The Case for Public Revenue

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

January 2014

Jennifer Doggett

Ian McAuley

John Menadue A.O.

Fellows of the Centre for Policy Development*

* Any opinion, findings, and conclusions or recommendations expressed in this submission are those of the authors and do not necessarily reflect the views of the Centre for Policy Development.

Summary

The Commission of Audit's brief is based on assumptions that Australia is burdened with "big government" and that taxes are an impediment to business investment and workforce participation.

There is no evidence for either assumption. The trend in Commonwealth expenditure has been downwards since the mid 1980s, falling from a peak of around 28 percent of GDP to a range of 24 to 26 percent of GDP in recent years. In comparison with similar prosperous countries Australia has one of the smallest public sectors.

The problem a body such as the Commission should address is our inadequate tax base, which is the main reason the Commonwealth has had a structural deficit for most of this century. We aren't collecting enough revenue to fund the public services needed if the economy is to thrive.

We should not shy away from raising taxes. Evidence from international comparisons and from surveys on competitiveness suggests that reasonable levels of tax do not impede countries' economic performance. In fact, countries which compete on the basis of low taxes do so to compensate for competitive weaknesses, such as inadequate infrastructure and poor standards of education – in other words impoverished public sectors.

Such evidence, however, seems hard to convey to those gripped by a zeal to cut spending and taxes. Even in a "small government"/low-tax country like Australia it is possible to find areas where private funding and provision of services can displace public funding and provision.

But such displacement is usually at high economic cost, simply to achieve an arbitrary fiscal objective. There is no point in reducing taxes if the private costs are greater than the saving in taxes, with no improvement (and in many cases a deterioration) in the services provided. We illustrate this in the case of health care funding. This is an area of significant public outlay and where, because of ongoing growth in demand, there are voices – often the voices of self-interest – calling for a shift from public to private insurance. Such a shift would be costly on all economic criteria – technical efficiency, allocative efficiency and equity.

The rushed and secretive processes of the Commission are not the path to good public policy. There may be areas where a change in the public/private mix is justified on economic grounds, but these are not one-way towards the private sector as implied in the Commission's brief. Because we already have a small public sector it is likely that a proper process, with research and consultation, would find a need for a net expansion of Australia's public sector. By shutting off that possibility those who drafted the Commission's brief are imposing a constraint which may be contrary to the community's wishes and sound economics.

Contents

1. Introduction – background to the Commission of Audit

The Terms of Reference for the Commission of Audit sets out many tasks. Among other matters the Commission is to be concerned with the "state of the Commonwealth's finances", to address "efficiency and effectiveness of government expenditure", to "identify areas or programs where Commonwealth involvement is inappropriate [or] no longer needed", and to "assess the current split of roles and responsibilities between and within the Commonwealth Government and State and Territory governments".

To gel that brief into three main themes, it is about:

- the Commonwealth's fiscal sustainability;
- the efficiency and effectiveness of government programs (in themselves two distinct issues);
- the appropriate economic role of government.

Implicit in that brief, and supported in the rhetoric surrounding the exercise, are the ideas that the Australian economy is held back by "big government", and that a policy priority has to be to reduce the burden of high taxes. In their appearance before the Senate on January 15 it was clear that the Commissioners saw their main task in fiscal terms, particularly by recommending savings in Commonwealth outlays.

That narrow fiscal interpretation of the Commission's task is understandable, because over the last few years, and particularly during the 2013 election campaign, the Commonwealth fiscal deficit and the timing of a return to surplus, have dominated the economic debate. Other economic issues have been pushed to the background, as if fiscal management is all there is to economic policy. Worse, that debate has been subject to simplifications, glossing over issues such as the distinction between net and gross debt, the difference between cash and accrual statements, the appropriateness of counter-cyclical management, the relationship between Commonwealth and state debt, and the relationship between government and private debt.

Once the assumptions that government is too big and that taxes are burdensome have taken hold, then the only logical conclusion is that the response to the problem of a sustained fiscal deficit is to cut expenditure.

In this submission we are concerned that the Commission's task is set around those two assumptions. We accept the need for public budgets to balance over the course of a business cycle, but we believe in Australia's case this should be by increasing public revenue, not by cutting expenditure. While there is always scope to improve the efficiency of public services, there is no evidence to support the assumption that Australia has unduly "big government" or high taxes. In fact in comparison with similar countries we are at the extreme of "small government" and low taxes. An economy, if it is to function efficiently, needs an appropriate mix of public and private goods, and in restricting the scope of the public sector we may be incurring unnecessary costs and forgoing economic opportunities.

In Part 2 we present evidence showing Australia's public expenditure and taxation to be very low in relation to other countries. In Part 3 we show that high taxes do not impede economic growth, provided they are spent wisely; in fact countries which use low taxes as inducements to invest do so to compensate for other competitive deficiencies. In Part 4 we show, using health funding as an example, that while funding can sometimes be shifted off-budget and on to private mechanisms, to do so often incurs high economic costs.

In this part we outline the fiscal environment within which the Commission's task is set (particularly the collapse in public revenue so far over this century), what we can infer as the economic policy of the current Government, and the limitations of the Commission's processes.

