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The Intergenerational Report Should Be More Frank and Fearless about Fiscal Sustainability

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Key points

- The intergenerational report (IGR) should play an important role in disciplining decision-making in the short run to ensure it is more consistent with long-run fiscal sustainability.
- The outlook in the 2021 IGR has been negatively affected by the pandemic, mainly due to lower migration and the accumulation of debt; but, in the long run, it reflects a similar lack of fiscal sustainability to prior IGRs.
- Since the 2021 IGR was released, spending pressures in the National Disability Insurance Scheme and defence have intensified, interest rates have risen dramatically, and the government has downgraded the productivity assumption and dropped the previous cap on taxes.
- The IGR's framing around the 'three Ps' is not grounded in economics and distracts from the thing that really matters: productivity. And the economic assumptions raise the pervasive issue of there being insufficient flexibility in the scenarios considered.

- There are many measures of fiscal sustainability—regardless, while we are not in crisis, it is clear that current budget settings are unsustainable and need correction.
- The cornerstone of sound budget management is a quantifiable fiscal strategy, something eschewed in the recent budget; that needs to be rectified. Reform options on both tax and spending are needed, and have been widely discussed.
- To address the lack of innovation and influence of the IGR, and improve perceptions of its independence, it could be moved to another agency, such as the Parliamentary Budget Office or the Productivity Commission. And the same could be said of budget and economic forecasting generally.

Introduction

‘How did you go bankrupt?’

‘Two ways. Gradually, then suddenly.’

—Ernest Hemingway, *The Sun Also Rises*

After a long period of fiscal consolidation, the budget went into substantial deficit from 2008 during the global financial crisis, as was appropriate in the circumstances. Net debt—which at one point had in fact become net assets—rose sharply, albeit from a low level globally. It would take more than 10 years, until 2019, for the budget to return to balance. At which point the most significant global pandemic in a century struck, driving the budget even deeper into deficit than during the global financial crisis 12 years earlier, ratcheting up net debt even further.

Past periods of fiscal prudence and consolidation laid the bedrock upon which our effective economic response to major crises was built. But, over time, a series of decisions were made by governments of both major parties that were inconsistent with long-run fiscal balance. These include overly generous and unfunded superannuation tax concessions under the Howard government, the introduction of a near-unfunded National Disability Insurance Scheme (NDIS) under the Gillard government, and the unfunded Stage 3 tax cuts under the Turnbull and Morrison governments.

The intergenerational report (IGR) was introduced with the intention of it being a key economic institution to prevent the budget from drifting to a structurally unsustainable position. Yet the 2021 IGR reveals a significant

structural gap that has emerged in the long run between spending and revenues. Many of the longer-run secular trends that have given rise to this unsustainability have been evident in successive IGRs since the first in 2002. But they appear to have had little impact given the budget has become less sustainable over time.

A detailed examination of the latest IGR is a worthwhile exercise for better understanding the long-run sustainability of the public finances in the wake of an acute crisis and amid building pressures. This is particularly important given the recent election of a new government, which has said it understands the budget challenges it faces and wishes to start a public conversation about budget sustainability. But it is also useful for understanding how the IGR functions as an economic institution and how it might be reframed to better fulfill its promise. This is particularly important given the government plans to release a new IGR during 2023, three years early. These are the two purposes of this chapter.

The role of the intergenerational report

Just as with the people they represent, it's common for governments not to 'intertemporally optimise'—that is, they systematically take decisions today that, were they still around in future, they would come to regret.

If it's unsurprising that each citizen might behave in ways they come to regret, it should be even less surprising for governments to do so, given it is often their successors who will suffer the consequences.

To combat myopia in individual decision-making, we typically encourage financial education, financial planning and advice, or rules of thumb for personal budgeting, and even legally mandate certain behaviours. But what do we prescribe for our policymakers? What institutions do we have to discipline politicians and public officials; to encourage them to take into account how their actions will affect their successors, to overcome short-term political incentives that are counter to maximising social welfare?

Some jurisdictions employ binding constraints on behaviour, such as deficit or debt limits, to prevent a government's decisions from imposing an unacceptable burden on future citizens. Indeed, Australia had such a debt ceiling, which periodically it had to seek parliamentary approval to raise, until it was abolished by the Abbott government in 2013 (*Commonwealth Inscribed Stock Amendment Act 2013*).

The IGR represents a softer constraint. It is a legislative requirement under the *Charter of Budget Honesty Act (1998)* (Cth) and appears now to be a permanent feature of Australian politics.

Separate from being a disciplining tool, the IGR provides an opportunity for politicians seeking to behave in a time-consistent manner. Where a government decision is needed today, which would generate benefits and costs unevenly across time, the IGR could serve as a communication tool for justifying such a decision—a tool that might help citizens overcome their own present bias.

The IGR is not about gazing into a crystal ball to predict the future. As a predictive exercise—‘what will the future look like?’—it is certain to be wrong, likely wildly so. That is a futile exercise. Its purpose, rather, is to take a best guess of the sustainability of current policy settings, well before they become a serious problem. The object of interest is sustainability, not the level of GDP in 2060.

