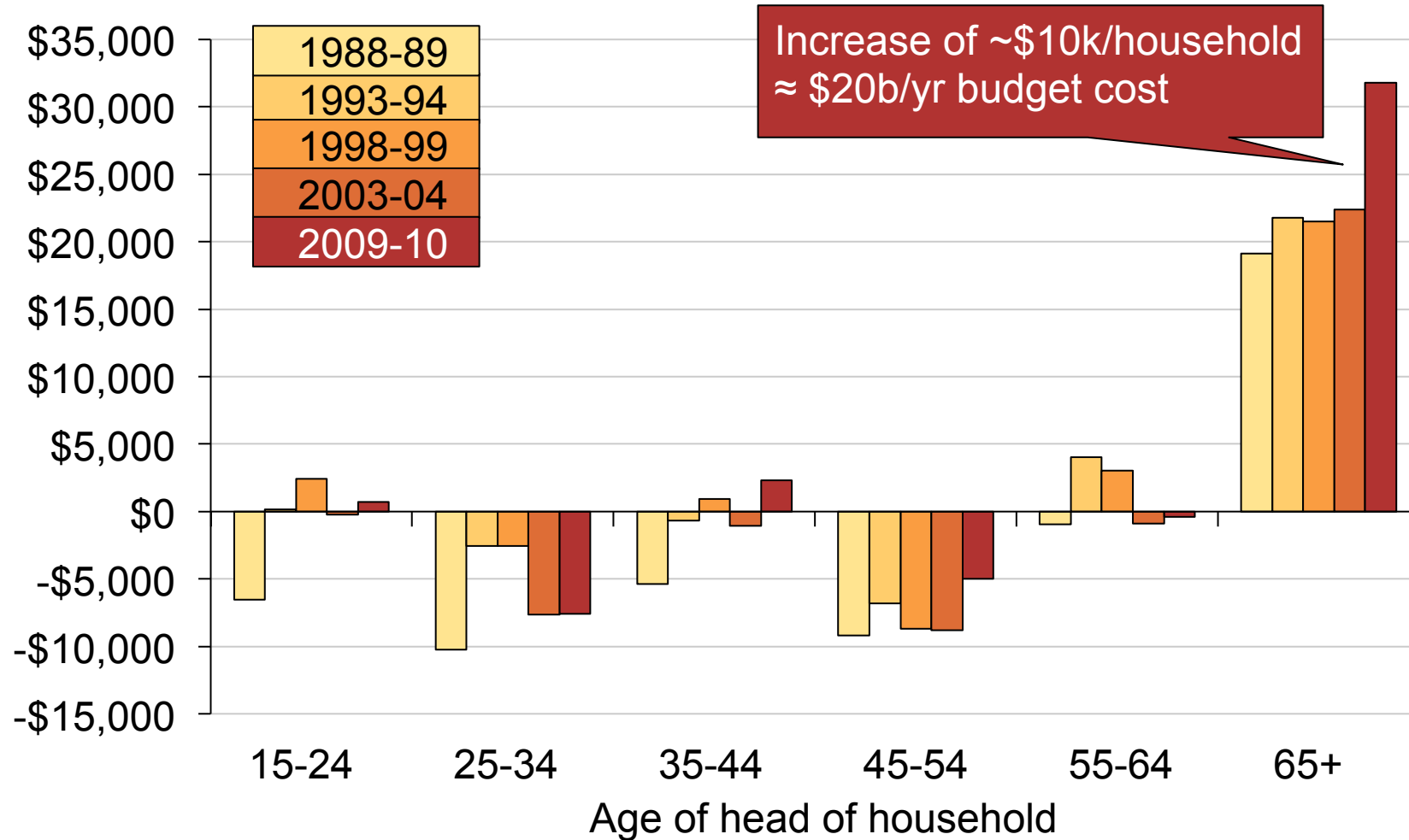
Budgetary impact of budget choices worth at least \$2b/yr
2013 \$b per year