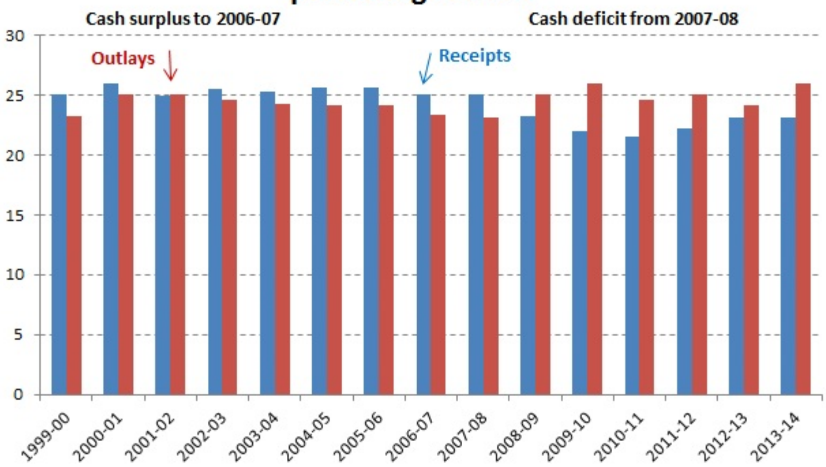
The fiscal environment – a collapse in revenue

Figure 1 shows Commonwealth receipts and spending since 2000. While there have been some recent upturns, there is no evidence of any sustained increase in spending. (In Part 2, where we look at the longer term, we point out that Commonwealth spending is trending downward, and that the 2013-14 spike is a result of spending having been pulled forward. Figures on cash outlays and receipts always need to be treated with caution.)

Fluctuations in spending are related mainly to counter-cyclical spending in response to general economic conditions. Spending peaked at 25.1 percent of GDP in response to mild downturn at the turn of the century (the "tech wreck"), and at 25.9 percent of GDP in response to the much more severe GFC.

What Figure 1 does show, however, is that there has been a slump in receipts. Although there was some stimulus spending, the Rudd Government's fiscal stimulus response to the GFC was mainly on the revenue side, rather than on expenditure. The starting point for the Commission of Audit should be more about a fall in revenue than a rise in spending, which is why its spending focus is unbalanced.

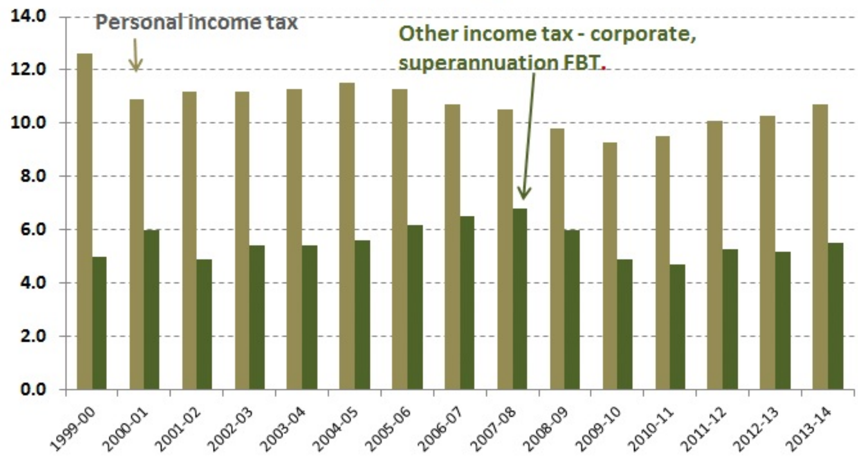
Figure 1: Commonwealth outlays and receipts as percentage of GDP



The Rudd Government's capacity to stimulate the economy in response to the GFC was helped by the previous Coalition Government having run a cash surplus for its last six years and having eliminated net public debt. This had been a period of easy revenue, as Australia experienced the investment phase of a commodity boom and rapidly rising asset prices, contributing to high receipts from company tax, GST and capital gains tax. The Coalition Government used those revenues to fund generous payments to families, tax breaks for superannuation, and cuts in personal taxes.

Figure 2 looks more specifically at the revenue side of public finance, showing how corporate tax revenue rose right up to the time of the GFC, while revenue from personal income tax fell from 2005, when the Coalition started cutting personal rates. Tax cuts continued under the Rudd-Gillard Government, but the falls in income tax receipts from 2008 were due mainly to a weakening economy in the wake of the GFC rather than cuts in tax rates.

Figure 2: Commonwealth income taxes as percentage of GDP



The consensus among economists is that the Government's largesse during the boom years was unsustainable. The Government was running a "structural deficit": under normal non-boom economic conditions, the budget would have been in deficit.

While there are some who say, out of ignorance or an opportunity to score a cheap political point, that a government should never run a deficit, most economists agree that in terms of giving a strong fiscal boost in response to the GFC the Rudd-Gillard Government acted appropriately, and it received strong support from international agencies. Some economists believe that the Government should have withdrawn the stimulus sooner. Its main shortcoming, however, was not to attend to the revenue base. The structural deficit is not the result of momentum in spending; rather it results from a tax base weakened by several rounds of taxation cuts, including expensive new tax rebates and deductions, covered in more detail in part 2.

The myth of public profligacy

In this context the brief for the Commission of Audit, and the projections laid out in the Mid Year Economic and Fiscal Outlook (MYEFO), are misdirected. They perpetuate the idea that the task of restoring a fiscal balance must be on the expenditure side, even though Australia already has among the developed world's smallest public sectors, and Commonwealth spending has been on a downward trajectory for 30 years, as will be pointed out in Part 2.

In fact, according to the World Bank, Australia also has a highly effective government, ranking 13^{th} out of 210 countries studied.[1] In other words, as pointed by Christopher Stone of the

Centre for Policy Development, Australia's government, by the standards of other prosperous countries, with a small *and* effective government, by definition has a highly efficient public sector.[2] It's reasonable to ask "what is the newly-elected Government's real concern?"

It's not that the Government is conducting a campaign of austerity, for the brief to the Commission aspires to a return to fiscal surplus by 2023-24. An austerity program would aim for a faster path, and a focus on revenue collection.

A cynic may suggest that the audit process is simply a political mechanism to discredit the previous administration, or that the Government has been captured by business interests, relishing the opportunity to profit from privatization. (The Government's appointments to key advisory roles, including to the Commission of Audit, reinforce this view.)