If at every point in time, current policy were adjusted so as to be sustainable according to our best guess of how it will translate into future outcomes, then we would simply rule out a set of very bad outcomes. If we were to do it often enough, there would be plenty of time to avoid bad outcomes at modest cost. If policy settings were not adjusted in response, then at least the unsustainability of current policy would be known publicly and inform debate.

The IGR should be viewed through this lens. Are current policy settings sustainable? Or do projected future outcomes indicate policy changes are required? Has the government configured the IGR to shift policy in the direction of greater time consistency? Are there changes one could make to the IGR’s format to better achieve this purpose?

In practical terms, the IGR has two functions: to provide a coherent set of projections about how demographic and economic variables are currently expected to evolve over the next 40 years; and to illustrate the implications of those projections for the federal budget under current policy settings.

In annual budgets, governments typically forecast economic and budget conditions, and the budgetary impacts of policy decisions, over the coming four years (the ‘forward estimates’). They also provide less sophisticated projections for policy and budget impacts over the coming decade (the ‘medium term’).

The IGR extends these medium-term projections to the long term. This requires modelling of the long-run evolution of demographics, based on current trends and expectations of future trends. It also requires assumptions about how policy will and will not change, based on current policy.

For example, migration is assumed to be capped in nominal rather than percentage terms (historical precedent tracking the latter), while the tax-to-GDP ratio is assumed to remain constant at 23.9 per cent (which would require explicit legislative change to achieve). So the IGR reflects a somewhat fuzzy relationship between current policy, future policy and future outcomes.

The 2021 IGR immediately justifies its existence by documenting a sharp fiscal deterioration just outside the ‘medium term’, around the mid-2030s (Commonwealth of Australia 2021:70); in contrast, according to the more recently released 2022 budget, current policy settings would appear sustainable (Commonwealth of Australia 2022). Only through the longer-term frame of the IGR does the unsustainability become apparent.

By generating a norm that the government of the day periodically considers the long-run impact of current policy settings, the hope is that the IGR generates sustainable policy. Permanent decisions, like structural spending or tax cuts, that are funded on the basis of temporary economic conditions may be politically tempting but are fiscally irresponsible—the IGR is intended to correct that time inconsistency.

Whether it actually does so depends on how clearly the issues are identified and necessary corrections explored. There have been some significant variations (and perceived levels of quality) across the five IGRs released by four separate governments across both political parties. The devil is in the detail, and the 2021 IGR is no exception.

Australia has the somewhat unusual practice of entirely non-independent economic and budget forecasting. The Treasury produces the economic and budget forecasts, but the document is ultimately authored by the treasurer and finance minister. If the treasurer wanted to be more optimistic about the economic outlook, and have that reflected in the budget forecasts, there would be nothing stopping them instructing the Treasury to that effect.

There is a degree of scrutiny of the process, via a number of channels. Some, but not all, documents are subject to Freedom of Information laws. Treasury and Finance department officials are required to attend Senate estimates

and answer questions truthfully, including those pertaining to the budget process. The Treasury and Finance secretaries are required under the Charter of Budget Honesty to release a 'Pre-Election Economic and Fiscal Outlook' (PEFO) during election campaigns (*Charter of Budget Honesty Act 1998*, Part 7), within the caretaker period, when government is administered on a semi-independent basis.

But all of these constraints are imperfect and potentially subject to influence by the government of the day. The Treasury and Finance secretaries know what the political and institutional consequences would be of a major revision to the forecasts in PEFO relative to the most recent budget, and they can never be sure which side will win the election.

In turn, the government of the day can anticipate how public servants might respond to unreasonable requests. So the equilibrium we find ourselves in might avoid the most extreme distortions to independent forecasting but nevertheless afford substantial wiggle room. Whether that is exploited is known only to those involved—but the mere appearance of potential bias is sufficient to call the process into question.

It is in this context that the IGR is produced. The document is notionally written by Treasury officials, but it is a document formally authored and released by the treasurer of the day. So, ultimately, its contents are subject to their discretion.

That very fact—even the mere perception of it—undermines the role of the IGR as a disciplining instrument. If a government introduces policy that is unsustainable but generates a short-term political benefit, what prevents it from tweaking the IGR forecasts in order to conceal that fact? How, upon reading the IGR, would one know that had occurred?

As such, it is appropriate to view the IGR sceptically, and to study closely its assumptions, and in particular their internal consistency and coherency. Are each of the assumptions defensible and, as a whole, does the document's vision of the future make sense? Do the assumptions appear to be geared towards a predetermined outcome?

The 2021 IGR

Context

The 2021 IGR was delayed a year by the pandemic, and it is impossible to view the report without considering the impact of that once-in-a-century event on the economic and budgetary outlook.

