The Commonwealth Commission of Audit: A Review in Advance

Submission to Senate Select Committee into the Abbott Government's Commission of Audit

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Summary

1. Despite the neutral-sounding name, a Commission of Audit is not an independent assessment of public finances and the accuracy of public accounts. Rather, it is an ideological exercise with a predetermined outcome. The Commission's report should be taken as advocacy for a particular position in a continuing public debate, and responses should be assessed in the same light.

2. The Commonwealth is in a strong fiscal position. Nevertheless, it would be desirable to undertake measures to improve the budget balance, to permit some offsetting of projected bracket creep and to allow scope for desirable expansions in Commonwealth and State public expenditure.

3. There are a wide variety of options for further fiscal consolidation. The most promising involve a critical assessment of tax expenditures.

4. Current Commonwealth debt levels are conservative, suggesting that the Australian government sector as a whole may be forgoing socially valuable opportunities for investment in infrastructure.

5. Changes in public expenditure should be based on an assessment of costs and benefits rather than on a political agenda of rewarding favoured groups and punishing opponents.

6. The recommendations of the Henry Review provide a good starting point for assessing revenue options

7. Because tax expenditures are shielded, to a substantial extent, from direct scrutiny, they commonly involve substantial costs for relatively limited social benefits. A critical assessment of tax expenditures should be a primary focus of any program of fiscal consolidation

8. In general, asset sales yield no net benefit to the fiscal position of the government. Nor do they provide any capacity for investment in new assets that do not generate income

Introduction

Among the least surprising measures announced by the Abbott government after its election was the appointment of a Commission of Audit. Not only was the Commission an election commitment, the appointment of a body of this kind has been undertaken by nearly every newly-elected conservative government since 1988.

The contents of the Commission's report are similarly easy to predict in advance. Every such Commission has discovered a dire fiscal situation, attributable to the mismanagement of the outgoing Labor government, and requiring immediate action if disaster is to be avoided. Moreover, every such Commission has recommended a wide range of policy actions, largely unrelated to the problem of fiscal balance, and unmentioned before the election, consisting of 'unfinished business' from the market-oriented reform agenda that has dominated Australian politics since the 1980s.

What is less predictable is the handling of the Commission's report. If the new government is doing well in the polls, and can afford to take some risks, the report released is thunderous publicity, aimed at creating a crisis atmosphere in which severe budget cuts can be imposed. The most recent example of this kind was the Interim Report of the Queensland Commission of Audit, headed by Peter Costello, which was released by the Newman government in June 2012.

When the government's ratings are not so good, the government sits on the report, waiting for an opportune time to release it quietly, along with some market-tested spin. Following sagging approval ratings after sacking thousands of public sector workers, the Newman government chose this course of action for the Final Report of the Costello Commision.

In the worst cases, the report is suppressed altogether. Victorian Premier Ted Baillieu, whose disastrous performance would lead to his sacking by party colleagues a few months later, did not dare release the report of the Commission he had appointed on his election.

The Abbott government has taken the second approach. Announcing the appointment of the Commission in October 2013, Treasurer Joe Hockey promised an Interim Report by the end of January 2014, with a final report in March.

The Interim Report arrived in February, only two weeks late, but was not released. The Commission wound up its operations on 31 March. The government's commitments are clearly inoperative, but there has been no new public statement as to when, if at all, the Reports will be released. A series of leaks, mostly unattributed, but clearly coming from the Treasurer's office, suggest that various components of the report will be dribbled out selectively, with the final publication coming within a few weeks of the Budget, by which time all the relevant policy decisions will have been taken.

Under these conditions, it is clearly pointless to wait for the release of the Commission's report before responding to the process and its likely outcomes. This report has been prepared on the basis of past experience with the Audit Commission process, the Commission's terms of reference, and media reports based on leaks. The analysis of the fiscal and economic situation is based primarily on budget documents, up to and including the Dec 2013 MYEFO, which presumably formed the basis of the Commission's work.