It is possible that the Government's political rhetoric, conveying the impression that its predecessor was a wasteful big-spending administration, is actually part of an economic strategy. There is an economic theory known as "Ricardian equivalence" (named after the nineteenth century British political economist David Ricardo). The theory has usually been used to discredit Keynesian stimulus measures, suggesting that they fail because consumers do not respond to fiscal stimulus payments. Rather, consumers hold back, because they expect that largesse from government will necessarily be followed by tax increases. The corollary is that withdrawing public spending, particularly if it is well-signalled, will stimulate people to spend, because they will be expecting future tax cuts. Ricardian equivalence rests on what is known as "rational expectations" theory – a notion that consumers are fiscally astute and calculating. Many economists question rational expectations theory and its offshoot Ricardian equivalence, because consumers are not as rationally calculating as assumed in the theory.[3]

It's hard to ascertain the present Government's economic policy. It has not articulated any clear set of policy principles and has created confusion with initiatives that seem to conflict with one another: some of its measures are market-friendly, while others are paternalistic and interventionist. But rhetoric about Australia being "open for business" and suggestions that the previous Government was a profligate high-taxing-high-spending administration leading us to record levels of debt fits with Ricardian equivalence theory. The message is that we can all be confident to start spending again now that we have rid ourselves of incompetent government. Impressions count, even if they don't match reality.

The Commission's process – too broad, too secretive and too short

Even if we have one of the world's most efficient governments, it is inevitable that in a $400 billion enterprise there will be some areas of waste and some opportunities to improve technical efficiency, in line with the Commission's brief. But in the Commission's time frame – appointment in late October 2013, with reports required by the end of January and March 2014 – all that is possible, even with the utmost diligence, is superficial consideration of complex problems.

Apart from improvements in technical efficiency, larger apparent savings could result from abandoning certain programs, pruning some severely, and transferring others to the private sector. But the guiding rule for the private-public division in Australia, particularly following the reforms of the 1980s, has been to apply strong market failure tests to justify the retention of government programs. While it is unlikely that the Commission will find many areas where cuts are economically justified, there is the possibility that they will take insufficient consideration of the economic reasons for maintaining or increasing public funding and provision of services.

The Commission's truncated process contrasts with the more thorough process adopted by the Productivity Commission, which researches specific issues, produces discussion papers, gives parties time to prepare considered submissions, holds public hearings (where complexities are exposed and where unintended consequences of superficially attractive proposals are revealed), and which issues draft reports.

When it comes to consideration of the whole of government, the task is daunting in comparison with the specific tasks assigned to the Productivity Commission and the Australian National Audit Office.

Risks – untested assumptions and misunderstandings

There are high risks in such a truncated process. One is that recommendations will be based on a commonly held but untested assumption that the public sector is intrinsically inefficient and that "without question" shifting activity to the private sector is the path to greater efficiency.[4]

There are indeed areas of waste and inefficiency in public service delivery, but because we reasonably subject the public sector to high standards of accountability, audit and parliamentary scrutiny, we are more aware of them than of similar problems in the private sector. (In Part 4, where we present health care as a case study, we reveal the huge bureaucratic cost associated with private health insurance.) Also, the public sector is often left with the tasks the private sector doesn't want and will therefore always look "inefficient" at a cursory glance – providing remote area postal services, operating 24/7 hospital emergency departments, providing education for children with special needs, and a host of other worthwhile functions. As Herman Leonard of the Harvard Business School says "The hard jobs are left to the public sector".

Instances of real waste and inefficiency in the public sector, revealed in some studies, generally concern poor labour productivity, resulting from either restrictive work practices and featherbedding, or from under-capitalization. In many state-owned enterprises, particularly power and water utilities, under-capitalization results from governments taking too much as dividends at the expense of retained earnings. And there is often poor governance and management when board and management appointments are used as forms of political patronage.

Such findings, however, do not establish a case for privatization. Rather, they establish a case for reform. Privatization of government enterprises is generally a lazy and costly substitute for reform.

In particular, when a natural monopoly is privatized it remains a natural monopoly, and there remains the economic problem of ensuring it is not abusing market power through over-pricing or under-providing and that it is not slipping into technical inefficiency (the economic costs of monopolisation). If governments do not regulate, or regulate weakly, these economic costs remain. Vigorous regulation may be necessary to ensure that the community's economic interests are not displaced by commercial interests, but that can require the government regulator having to run a virtual mirror management, with significant costs in duplication, investigation and negotiation.

Sometimes waste in public administration can result from misguided attempts to cut public expenditure. Professionals Australia, a body representing engineers and architects, claims that a shortage of engineers in the public service who can scope, design and deliver projects, is costing $6 to $7 billion a year in terms of mismanagement.[5] This shortage of analytical skills in the public service is confirmed by a 2012 study by Tim Roxburgh for the Centre for Policy Development and by a 2010 study chaired by Terry Moran, then Head of the Department of Prime Minister and Cabinet.[6,7] While the ranks of public servants providing secretarial services to ministers seem to have stayed intact, privatization and ongoing staff cuts seem to have reduced the ranks of public servants with on-the-ground experience and the analytical skills necessary to manage government projects responsibly.

Another risk with a rushed process is misinterpretation of available data, or guidance by inappropriate criteria. For example, a former Finance Minister said:

> I'm always concerned as Finance Minister if government business enterprises incur losses. In general terms, that's one of the reasons why, in principle, it's not necessarily a good idea for governments to own businesses.[8]

Profit is a reasonable indicator of efficiency in a firm in a competitive private market, but in a government enterprise it can be an indicator of over-pricing in a monopoly situation, while a loss can be a sign that it is performing an economically important function from which the private sector cannot make a profit; that's the essence of market failure. The decision-rule implied in the former minister's statement is 180 degrees wrong – if a government enterprise is making a profit in a competitive market it probably should be privatized, and if it is making a loss, in spite of good operating efficiency, it probably should be retained in the public sector.