Source: Grattan Institute, *Balancing Budgets*

Current net transfers to older households are unsustainable

Average net benefits per household (government payments, less tax)
2010\$

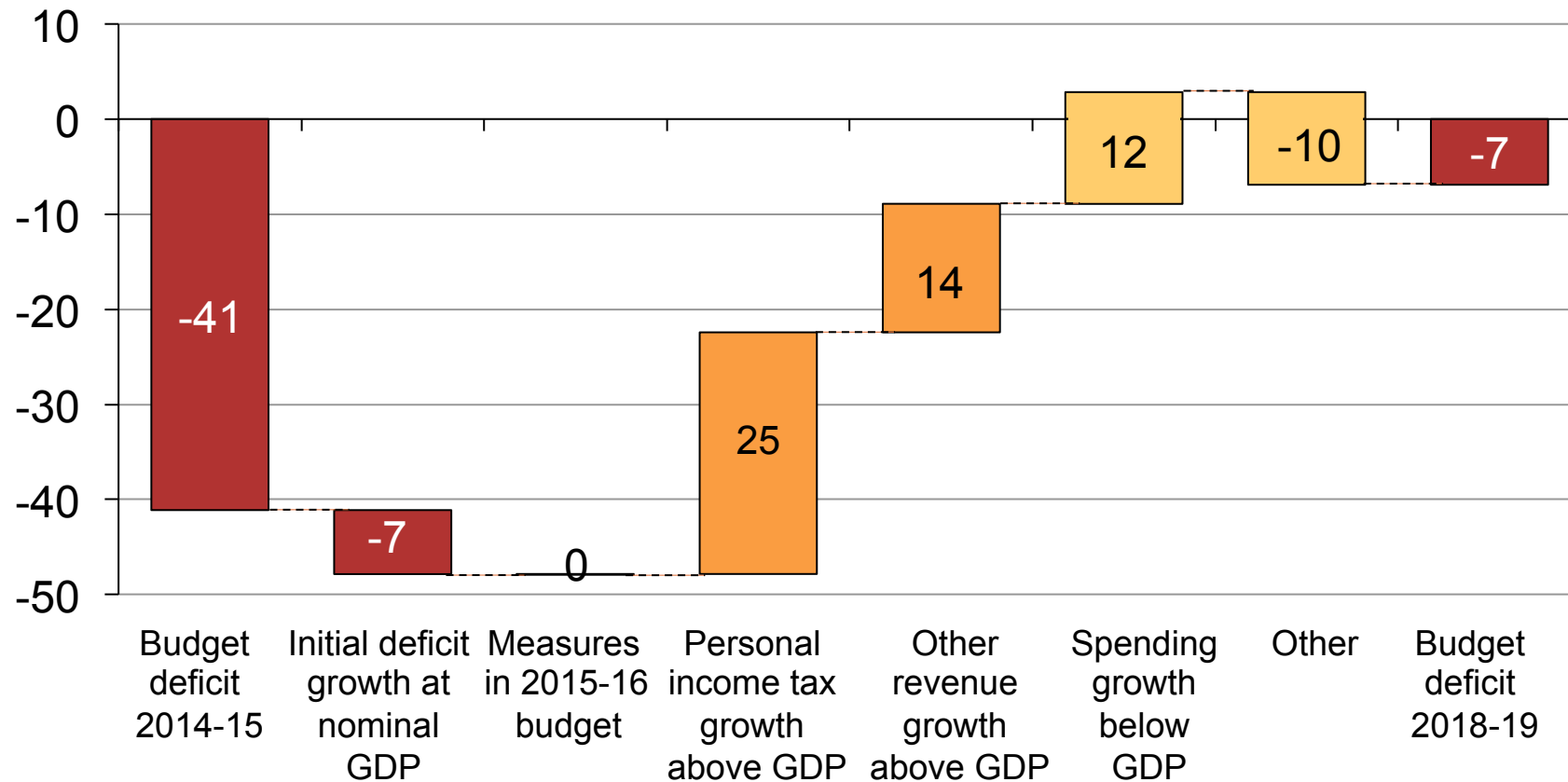


Notes: Net benefits are social assistance benefits in cash plus support in kind (such as health and education), minus income and sales taxes
Source: Grattan Institute, *The Wealth of Generations*, p.22

Budget repair mostly relies on organic increases in income taxes

Budget balance

2018-19 budget compared to 2014-15 budget, nominal \$ billion



Notes: Budget balance is the underlying cash balance from the 2015-16 Budget. Estimates for spending growth, revenue growth and personal income tax are based on forecast growth in these categories above nominal GDP. Personal income tax includes income and other withholding taxes, superannuation fund taxes and fringe benefits. Initial growth in deficit at nominal GDP shows impact on budget balance if spending and revenue had continued to grow at nominal GDP. Other is a balancing item and includes effects of parameters changes.

Source: *Commonwealth Budget Papers 2015-16*; Grattan Institute, *Fiscal challenges for Australia*