The long-run economic and fiscal outlook presented in the 2021 IGR diverges from the prior 2015 IGR mainly for two reasons, both associated with the pandemic. The first is slower population growth due to lower migration during the pandemic and a lower fertility rate. The second is permanent deficits (and an associated substantial increase in net debt) following the deterioration in the short-term fiscal position during the pandemic and the accumulation of debt and its associated interest payments (in the prior IGR, which was based on the then government's proposed policies, not existing legislated policy, surpluses were predicted for the entire 40-year projection period).

Beyond these impacts, the 2021 IGR documents a fairly rapid return to pre-pandemic trends in a range of areas. But the economic and fiscal outlook has changed significantly in the year and a half since it was released. There has been a change of government, which has brought about a number of policy changes (e.g. child care), but also changes in key assumptions affecting the outlook (e.g. productivity, see Commonwealth of Australia 2022). There has also been a far sharper increase in inflation and interest rates than anticipated at the time the 2021 IGR was published. And key spending pressures have further intensified (e.g. the NDIS). An updated IGR, which would reflect these changes, is planned for 2023 (Wright 2022).

The key message from the 2021 IGR, only strengthened since, is that the public finances are unsustainable and major policy change will be required to make them so. The problem is far from a crisis, but reforms to correct it take time so the groundwork for them ideally would already have begun. The longer this is delayed, the greater the risks in the medium term—say, if we encounter another crisis of the order of the global financial crisis or COVID-19 pandemic.

Because the budget is in structural deficit, rather than falling as a share of the economy between crises, net debt has ratcheted up since 2008. Debt levels remain below the Organisation for Economic Cooperation and

Development (OECD) average (OECD 2023), and there is no sign of our running out of ‘fiscal space’—but the brief fiscal crisis in the United Kingdom in late 2020 is a reminder of the potency of these medium-term risks (Hamilton 2022a). We should not take our ability to continue to introduce new and substantial unfunded government measures for granted.

Developments since the 2021 IGR

The two drivers of the unsustainability of the public finances in the long run, as presented in the 2021 IGR, are: (1) long-run cost pressures in areas such as health care and aged care, driven both by demographic factors (e.g. lower fertility and longer life expectancies) and non-demographic factors (e.g. cost increases); and (2) tax receipts being capped at 23.9 per cent of GDP, which prevents automatic growth in tax receipts via bracket creep to cover costs growing faster than the economy.

Long-run trends in these expenditures are covered elsewhere in this volume. But there are a number of areas in which recent (and likely future) trends suggest the outlook portrayed in the 2021 IGR is overly optimistic. In the October 2022–23 budget, while the budget position in the short term improved dramatically by virtue of higher commodity tax receipts and a more rapidly rebounding economy post-pandemic than expected, the longer-run fiscal outlook deteriorated dramatically (see Figure 3.1). Where the budget position steadily improved through the decade, it now flatlines. When these new forecasts are projected out 40 years in the 2023 IGR, the outlook can be expected to have deteriorated substantially.

This deterioration has several causes. In the budget, costs under the NDIS continue to grow at a seemingly unsustainable rate, in the order of 14 per cent per year for the federal component of NDIS costs (Commonwealth of Australia 2022). Major reform will be necessary to achieve NDIS cost growth even in line with cost growth in the broader health system. While health expenditures have grown faster in Australia than in the median OECD country, at around 5 per cent per year the rate is far below what is projected for the NDIS (Australian Institute of Health and Welfare 2019). If these faster NDIS growth projections were incorporated into the IGR, the long-run fiscal position would deteriorate dramatically.

3. THE INTERGENERATIONAL REPORT SHOULD BE MORE FRANK AND FEARLESS

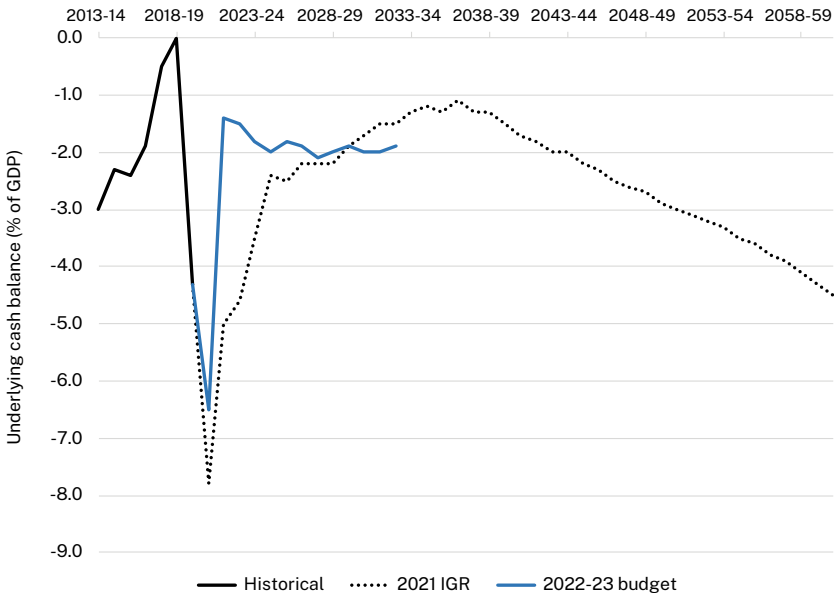


Figure 3.1: Underlying cash balance in the 2021 IGR vs 2022–23 budget.