A related risk is that government enterprises operating in areas of natural monopoly will be privatized and broken up, in a naive belief that competition is *always* preferable to monopoly. (In Part 4 we deal with this risk specifically in the context of health insurance.) For example the Keating Government, obsessed with competition, allowed Telstra and Optus to string parallel cables along the streets, delivering pay TV to well-serviced areas and leaving others unserviced.[9] Similarly there is no evidence that breaking up electricity retailing into competing "suppliers" (in reality competing commission agents all selling exactly the same product) has conferred any benefits on consumers.

We are not trying to single out one particular finance minister or one prime minister for economic naivety, but we are warning that the economics of the public sector are complex, and it is not reasonable to expect the Commissioners to deal with these complexities across the whole Commonwealth (and, in areas of overlap with the states) in a five month period.

Finally, there is the risk that the Commission will do no more than to re-state some well-known problems, without considering the pathway to their resolution. The 1996 Commission of Audit made several recommendations around the perennial problems of duplication, overlap and conflict in Commonwealth-state relations. In the intervening 18 years both Coalition and Labor Governments have worked on these issues, with limited success. That is not to say that the exercise is futile, but it is to point out that it is not amenable to fast resolution. Gary Banks, former Chair of the Productivity Commission, explaining the success of the difficult reforms of the 1980s said:

> Acceptance that reform was needed did not come about overnight. It emerged over time, with mounting awareness of the costs of the status quo and the potential gains from doing something about them. This in turn resulted from research and evidence on the deficiencies of existing policies, and deliberate efforts to communicate that information to the community.[10]

If the recommendations of the Commission are seen to result from a rushed process, or one dominated by partisan prejudices, they are unlikely to survive the processes of political scrutiny. Even those which make it through to enacted legislation may survive only for one electoral cycle. A textbook case study is the 25 percent tariff cut made by the Whitlam Government, which was made in such haste and with so little consultation tariff reform was off the table for the next ten years.

The greatest risk of poor recommendations, however, comes from an assumption, held in many quarters, that Australia suffers the burdens of high taxes and "big government", an assumption we turn to in the next section.

2. Economic theory – the case for government

For an economy to operate at its full potential it needs an appropriate mixture of private and public goods.[11]

Private and public goods are not substitutes; rather they complement each other. To illustrate, an automobile – a private good – provides its owner with little utility unless there is a network of publicly-provided roads and a set of rules governing use of those roads.

We gain benefits ("welfare" in the language of economists) from a balance of public and private goods. We know the consequences when the balance is too far in the direction of collective provision, as it was in the centrally-planned economies of the Soviet Union and its satellites. At the other extreme are "failed states" where government is weak or absent.

There is an optimum mix, defined in conventional economic texts:

> If the amount of a public good can be varied continuously, the optimal quantity to produce is that quantity for which the marginal cost of the last unit is just equal to the sum of the prices all consumers would be willing to pay for that unit.[12]

That's the normal economic criterion for an optimum allocation in private or public markets. To take two important examples, we may want the government to provide more education and health care, and may be willing to pay for those services through our taxes. If a government ignores these preferences, and in the name of an ideology of "smaller government" paternalistically suppresses spending on those services, we lose out, in the same way as we would if a government forced us to pay for public goods of little or no benefit. Those who pursue a "small government" ideology emphasize the latter costs, but they seldom mention the former.

It is possible, through opinion surveys, to detect areas where there is a clear community desire for greater public provision and a corresponding willingness to pay, particularly when there is a strong link between taxes and benefits. In Australia surveys generally find a strong desire for more public expenditure on health care and education, matched with a willingness to pay higher taxes for them. Other areas of desired expansion of public expenditure generally include transport and environmental protection.[13]

It is not possible, however, to make a categorical statement that an economy should comprise X percent private goods and (100 – X) percent public goods. In a seminal paper in 1954 Paul Samuelson pointed out that while there is such an optimum, the determination of preferences makes that optimum impossible to find.[14] Different people want different public goods – A wants national parks, B wants public schools, C wants neither. Those who state, for example, that public expenditure should be constrained to a certain level, or that the public sector must be pruned, have no justifiable basis for such dogma.

The Commission's one-sided brief

The Commission has an asymmetric brief. It has:

> ... a broad remit to examine the scope for efficiency and productivity improvements across all areas of Commonwealth expenditure, and to make recommendations to achieve savings sufficient to deliver a surplus of 1 per cent of GDP prior to 2023-24.

That brief is about meeting a long term fiscal target through cutting expenditure, rather than raising revenue.

While it is quite reasonable to expose waste and inefficiencies in public service delivery, it does not follow that the response should be to cut expenditure. That would be the appropriate response only if we were already providing an optimum set of public services, and could cut expenditure without reducing output. If there are unmet needs for more public goods, then improvements in efficiency should be devoted to greater outputs.

The notion that in Australia we are already providing an adequate level of public goods, or that we are over-providing public goods (revealed in language such as "big government", "tax burden", "crowding out") has no basis in fact or theory. As pointed out above, determination of the optimum public-private mix is elusive, but in terms of the "size" of government, Australia has one of the smallest public sectors of all developed countries. In terms of our public-private balance Australia tends to stand apart from other prosperous countries.