1. The role and function of Commissions of Audit

The establishment of a Commission of Audit has been a routine measure for newly elected conservative governments since the election of the Greiner government in NSW in 1988. The primary stated task of these Commissions, as implied by the name, is to review the current and forecast condition of public finances and to make recommendations for improvement. In reality, however, the primary function has been to justify cuts in public expenditure and other policy changes. In most cases, these policy changes have not formed part of the platform on which the newly elected government campaigned and, in many cases, they represent a direct repudiation of election promises.

The same process has been undertaken by newly elected conservative governments in Western Australia, New South Wales and Victoria. A partial list includes

McCarrey Report (WA) 1993

VIC Commission of Audit (1993)

QLD Commission of Audit (1996)

Commonwealth – National Commission of Audit established March 1996

NSW Commission of Audit, The Curran Report (1998)

Victorian Independent Review of State Finance (Interim Report 2011, Final Report not released)

NSW Commission of Audit (2012)

Northern Territory Review of Territory's Finances (2012, yet to report)

The Queensland Commission of Audit (2012)

In every case, the result has been support for cuts in public expenditure, typically involving the repudiation of election commitments.

The presentation of these commissions as 'independent reviews' or 'audits' suggests that they are aimed at producing a disinterested and non-partisan assessment of the government's fiscal position. In reality, Commissions of Audit are political exercises. In most cases, the leading members of the committee are active in conservative politics, and the terms of reference reflect the political program of the government. The current Commonwealth Commission fits this pattern.

Summary: Despite the neutral-sounding name, a Commission of Audit is not an independent assessment of public finances and the accuracy of public accounts. Rather, it is an ideological exercise with a predetermined outcome. The Commission's report should be taken as advocacy for a particular position in a continuing public debate, and responses should be assessed in the same light.

2. The budget situation and outlook

Keynesianism and austerity

The analysis of this report will be based primarily on a 'hard Keynesian' model in which the appropriate stance of fiscal policy is assumed to be countercyclical, subject to a long-run stability constraint. The Keynesian model implies that deficits should be expanded to stimulate the economy during recessions, and offset by surpluses during periods of expansion.

The Keynesian framework may be contrasted with the idea of 'austerity' which has informed economic policy in the European Union since the emergence of sovereign debt problems in

2010. The central claims of austerity theorists (most notably Alesina with various co-authors and Reinhart and Rogoff) are

(i) rather than pursuing countercyclical fiscal policy, governments should seek at all times to target fiscal policy to the attainment of stable and sustainable ratios of public debt to GDP

(ii) sustainable debt/GDP ratios are consistent with the Maastricht accords for the establishment of the eurozone (60 per cent of GDP) while ratios in excess of 90 per cent pose serious risks

The classical perspective implies that the adoption of fiscal stimulus in response to the Global Fiscal Crisis was a mistake. On the other hand, when applied to the current fiscal position of the Australian government, it suggests that there is no cause for immediate concern, at least at the aggregate level. The ratio of public debt to GDP is far below the levels considered desirable by advocates of austerity, and current projections imply that this ratio will remain broadly stable over the next decade.

By contrast, a Keynesian perspective implies that it is desirable to aim at a budget surplus when the economy is strong in order to fund deficits during periods of recession. Conversely, this perspective implies that policies of fiscal consolidation should be relaxed during periods of economic weakness.

This report will consider both classical and Keynesian perspectives.

MYEFO

The Mid-Year Economic and Fiscal Outlook (MYEFO) projects cash balance deficits in the range 0 to 2 per cent of GDP over the medium term to 2023-24 (Chart 3.3). Since nominal GDP is projected to grow at around 5 per cent per year, this projection is consistent with a gradual decline in the ratio of net debt to GDP. MYEFO (Chart 3.5) projects that debt will peak at 16.2 per cent of GDP in 2018-19, before gradually declining.