Source: Commonwealth of Australia (2021, 2022).

In the IGR, defence spending is assumed to track the existing medium-term projections in the budget, and then to remain a constant share of nominal income. Defence spending has risen in recent years, but it seems likely to rise substantially in the years ahead, far outpacing growth in the economy (Stayner 2022). Defence spending is currently around 2 per cent of GDP and it seems conceivable that it may even grow beyond 3 per cent over the medium term. The nuclear submarine program, for example, could easily run into the many hundreds of billions of dollars.

The other major recent area of growth is in government borrowing costs. Short-term interest rates increased by around 3 percentage points during 2022 alone, compared to earlier guidance by the Reserve Bank of Australia that rates would not begin to rise until 2024. Consistent with this, the 2021 IGR did not project 10-year bond yields to begin to increase until 2025–26, and then only to converge to their long-run average rate of around 5 per cent over the subsequent 15 years. As of writing, the 10-year yield is at more than 3.5 per cent, and it's possible it could exceed 5 per cent in the next 12 months, nearly 20 years ahead of the IGR assumption (RBA 2023). This is faster even than the IGR's 'high-yield assumption', which itself would

increase the deficit by 0.6 percentage points and gross debt by 14 percentage points by 2060. The 2023 IGR can be expected to incorporate an even worse outcome for government borrowing costs.

The tax cap of 23.9 per cent of GDP, assumed in the 2021 IGR, has since been dropped by the new government. Without the cap, tax receipts rise substantially over time, but likely not fast enough to offset rapid spending growth. It's important to understand that without the tax cap, average tax rates on personal income will rise considerably for those at all income levels. And the tax mix will skew towards personal income as it is the only major tax base that grows automatically as a share of the economy over time. It is difficult to conceive of this being allowed to proceed unabated over the coming 40 years. Whether the government incorporates such a constraint into the IGR projections without a tax cap remains to be seen.

Economic assumptions

The 2021 IGR promotes the 'three Ps' narrative, in which economic growth is said to be a function of growth in each of population, participation and productivity. This 'model' may be useful to politicians, but it is of dubious value in describing how the economy works.

In the IGR, population growth is modelled, as is common, such that it causes GDP but not GDP per capita to rise over time, other than due to compositional effects. For example, if population growth occurs disproportionately via immigration among younger, more productive workers, GDP per capita will rise—but this effect really ought to be seen as operating via the 'productivity' channel. Otherwise, population has no effect on GDP per capita in this kind of model.

In reality and over a long time span (such as the 40-year period considered in the IGR), the truth is that population growth *can* raise GDP per capita via agglomeration effects. Higher density, in and of itself, can make an economy more productive—raising rates of innovation and more easily overcoming the fixed costs that constrain low-population countries like Australia. This of course relies on the necessary public investments to facilitate that greater density. One could conceive of a more sophisticated, perhaps more speculative, modelling exercise considering such a possibility—but the IGR as it stands contains no such scenario. Population is substantively irrelevant.

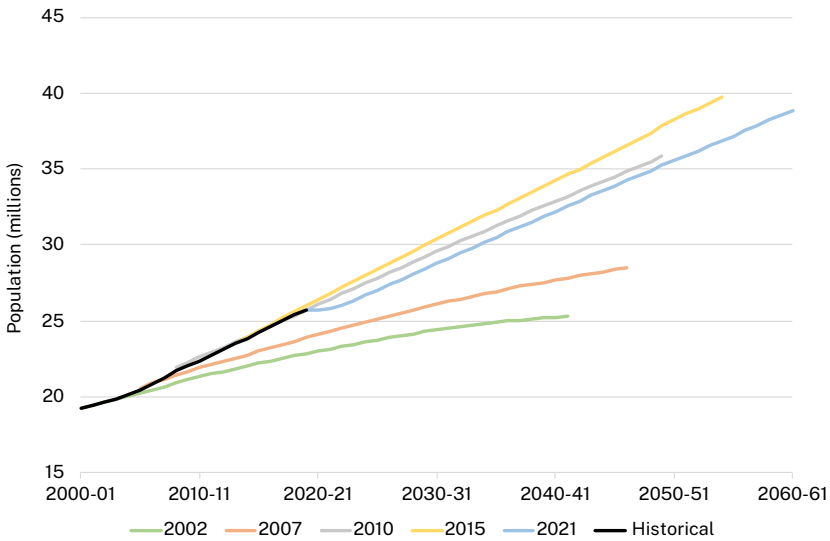


Figure 3.2: Population projections across IGRs.

Source: Commonwealth of Australia (2021).