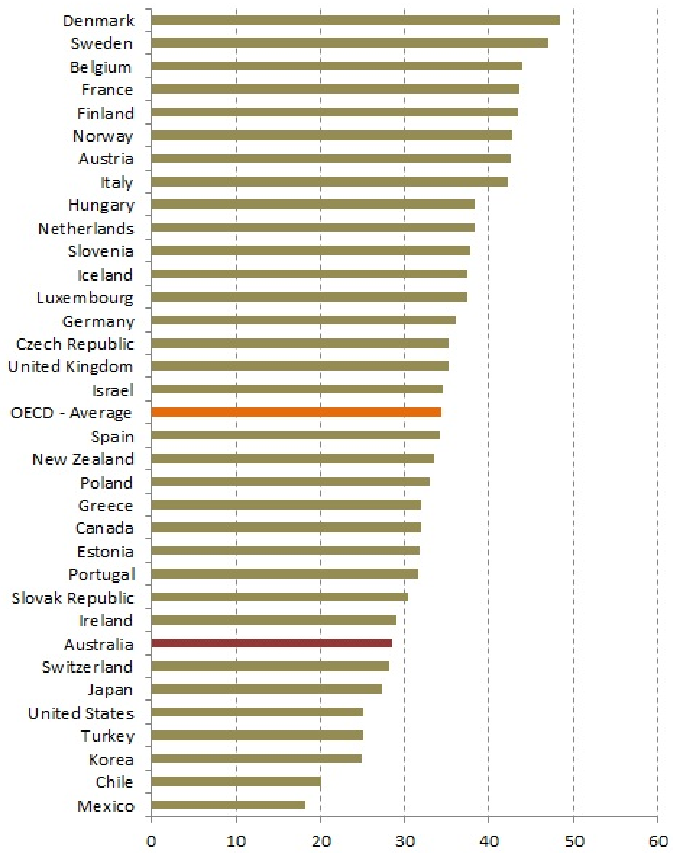
There is no one measure of the "size" of government, but different measures (expenditure, taxes, regulatory reach) tend to correlate. Public expenditure as a percentage of GDP is one measure, but it has been influenced in recent times by the effect of temporary fiscal stimuli associated with the GFC and its aftermath, and in any case measures of public expenditure are difficult to compare across countries, because of different accounting treatments of government business entities.

Rather than relying on expenditure, we have used taxation as a percentage of GDP as an indicator of the economic size of government, and in order to smooth out short-term fluctuations, have taken the average over the ten years to 2011 – the latest OECD data available. Because, over the long run, public expenditure must be matched with public revenue, public revenue gives an indication of the long term sustainable size of public expenditure for most countries. (Taxation revenue does not include non-tax revenue, which is generally a significant item only in countries with large nationalized industries.)

In any case, this submission is specifically about the Commission of Audit, and its de-facto assumption that expenditure reductions, rather than taxation increases, are to be used to fill the projected budget gap. In this submission we focus on the need to increase taxes.

Figure 3, drawn from the OECD database, shows Australia's

Figure 3: Taxes as a percentage of GDP -- OECD Countries Average 2002-2011

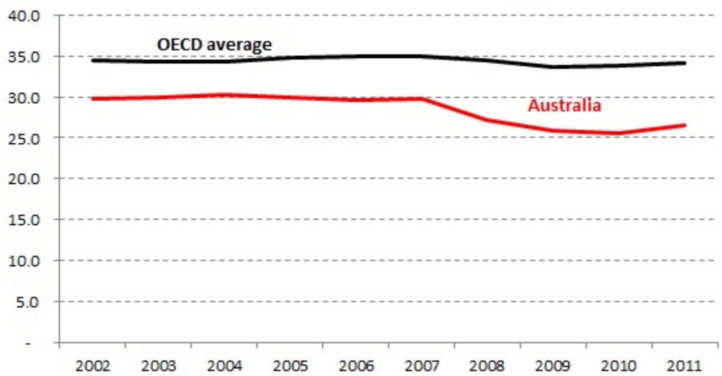


taxation as a percentage of GDP (consolidating taxes collected by all tiers of government) in comparison with other OECD countries. Although the Commission's brief relates specifically to Commonwealth revenue and expenditure, because of the interrelationship of Commonwealth and state finances through revenue sharing and joint programs, and references to issues of Commonwealth-state duplication, the Commission will have to take the fiscal policies of all tiers of government into consideration, and international comparisons are irrelevant unless such a consolidation is made.

With taxes at 28 percent of GDP Australia's taxes are well below the OECD average of 34 percent. Among countries with comparative levels of income, only Switzerland, Japan and the USA have lower taxes, and these figures need qualification, for Japan and the USA have both been running high budget deficits over those years – much higher than Australia's. Were the USA to be raising enough tax to reduce its budget deficit to Australia's level, its level of taxes would be higher than ours.[15] Also the USA and Switzerland both rely heavily on private health insurance – compulsory in the case of Switzerland, and, until this year, largely employer-financed through enterprise agreements in the USA. When private health insurance is compulsory or near-compulsory it is essentially a privatized tax, but it doesn't appear in national accounts as a "tax". (We cover private health insurance more specifically in Part 4.) In Australia compulsory superannuation comes closest to a privatized tax – most other OECD countries have social security taxes.[16] With a compulsory component of around 5 percent of GDP, however, it's lower than compulsory health insurance in the USA and Switzerland.[17]

Not only do we stand apart from similar countries; we are also heading in a different direction, because while other countries have been holding taxes more or less constant, we have been reducing taxes, as shown in Figure 4. Notably, with the exception of the USA, those countries with lower average taxes than Australia over this period have been increasing taxes, while we have been reducing taxes.

Figure 4: Taxes as a percentage of GDP -- Australia and OECD average



A longer-term perspective on public expenditure

Over the longer term, however, all developed countries, including Australia, have been increasing taxes and expenditure. There is a view, given a veneer of academic respectability by a theory known as "public choice", that governments, by virtue of their power to raise taxes, have a natural tendency to grow, and must therefore be curtailed. That theory was embraced with great enthusiasm by the Thatcher and Reagan Governments for example, and still has following among many Australian politicians. Public choice theory is implied in the language of the Commission's brief that the Commonwealth should "live within its means", as if it is some irresponsible spendthrift.