From a classical perspective, the budget aggregates reveal no need for concern. The budget is close to balance, and the ratio of debt to GDP is far below the level at which issues of sustainability would arise. The primary concerns on this view are

* The projections assume no changes in income tax schedules and therefore imply heavy reliance on bracket creep

* The projections do not allow for unexpected expenditure requirements such as those arising from natural disasters

In addition, it may be observed that the fiscal position of state governments is generally less satisfactory than that of the Commonwealth, and that states have relatively limited room to raise additional revenue or reduce spending without cutting vital services. Hence, an expansion of Commonwealth grants to the states is highly desirable.

From a Keynesian perspective, assuming continued strong growth, it would be desirable to achieve a budget surplus, ideally of around 2 per cent of GDP. It is worth noting that this would imply a rapid decline in the ratio of net debt to GDP, which would approach zero over the medium term, and then become negative. As discussed above, it is doubtful that negative net debt is an optimal capital structure for the Commonwealth, any more than for a private business.

The Keynesian case for fiscal consolidation depends on the assumption that economic expansion will continue. Hence, this analysis should be applied in conjunction with economic forecasts at the optimistic end of the range of projections. In the event of a slowdown, the appropriate response would be both to accept the automatic decline in the budget balance arising from lower taxation receipts and to slow or defer the pursuit of discretionary measures aimed at fiscal consolidation.

Summary: The Commonwealth is in a strong fiscal position. Nevertheless, it would be desirable to undertake measures to improve the budget balance, to permit some offsetting of projected bracket creep and to allow scope for desirable expansions in Commonwealth and State public expenditure

3. Debt, assets and the balance sheet

Recent discussion of fiscal policy has focused primarily on measures of net debt. This is not, in general, the most appropriate summary statistic for a balance sheet whether for governments, corporations or households. The variables of primary interest are net worth and net financial worth.

Although these measures are fairly similar in absolute magnitude, they have radically different policy implications. Changes in net debt achieved by selling income-generating assets, for example through privatisation or sale-and-leaseback transactions have little or no impact on net worth and make little or no difference to the sustainability of the balance sheets of governments or other entities.

Whichever measure is used, the Australian government is in a much stronger position than most other governments, including those of the US and of most EU countries. MYEFO (Chart 3.5) projects that debt will peak at 16.2 per cent of GDP in 2018-19, before gradually declining. Net worth and net financial worth are projected to follow a similar trajectory.

Measures of gearing, such as the ratio of interest expenses to total income, are also of relevance in assessing the financial position of governments and other entities. Currently, net interest payments amount to around 0.7 per cent of GDP while total revenue is around 25 per cent of GDP. This is an exceptionally conservative ratio, suggestive of a lazy balance sheet in which little use is made of the Commonwealth's capacity to borrow at very low rates, both historically and in comparison to other borrowers.

By contrast, State governments have much higher levels of gearing, and face constraints on socially valuable infrastructure investment. There is a strong case for increased capital transfers to the States to permit new investment. However, it is important to note that the associated debt service requirement, while modest, would add to the task of fiscal consolidation at the Commonwealth level.

This requirement does not apply to infrastructure investments that generate a revenue flow sufficient to service the associated debt, such as ports, railways and (in the presence of appropriate pricing) roads.

Summary: Current Commonwealth debt levels are extremely conservative, suggesting that the Australian government sector as a whole may be forgoing socially valuable opportunities for investment in infrastructure.

4. Possible avenues of fiscal consolidation

Four main avenues for fiscal consolidation may be considered:

(a) Expenditure

(b) Revenue

(c) Tax expenditure

(d) Asset sales and other balance sheet measures

Expenditure

The government has implemented a range of expenditure measures presented in its election platform, notably including reductions in foreign aid. The standard role of Commissions of Audit is to argue for expenditure cuts not included (or explicitly disavowed) in the incoming governments election platform. In the absence of a report, it may be useful to examine the recommendations of the Institute of Public Affairs, a thinktank closely aligned with the government, which made a set of 75 recommendations to the government.