Another major issue with the IGR is that, because the migration rate is fixed in absolute terms as a matter of policy, its central modelling scenario assumes that to be the case indefinitely, generating a reduction over time in both the migration rate and population growth rate. This is also a feature of past IGRs. The issue is that this policy is semi-regularly updated to keep the *rate* of migration at roughly a constant level over time, so past IGRs have systematically underestimated true migration and population growth rates (see Figure 3.2).

This raises a common issue applicable throughout the IGR: should it take a black-letter approach and assume the current policy or law is never changed, or should it model a more realistic scenario that reflects how policy is likely to be updated consistent with past practice? Each choice has its pros and cons; the trouble with the IGR as it stands is its inconsistency. As noted earlier, while not legislated, the 2021 IGR assumes the (former) government’s ‘policy’ to cap tax receipts at 23.9 per cent of GDP will be implemented via unspecified future changes to legislation. Despite this policy, under the status quo tax receipts would in fact inexorably rise.

Broadly, this inconsistency in approaches in defining the status quo could be resolved simply with a richer examination of scenarios. It’s worth noting that the IGR does consider an alternative scenario under which instead the migration *rate* is kept constant (implying future policy changes consistent

with past practice), though this is an *alternative*. As such, it is not explored how this more realistic future population growth scenario would interact with other more realistic assumptions (such as the low-productivity scenario). So we are missing a single scenario that incorporates all of the most likely assumptions.

The second ‘P’, participation, is similarly unfit for purpose. Participation can indeed have a big effect on GDP growth, both in absolute terms and per capita, but most of this effect is spurious. Much economic activity that is of value to people is not measured in GDP. In particular, it does not measure the value of non-market goods. On the face of it, this production need not be any less valuable than that of market goods, and yet our measurement of GDP values it as zero. As such, an economy in which we act solely to maximise GDP growth, ignoring the change in non-market production, could well be one in which *lived* living standards go backwards.

The trouble with participation as a driver of economic growth is that it mostly just swaps the unmeasured for the measured and, in so doing, radically overstates the increase in true output (formal and informal) over time. Economists are, for convenience, fond of referring to non-work time as ‘leisure’. Indeed, leisure is among the most valuable consumption goods—and yet it is tallied as economically worthless in the national accounts. Another missing category is home production. If you make dinner at home instead of eating out, the value of your time preparing the meal will not count towards GDP, though the value of the time of a professional chef who made dinner for you would have. Therefore, a trend towards eating out would raise GDP, but much of this effect would simply be an increase in what is measured.

What really matters, economically, is how productive you are at (and the enjoyment, or lack thereof, you derive from) cooking relative to the professional chef. Again, it’s not ‘participation’ per se that matters for growing living standards, but rather improvements in productivity that greater participation might enable—a kind of rhyme with the story of population growth.

This issue is particularly acute regarding female labour force participation, the true gain in living standards from which is mechanically overstated by growth statistics that place a value of zero dollars on foregone home production. The lesson is not to maximise GDP as a matter of policy, because doing so would lead us to see greater ‘participation’ as desirable in and of itself without recognising that there is something given up in exchange.

We should remember that there is such a thing as too much participation. The IGR grapples not at all with this important issue. More participation is better, it readily assumes.

Which brings us to the only one of the ‘three Ps’ that actually matters. Notwithstanding all of the issues raised above, the IGR itself shows the other two Ps are, relatively speaking, just rounding errors in terms of measured economic growth over the next 40 years. Though it has become a bit of a cliché, we should heed Nobel laureate Paul Krugman’s famous saying: ‘Productivity isn’t everything, but in the long run it is almost everything’ (Krugman 1990). The 2021 IGR’s sensitivity analysis makes clear that no assumption has a greater impact on the sustainability of the public finances than the assumed rate of productivity growth.

In the 2021 IGR, the government assumed productivity growth would return to its 30-year average of 1.5 per cent per year. This assumption was unchanged from the 2015 IGR, even though the 2010 and 2015 IGRs had both successively lowered the productivity assumption (see Figure 3.3). Critically, that period includes both the 1990s productivity boom and the 2000s mining boom. The average since the cooling of the mining boom has been a far lower 0.8 per cent per year.

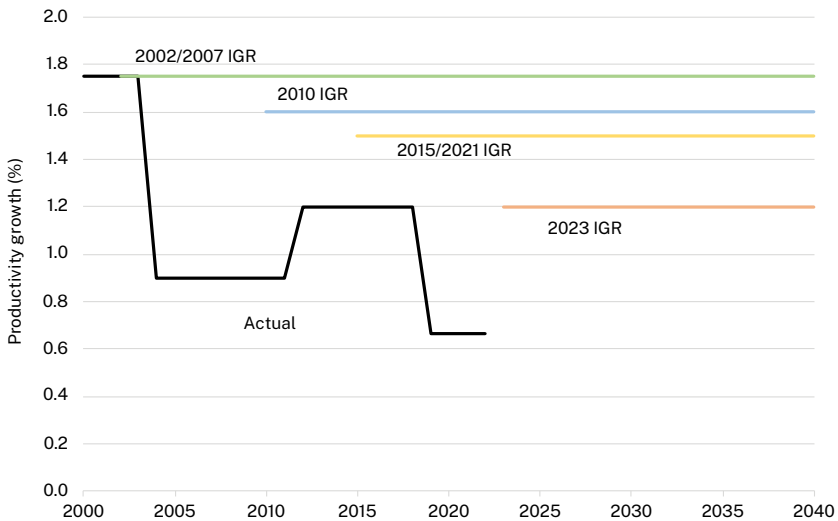


Figure 3.3: Actual vs projected productivity across IGRs.