A more compelling explanation of the growth in government is in terms of the conventional economics of diminishing utility. For at least the last 200 years, thanks to industrialization, new technologies, and globalization, there have been dramatic falls in the real prices of most manufactured goods.[18] Cheaper appliances, cars, communications and clothing have all contributed to an improvement in living standards. On the other hand, some public goods, most notably education, health care and policing, are intrinsically labour-intensive. All have benefited from the adoption of new technologies, but because human services are essential to their production, they cannot show the same cost reductions as private goods. As we approach satiation in private goods, it is natural that we should seek greater expenditure on public goods to achieve the same standard of satisfaction.[19]

Another explanation is more mechanical, in that in order to sustain government services, such as education, health care, defence, policing etc, known to economists as government "own purpose" expenditure, governments have had to increase taxes because government "transfers", such as age pensions and unemployment benefits (payments made by governments to individuals but which the recipients are free to use as they wish) have grown. An ageing population is one reason such payments have grown. Another is that globalization and the opening of domestic markets to greater competition have increased the need for transfers in order to compensate for widening income disparities.[20]

In Australia's case, tariff protection and measures such as retail price maintenance, although they came at a high cost in terms of economic growth, were able to keep unemployment low and income disparities withing reasonable bounds, but following the opening of the economy in the 1980s we have had to increase transfer payments to stop disparities becoming too wide. The recently-released Parliamentary Budget Office analysis of Commonwealth spending over this century so far points out how the category "social security and welfare" has been the biggest contributor to recent Commonwealth spending growth.[21]

This growth in personal transfers has been a long-term trend in Australia and in other democracies. Because of complications in aggregating Commonwealth, state and local government expenditures, and some definitional issues around the margin (is an unpaid HECS loan a "transfer" or a government expenditure on education"?) we don't have neat set of consolidated government accounts, but from national accounts we do have a record of social security transfers to households and government "own purpose" expenditure.

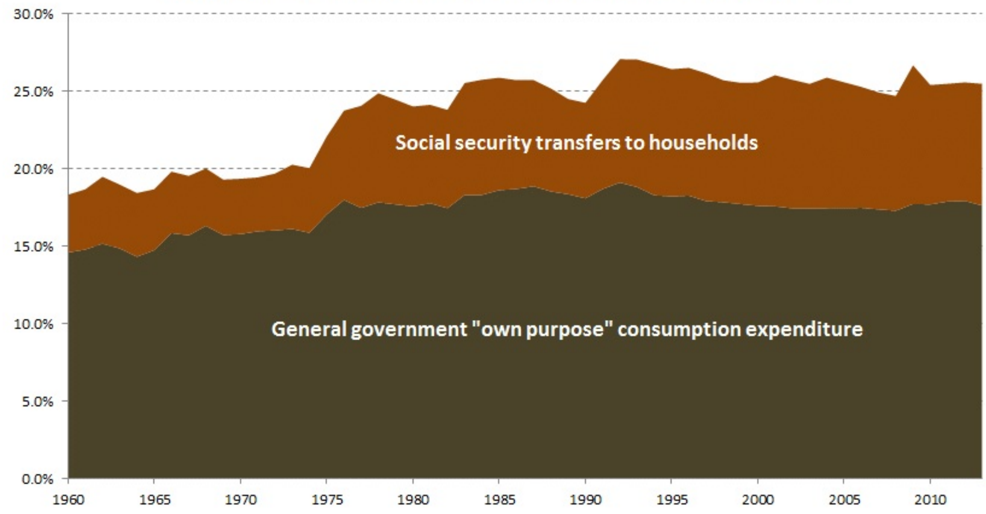
Over 1960 to 2013 (the period of ABS consistent data in national accounts), while social security payments to households have risen from 3.7 percent to 7.8 percent of GDP – more than doubling – government "own purpose" expenditure has risen more modestly – from 14.6 percent to 17.6 percent of GDP, and has been on a downward trend since around 1990. Social security transfers, such as pensions, are tending to crowd out government services such as education, health care, defence and all other "in kind" services. It's a distinction rarely made by critics of "big government". These trends are shown in Figure 5.

It is notable that while the trend in social security transfers is upwards, expenditure rises sharply at times of economic downturns – reflecting the effect of "automatic stabilizers" and of some specific interventions, such as the spike in 2009 when the Commonwealth made a payment of $900 to every taxpayer.

Also notable is the reversal in the trend of government "own purpose" expenditure since 1987, when it reached 18.8 percent of GDP, before the Hawke-Keating Government applied tight fiscal and monetary policy. It fell to a low of 17.3 percent of GDP in the last years of the

Howard-Costello administration, before recovering a little under the Rudd-Gillard Government, reaching 17.6 percent of GDP.

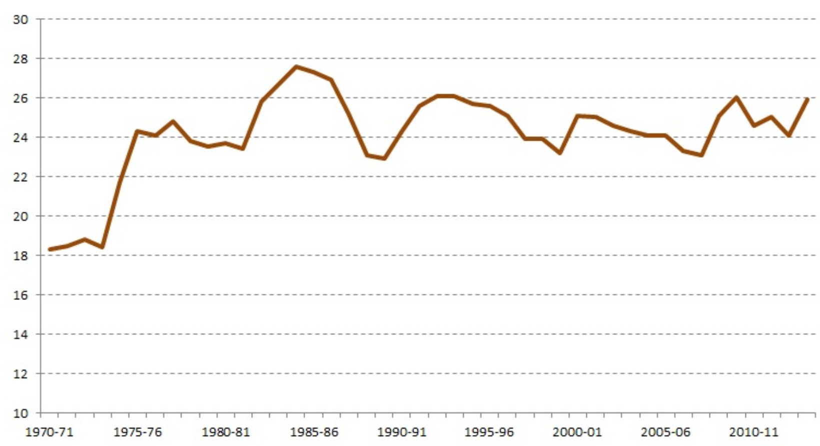
Figure 5: Government Expenditure as percentage of GDP



There is no expenditure problem

The important point, of relevance to those scrutinizing the Commission of Audit process, is that the myth that the task of this Government is to compensate for the extravagances of recent times does not hold, for there has been no great increase in the government "own purpose" expenditure, which is still below its level of 25 years ago. While Figure 3 shows all government expenditure – Commonwealth, state and local – Figure 6, taken from the latest MYEFO updates, shows Commonwealth outlays since 1970-71.