http://ipa.org.au/publications/2080/be-like-gough-75-radical-ideas-to-transform-australia

Broadly speaking, these recommendations reward groups and institutions associated with the government and the IPA and punish groups seen as hostile. There is, for example, a sharp contrast between measures to shut down or privatisation institutions such as CSIRO, the ABC and SBS (perennial targets of IPA criticism) and proposals to introduce special tax holidays and subsidised infrastructure projects to benefit Northern Australia. These proposals were developed in consultation with a lobby group established by Ms Gina Rinehart, the principal financial backer of the IPA and the biggest single beneficiary of the proposed measures.

It is to be hoped that the recommendations of the Commission of Audit will not display the naked rent-seeking and tribalism of the IPA proposals. However, in the absence of a transparent process, and with very limited time for debate, there is a substantial risk that any recommendations of the Commission that harm favored interest groups will be disregarded, while recommendations that harm interests seen as opposed to the government will be adopted.

Such an approach is a recipe for fiscal instability, since succeeding governments will seek to reverse changes of this kind that harm their support base, while the beneficiaries of political favoritism will expend resources seeking to maintain their privileges.

Summary: Changes in public expenditure should be based on an assessment of costs and benefits rather than on a political agenda of rewarding favored groups and punishing opponents.

Revenue

The persistence of substantial deficits after the expiry of the stimulus measures adopted in 2008 may be traced, in large measure, to the Rudd government's decision to adopt, and implement, tax cuts first proposed by the outgoing Howard government in the leadup to the 2007 election. In an atmosphere of continued low inflation, these cuts have not yet been offset by bracket creep, which, in any case, bears more heavily on low and middle income earners than on the high income groups that benefited most from the tax cuts.

The most economically responsible way of repairing this fiscal damage would be to partially rescind these tax cuts by lowering the thresholds for the top two tax brackets. However, given that this measure was not undertaken by the Labor government, it seems unlikely to be politically feasible for the current government

The other major source of revenue is the GST. An increase in GST revenue could address the problem of inadequate state revenue which is otherwise likely to lead to a need for higher Commonwealth grants than are envisaged in the forward estimates.

GST revenue could be increased either by raising the rate or broadening the base. Neither approach will be easy, given the initial agreement that any change to the rate or the base of GST requires the unanimous support of the Commonwealth and every State. Of the two, raising the rate appears less contentious, since any particular expansion of the base would hit particular groups in the community (low income earners in the case of food, private school students in the case of education, and so on). An increase to 12.5 per cent could be expected to raise around 1 per cent of GDP.

More generally, it would be desirable to revisit the recommendations of the 'Australia's future tax system' report (Henry Review 2009) which provided a comprehensive assessment of the main directions of reform for the Australian tax system. The only recommendation of the review adopted by by the Labor government was a modified form of the resource rent tax, which the current government proposes to abolish. Among the most noteworthy recommendations that should be considered are

* Expanded use of land tax

* Congestion-based pricing for road use

There are a variety of other revenue enhancement measures available to the government, such as more aggressive restrictions on tax minimisation. It seems unlikely that the Commission of Audit will provide much guidance on these matters, for which the established expertise of the Treasury and Finance departments is more relevant.

Summary: The recommendations of the Henry Review provide a good starting point for assessing revenue options

Tax expenditures

Because tax expenditures are shielded, to a substantial extent, from direct scrutiny, they commonly involve substantial costs for relatively limited social benefits. Four examples of tax expenditures are of particular importance

(i) the concessional treatment of capital gains. The 50 per cent exemption for capital gains was introduced in the 1990s, following the lead of the United States, in the hope of promoting investment in technological startup firms, many of which flourished in the bubble economy of the time before collapsing in the 2000 crash. These hopes were never realised in Australia. Instead, the concessional treatment of capital gains, in combination with unlimited deductibility of interest expenses (commonly referred to as 'negative gearing') has encouraged speculative investment in real estate.