Note: ‘Actual’ is the average labour productivity growth rate within productivity cycles defined by the Australian Bureau of Statistics.

Source: Australian Bureau of Statistics (2022); Commonwealth of Australia (2002, 2007, 2010, 2015, 2021).

The IGR's low-productivity scenario considered the average of the past 20 years of 1.2 per cent (similar to that assumed by foreign agencies like the US Congressional Budget Office), which still contains the mining boom and may thus be seen as optimistic. A 1.2 per cent productivity growth rate generates 9.5 per cent lower GDP, a 2.2 percentage-points-of-GDP higher deficit, and a 22.7 percentage-points-of-GDP higher net debt in 2060 (Commonwealth of Australia 2021:53). It matters a lot.

The central assumption was at the time clearly optimistic. The IGR itself notes most foreign-equivalent agencies had downgraded their long-run productivity assumption in light of recent history. There has been a secular decline in productivity across the world, and there is no reason to assume a reversal of that long-run trend. Indeed, an exercise such as the IGR should principally be about considering the implications of existing trends for the sustainability of the public finances. To assume, as the central scenario, an inexplicable return to the much faster growth of the past is inconsistent with this purpose. Considering a highly optimistic central scenario also precludes consideration of the implications of a future scenario significantly worse than the status quo, a critical risk management exercise.

The new government appears to concur with this judgement, as it lowered its productivity growth assumption to 1.2 per cent per year in the recent October 2022–23 budget (Commonwealth of Australia 2022). This assumption will presumably be incorporated into the 2023 IGR and enable consideration of an even-lower-productivity scenario, consistent with the pre-pandemic status quo, of 0.8 per cent per year. This would help communicate the risks to fiscal sustainability of continuing secular stagnation and highlight the importance of policy reforms that can help raise the rate of productivity growth.

Fiscal sustainability

There are a range of views among economists about what constitutes fiscal sustainability. In recent history, governments on both sides of politics have adopted a formal fiscal strategy, required under the charter, of achieving a budget surplus on average over the cycle. Such a goal would enable deficits during recessions due to countercyclical tax and fiscal policy offset by surpluses during periods of economic growth, and would see windfall gains returned to the bottom line (and unanticipated negative shocks, like a pandemic or natural disaster, detract from it).

Such a goal has nothing to say about the *level* of net debt, just that it must not be growing on average over time. There are also a range of views on the level of net debt that is sustainable. It is hard to argue with the trivial claim that there exists some maximum level of net debt that is sustainable; the only question that really matters is where does that point lie? Wherever it lies, prudent fiscal management that takes into account political constraints would prescribe stopping well short of it so as to maintain ample fiscal space for responding appropriately in a significant crisis. It's also clear a country like Australia faces a lower limit than the reserve-currency-issuing United States.

There is no suggestion Australia's current or projected level of net debt, which even in the latest, more pessimistic budget update is not forecast to exceed even one-third of GDP over the next decade, is anywhere near unsustainable. But where it was projected prior to the election to start falling over the next few years, it is now projected to continue to rise indefinitely—the very definition of unsustainable in the long run (Commonwealth of Australia 2022). At some point we will need to do something—if not now, when?

Moreover, after more than a decade since the global financial crisis, the budget only returned to balance in the year before the pandemic struck. So rather than generating surpluses in good times that draw down on net debt in order to generate capacity to finance a shortfall in the bad times, the budget position has led the level of net debt to ratchet up over time with each new crisis. This raises a legitimate question of how many additional crises we can withstand, given the strongly deteriorating fiscal position, before we run out of fiscal space—a possibility that recently brought the UK to the brink of financial crisis and beyond the brink of political crisis (Hamilton 2022a).

Prior to the recent federal election and in light of the budget pressures generated by the pandemic, the former government amended its fiscal strategy, reorienting away from an accounting-type balanced budget target to a commitment to stabilise and reduce net debt as a share of GDP over time. This reflects the fact that, as a matter of basic arithmetic, it is unnecessary to generate budget surpluses in order to shrink the level of net debt as a share of the economy over time; that is, the budget can become perfectly sustainable over time while never delivering an actual budget surplus.

This should be uncontroversial. It merely reflects a more modern conception of budget management in the economics literature focusing on the relationship between ' r ', the real rate of interest on government borrowing, and ' g ', the real rate of economic growth (Cochrane 2021). So long as $r < g$, then the economy is growing fast enough that net debt will shrink as a share of the economy over time. That is, the cost to service the debt is falling as a share of the economy, or our capacity to service our borrowing costs is improving over time.