Figure 6 -- Commonwealth outlays, percent of GDP -- 1970-71 to 2013-14



If anything, Commonwealth outlays have been trending downwards since the mid 1980s, when the momentum of rapidly rising expenditure was halted. The general pattern has been for sharp rises when business conditions downturn, and for a steady fall as conditions improve. The 2009-10 peak in response to the GFC at 26.0 percent of GDP was only 0.9 percent of GDP higher than the previous peak of 25.1 percent of GDP, in response to the mild "tech wreck" downturn around the turn of the century, and was well below the peak of the early 1980s of 27.6 percent of GDP.

The upturn at the end of the graph for the current year (2013-14) is an estimate based on MYEFO data. It should be noted that it includes a capital injection of $8.8 billion to the Reserve Bank made by the newly-elected Coalition Government. This equates to about 0.5 percent of GDP. Many economists suggest that this injection, which may be needed in future years, was premature, and was made simply for cosmetic reasons – to establish a high base for comparison with projected expenditure reductions. The MYEFO projections show Commonwealth outlays falling back to 25.0 percent of GDP by 2016-17.

That is not to say the Rudd-Gillard Government could not have done better. As pointed out in Part 1 it inherited from its predecessor a significant budgetary structural deficit, resulting from diversion of revenue to middle class welfare (generous family allowances, private health insurance rebates), cuts in personal taxes, and large tax concessions for superannuation.[22] Taxes forgone as a result of rebates and deductions, such as superannuation, are known as “tax expenditures”. As estimated by the MYEFO, tax expenditures amount to around 8 percent of GDP, the main ones being superannuation and capital gains tax exemption on owner-occupied housing (both around 2 percent of GDP).

The Rudd-Gillard Government made some minor changes to superannuation and private health insurance rebates. It introduced a carbon tax, but offset it with a “compensation” package, and severely watered down the Henry Review’s Mineral Resource Rent Tax. These measures were half-hearted. Otherwise it passed on to the Abbott-Hockey Government the same structural deficit it had inherited from the previous Coalition Government.

Because of the likelihood of subdued economic growth and rising unemployment over the next few years, as the investment and high-price phase of the commodity cycle winds back – confirmed in the MYEFO economic forecasts – there is likely to be more demand for personal transfers.

That means that, if the budget is to brought back to balance with expenditure cuts, these cuts have to be in government ”own purpose” expenditure, which has been on a downward trend since 1987. We have been on an almost continuous path of cutting government services such as education, infrastructure and other economic services. Only in health care has public expenditure been rising, which means other services have been even more squeezed, a point to which we return in Part 4.

But we do have a revenue problem

Without a radical and disruptive change in tax arrangements, the Commonwealth is likely to remain the dominant source of taxation. It collects 81 percent of all taxes. States’ capacity to raise taxes is limited: for example, their capacity to raise payroll taxes, their biggest revenue source after the GST, will be constrained in a period of slow economic growth. Therefore Commonwealth policy will be the prime determinant of our tax revenue.

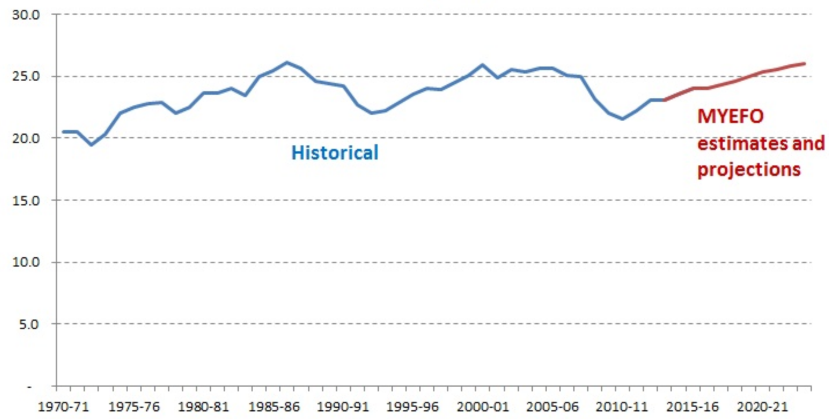
The MYEFO in fact specifically rules out income tax increases, with the claim “the heavy lifting to achieve a surplus must come through expenditure restraint as a rising personal income tax burden would also have negative impacts on workforce participation.” (That statement on workforce participation is not backed with any specific evidence, however.)

A rise in GST was ruled out in the pre-election period, when, in a leaders' debate, Prime Minister Rudd challenged Opposition Leader Abbott on the GST, and Abbott ruled it out, presumptuously qualifying that the promise would hold for an Abbott Government's "first term". Company tax rises are unlikely, unless the Government's generous parental leave proposals make it through the Senate, and even if they do the revenue would be earmarked. The Government has ruled out changing superannuation rules (apart from the low income contribution), even though projections in the MYEFO suggest that superannuation tax expenditures are to rise from 2.1 percent of GDP in 2012-13 to 2.9 percent of GDP by 2016-17.[23]

The Coalition Government's initial moves, subject to Senate compliance, have been to weaken the taxation base further. The carbon tax and the minerals tax are to go and the previous Government's proposals to reduce tax concessions for high wealth retirees and to close rorts in fringe benefit taxes have been dropped.