It is important to observe that the primary problem is not with 'negative gearing'; if capital gains were fully taxed on accrual, there would be no distortion involved. Even with full taxation on realisation, the distortion associated with unlimited deductibility of interest expenses would be greatly reduced.

The other distorting effect of concessional treatment of capital gains is the creation of incentives for tax avoidance through the conversion of ordinary income into capital gains. It follows that removing this concession would increase revenue from personal income tax in general, as well as from capital gains.

Assuming that the removal of concessional treatment applied only to newly acquired assets, the initial impact would be small. However, the benefits would grow over time. In the absence of any immediate budget crisis, long-term measures of this kind are to be preferred to short-term expedients.

The Henry Review recommendation for a general reduction in the rate of tax on capital income rests on an incorrect assessment of the likely implications arising from the use of Gross Domestic Product rather than the more theoretically correct Net National Income. However, it is highly desirable that all forms of capital income be treated equally. At present interest income is overtaxed, interest expenses are oversubsidised and capital gains are undertaxed.

(ii) Tax concessions and access to government benefits for self-funded retirees. Although the issues here are complex, this is clearly the largest single area of 'middle-class welfare'. Any serious attempt at fiscal consolidation must including a close examination of the favorable treatment of this well-off group. Again the Henry Review (recommendations 18-24 should be the starting point).

(iii) Concessional FBT treatment for motor vehicles. The reinstatement of favorable FBT treatment for motor vehicles in 2013 was justified on a number of spurious grounds including

(a) benefits to the motor vehicle industry. This case was weak at the time and is now non-existent

(b) benefits to the salary packaging industry. This industry exists solely to increase the tax burdens of the majority of Australians who do not have access to tax minimisation schemes. The object of public policy should be to close it down, not to sustain it

(c) Sympathetic cases of relatively modestly-paid workers in NGOs who benefited from the concession. Such cases arise whenever any tax is increased or benefit withdrawn. NGOs reliant on these concessions could be compensated with higher direct funding that would enable them to cash out these benefits. This would cost a fraction of the value of the tax concession and would be of greater benefit to workers than a concession that can only be exploited by driving an expensive car

The Henry Review (Recommendations 6 and 7) notes a number of offsets that should be modified or abolished. Particularly noteworthy, and in direct contrast to the recommendations of the IPA is that the zone allowance should either be removed or based on contemporary notions of remoteness. The notion that life in popular tourist destinations like Cairns, Port

Douglas, Darwin and Broome is a hardship deserving of special subsidy is obsolete and indefensible.

(iv) The exclusion of owner-occupied housing from land tax. By raising house prices, the effect is to exclude new purchasers from the housing market, as has become evident with the decline in the proportion of first home buyers to 12.5 per cent of all purchases.

Summary: Because tax expenditures are shielded, to a substantial extent, from direct scrutiny, they commonly involve substantial costs for relatively limited social benefits. A critical assessment of tax expenditures should be a primary focus of any program of fiscal consolidation

Asset sales

In general, asset sales yield no net benefit to the fiscal position of the government. Nor do they provide any capacity for investment in new assets that do not generate income.

The exception is where assets have ceased to be needed or where the sale price of a government business enterprise is greater than its value in continued public ownership. Cases of the first kind can be addressed by a standard program of asset management, while cases of the second kind are rare.

In general, if privatisation is undertaken it should be done for policy reasons (for example, to promote competition in a particular market), without the illusion that there is any associated fiscal benefit.

Summary: In general, asset sales yield no net benefit to the fiscal position of the government. Nor do they provide any capacity for investment in new assets that do not generate income.

Concluding comments

In the absence of any public release of the Commission of Audit report, this review has taken the form of a response to claims and policy proposals of the kind commonly found in the reports of previous Audit Commissions and similar bodies. Contrary to claims commonly made in the aftermath of a change of government, the Commonwealth is in a strong financial position and has a variety of options for further consolidation. The most promising single avenue is a critical assessment of tax expenditures