This is a perfectly sound approach to budget management. There are some big downsides to the traditional 'balanced budget' approach—principally that governments may be constrained from responding appropriately in a crisis or might choose not to spend on or invest in things that would generate sufficient economic growth to at least partly 'pay for themselves'. Indeed, it is clear that when we were targeting balancing the budget on average over the cycle, we were 'leaving money on the table', choosing a smaller economy and lower living standards in future than was necessary to ensure fiscal sustainability.

But we must also keep in mind that the relationship between r and g , and thus the sustainability of the current level of net debt, depends on the choices we make. All other things equal, as net debt rises, the gap between r and g shrinks and eventually even flips. Poor public investments that fail to generate higher economic growth do the same. And, of course, unanticipated external shocks or emerging secular trends could well alter the relationship between r and g in ways that are beyond our control. We should not consider the current relationship to be immutable—it is no blank cheque with which to spend (or slash taxes) with abandon.

Another concern with such a benchmark is one of political economy. Perhaps the most important role of a fiscal strategy, and the targets and constraints it includes, is to discipline the government's internal decision-making. Relative to a balanced budget target, the stabilisation of net debt as a share of the economy is vaguer and more subject to forces beyond the government's control. There is something reassuringly concrete, as a means of anchoring government decision-making, about a balanced budget target. One alternative is to consider at any given time the deficit required (say, 2 per cent of GDP) to stabilise net debt as a share of the economy and enshrine that as the target instead of absolute balance.

Policy implications

The 2021 IGR tells a similar story to prior IGRs: the public finances are unsustainable. But the baseline has deteriorated considerably given the fiscal cost of the pandemic, which also worsens the long-run trajectory somewhat. And since the 2021 IGR, while things have improved in the immediate term, they have deteriorated considerably in the longer term, raising the urgency of correcting the long-run fiscal imbalance.

It seems clear the underlying cash balance needs to increase by roughly 2 percentage points of GDP on average over time—but this gap currently is expected to grow. That means the things chosen to fill that hole would need to grow too. The policy challenge is to execute a reasonably large structural fiscal consolidation in a reasonably short timeframe. That poses political risks, given that even revenue-neutral reforms have proved difficult to achieve in recent times. In this instance, we will need to take money away from people without giving them anything in return—other than a promise that the governments of their children and grandchildren more likely will be solvent.

This consolidation should begin with a clear, quantifiable fiscal strategy—a requirement under the Charter of Budget Honesty. The updated fiscal strategy in the recent 2022–23 budget was disappointing in this regard. Some of the task will be achieved via discrete policy changes, but much will be achieved gradually over time. The less disciplined is the growth in spending, the greater the discrete reform gains must be. Given the likely political cost, this doesn't seem the most sensible path forward.

The government should set a binding cap across government to keep real growth in spending to less than 2 per cent per year. And it should explicitly commit to offset any new spending with savings elsewhere. This exerts immediate pressure on growth in NDIS spending. Over time, governments of both sides at both federal and state levels have been successful in constraining the growth in health funding. That same discipline must be applied to NDIS funding in order for growth in spending overall to be contained.

Caps on real growth in spending can lead perversely to gaming of annual expenditures—seen most recently under the Gillard government. Movable spending items can be 'reprofiled' in order to sneak under the spending cap, with the budget numbers themselves becoming unmoored from reality.

Indeed, this being a mere reporting artefact is the best-case scenario—if real spending were to be gamed in response, that could involve real costs. This is unfortunately an unavoidable consequence of concrete budget rules—and not a good reason to eschew them entirely. But observers should keep this in mind when assessing outcomes against those rules.

One final point on spending, often overlooked in discussions of budget sustainability, is worth making. Over time, governments' uses of the balance sheet to pursue policy objectives have increased considerably. This has a straightforward, if cynical, explanation: it allows governments to claim a very big dollar spend to solve lots of problems at no cost to the budget bottom line. This trend is problematic for a range of reasons too extensive to discuss here. But the implication for the IGR, and fiscal sustainability broadly, is simple. The IGR should comprehensively consider the long-run impacts of and risks around these off-budget spending items, given they otherwise will fall through the cracks of the aforementioned budget rules.

While setting a spending cap, we should keep in mind that the scope for restraining (and reducing) government spending may be limited, both functionally and politically. A good share of the budget shortfall will need to be made up via increased revenue—perhaps 1.5 per cent of the required 2 per cent consolidation. Given the government has abandoned the former government's cap on tax receipts, if the new government does nothing then this part of the problem would automatically solve itself. The only federal revenue source that grows as a share of the economy, personal income tax, would close the gap via bracket creep.

But this is far from optimal. If an additional 1.5 per cent of GDP in tax revenues are to be collected, then the emphasis should be on doing so in the way that maximises social welfare. Personal income tax already accounts for a high share of federal revenues. There are alternative tax bases that collect the same amount of revenue without damaging economic output to the same degree. The need to make the budget sustainable should prompt a push to make the tax base more efficient. That means not relying on lazy bracket creep to do the budget repair job for us.

Part of the upcoming 'Stage 3' tax cuts, which flow from mid-2024, are about addressing bracket creep. The raising of the top tax threshold from \$180,000 to \$200,000, for example, doesn't come close to offsetting the wage growth experienced since 2008, the last time that threshold was adjusted. So scrapping Stage 3 entirely would be consistent with our relying

entirely on bracket creep to solve our budget problem for us. One part of those tax cuts—eliminating the 37 per cent bracket—does not move the personal income tax system in the right direction, and could be scrapped. I estimate this would save the budget around \$8 billion or 0.4 per cent of GDP a year.

Another obvious area in which both to raise revenue and improve the tax system is superannuation tax concessions. The tax treatment of superannuation is out of step with both what should be the intention of superannuation (to provide for an adequate retirement) and the tax treatment of other forms of saving. This is inefficient, inequitable and unsustainable. There are many options, but an obvious set of reforms would restore taxation of superannuation returns in the retirement phase and cap balances at \$1.7 million. This would raise in the order of \$5 billion to \$10 billion or 0.25 per cent – 0.5 per cent of GDP a year (Hamilton 2022b). (A different approach to assessing superannuation tax concessions and to superannuation reform is explored in Chapter 5's detailed study of the 2021 IGR's examination of retirement incomes.)

Those two very significant and politically contentious policy changes would together barely raise half the required revenue to close the long-run structural budget shortfall. So a conversation must be had about more substantive reforms to the way we raise revenue. This should include a discussion of the rate and base of the GST, including federal–state financial relations broadly. It could also include a discussion of the appropriate taxation of natural resources. Ideally it would even include a discussion of estate taxation and the inclusion of the family home in the pension assets test. None of these is easy—but none of the more politically viable options would be sufficient to achieve fiscal sustainability.

There are many other areas of tax reform needed, but most would either be revenue neutral (as with a more uniform treatment of capital income taxation) or revenue negative (as with a lowering of corporate income tax rates and/or permanent expensing). So it would seem prudent, as many have called for, to get the ball rolling on a new tax reform discussion that would be all-encompassing, allowing us to both improve the tax system broadly and make the budget sustainable.

Concluding remarks

The IGR has never quite fulfilled its promise. Despite successive IGRs demonstrating the long-run unsustainability of the public finances, nothing has been done in response. Indeed, major unfunded spending decisions have been made, much to the detriment of long-run fiscal sustainability. The IGR needs to do a better job of encouraging long-run fiscal sustainability.

In the context of the new treasurer's stated intention of considering a broader range of budget outcomes (embodied in the 'wellbeing budget'), it is striking that the word 'inequality' does not appear anywhere in the 2021 IGR. Inequality is an important dimension of sustainability—just ask Marie Antoinette. There exists no systematic exercise by government in Australia to consider recent trends in inequality—which are a key outcome of and consideration for the setting of policy, including budget policy—and how current settings are expected to affect inequality going forward. Concerns about inequality have gained increasing prominence among the public in recent years, but also among economic scholars. The measurement of inequality is an exciting, burgeoning area of active research. This could be leveraged in upcoming IGRs to make the document more relevant and more useful.

One way to reinvigorate the IGR and better ensure its credibility would be to remove it from Treasury (and thus the treasurer and finance minister) and place it with an alternative, independent government agency, such as the Parliamentary Budget Office or Productivity Commission. A more dramatic step, in my view warranted, would be to spin off all budget forecasting functions from Treasury, embedding them in an arms-length agency that would also handle the IGR. This is the arrangement in the United Kingdom (and in the United States via the Congressional Budget Office), and it has a lot to recommend it, for reasons discussed earlier about the credibility or lack thereof of non-independent forecasting. This may enable more creativity and innovation.

Wherever the IGR lies, the document needs to be more useful. It needs to explore a greater variety of scenarios, those scenarios need to be more realistic and be better framed in terms of current policy or most likely future policy, and all the interactions between each of the scenarios across all the assumptions need to be communicated. One way to facilitate this would be to build an online tool connected to the various underlying modelling outputs, which would take user inputs of different assumptions and different

policy options and return different results for fiscal sustainability under each of those assumptions. Ultimately, the IGR is simply a modelling exercise, but as it stands just a tiny, arbitrary fraction of the potential results from that exercise are revealed. It ought to be fully open source.

The ultimate goal is to better inform a public discussion about the sustainability of the public finances and in so doing overcome barriers to making difficult policy changes—policy changes that may involve trading off costs and benefits borne by different people at different points in time. Australia’s current fiscal position is among the strongest in the world, and yet it is clearly unsustainable. And several significant, consequential policy decisions have been made in recent years that make it even worse in full knowledge of that unsustainability. An IGR that was fit for purpose would help us overcome these challenges.

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