In the MYEFO, however, is a heroic assumption that Commonwealth revenue will rise – with this projection shown in Figure 7. The only explanation provided is that "bracket creep" – the way inflation causes real income tax collection to rise if brackets are fixed in nominal terms – will help increase tax collections, but this is unconvincing.

Figure 7: Commonwealth Revenue as percentage of GDP - historical and projections



In fact the Commonwealth itself doesn't seem to be too convinced of the rise in tax revenue, for the MYEFO acknowledges that "there is notable uncertainty around receipt forecasts and that this uncertainty increases over the estimates period".

Forecasting revenue is just plain difficult. It is dependent on many variables, ranging from the decisions of the Chinese Government through to the state of consumer sentiment, with a host of intervening variables – inflation, the exchange rate, the unemployment rate, corporate profits, and, for this Government, an unpredictable Senate. The previous Government didn't get its forecasts right, and there is no reason why this one should do any better.

Improving the tax base – missed opportunities

One of the early initiatives of the Rudd Government was to commission a review of taxation by the Head of Treasury, Dr Ken Henry. The terms of reference were wide-ranging and open, with one exception, the GST, which was ruled out. Because of the interaction of state and Commonwealth taxes, taxes collected by all tiers of government were to be considered.

The Henry Review reported to the Treasurer in late 2009, and the Government released it, along with its decisions, in May 2010. The timing is significant, for the GFC hit the Australian economy in late 2008, and in May 2010 a federal election was due.

The Review made 138 recommendations, ranging from detailed administrative matters through to major changes. While it recommended a reduction in company tax, it also recommended several significant tax increases, including, most notably, a 40 percent resource rent tax on mining companies, a significant simplification of personal taxation (a threshold of $25 000 and a uniform rate of 35 percent for 97 percent of taxpayers), improvements in capital gains tax collection, more consistent alcohol taxes, road user charges to replace state motoring taxes (once the technology allowed), re-introduction of indexation of fuel taxes (abolished by the Howard Government in 2001), a land tax to replace real-estate transaction taxes, tighter asset testing for benefits, and consideration of wider tax reforms, such as a tax on wealth transfers. Its general approach was a consolidation and rationalization of taxes – to reduce distortions in the tax system and to reduce the number of taxes collected while improving the effectiveness of those taxes which remained.

The Government's response was timid. Most recommendations likely to cause pain to particular constituents were rejected. Although the Government could say it rejected only 20 of the Review's 138 recommendations, these rejections included most of the politically difficult (but revenue-rich) recommendations.[24] The only significant tax to survive the Government's initial announcement was the resource rent tax, and between May and the election in August that was severely weakened. After the election the only significant new tax was the carbon tax. The Government did, however, make some changes in the spirit of the Henry Review, such as more generous depreciation allowances for small businesses (proposed to be reversed by the current Government) and a significant increase in the tax-free threshold.

The Rudd-Gillard Government, in fact, continued with the previous Government's policy of cutting personal taxes, including for those with high incomes. In 2005 a taxpayer with twice the average earnings of all wage and salary earners – an income which would be typical for a well-paid professional – faced a marginal tax rate of 47 percent.[25] In 2006 the Howard Government reduced the marginal rate for such a taxpayer to 40 percent, in 2009 the Rudd Government reduced it to 38 percent, and in 2010 reduced it further to 37 percent. The Gillard Government continued with tax cuts, aiming at very low incomes, when it raised the tax-free threshold from $6 000 to $18 200.

Political realists, excusing the Rudd-Gillard Government for its weak action on taxes, suggest that a government managing during an incipient recession and with an election on the horizon cannot raise taxes. Political realists also point out that the preceding Government, managing during a boom and with good polling, has no reason to raise taxes. The conclusion from this logic is that there is *never* a time to raise taxes.

Yet there are possibilities, and governments do raise taxes without costly political consequences. The Howard Government's GST is the strongest case in point. People are accepting of taxes if they can see clear links to desired benefits, which is why levies such as the Medicare Levy and occasional levies, such as that used to compensate Queensland flood victims, are politically acceptable.

Raising the GST has been the subject of bipartisan avoidance. One political problem with the GST is that while the Commonwealth would bear the political costs, states would enjoy the political benefits.

The economic objection to raising the GST is that consumption taxes are regressive – much more regressive than income taxes. But that's a limited view. Because the GST goes to states, and states are responsible for schools and hospitals (accounting for around half their expenditure), the net redistributive benefits of a higher GST may be positive because education, health care and some other state services are progressive in their distribution.[26] Also, GST collects revenues from those who presently pay no income tax – "self-funded" retirees and visitors.

At 7.3 percent of GDP, our consumption taxes are low by OECD standards. The average for OECD countries is 11.0 percent of GDP, and the Nordic countries, which certainly cannot be accused of neglecting social equity, have consumption taxes collecting between 11.8 percent of GDP (Norway) up to 15.2 percent of GDP (Denmark).

In this submission we are not advocating any specific tax changes. Just as we do not believe a five month Commission of Audit process can do justice to complex issues in public revenue, so too do we believe that a general submission based on a short period of research should be cautious about making specific proposals. But if the Government is to proceed with its promised tax review, we suggest it should be at least as broad as the Henry Review, not rule out any specific taxes, and not be framed in a way that presupposes a need for reduced taxation.

We need to be improving the taxation base, rather than relying on assumptions that the present taxes will deliver adequate public revenue. It is already established that our taxes are low by international standards. Is there any evidence to suggest higher taxes would be detrimental to our economic performance? Have those countries which have raised and sustained high taxes suffered economically as a result? We address those questions in the next section.

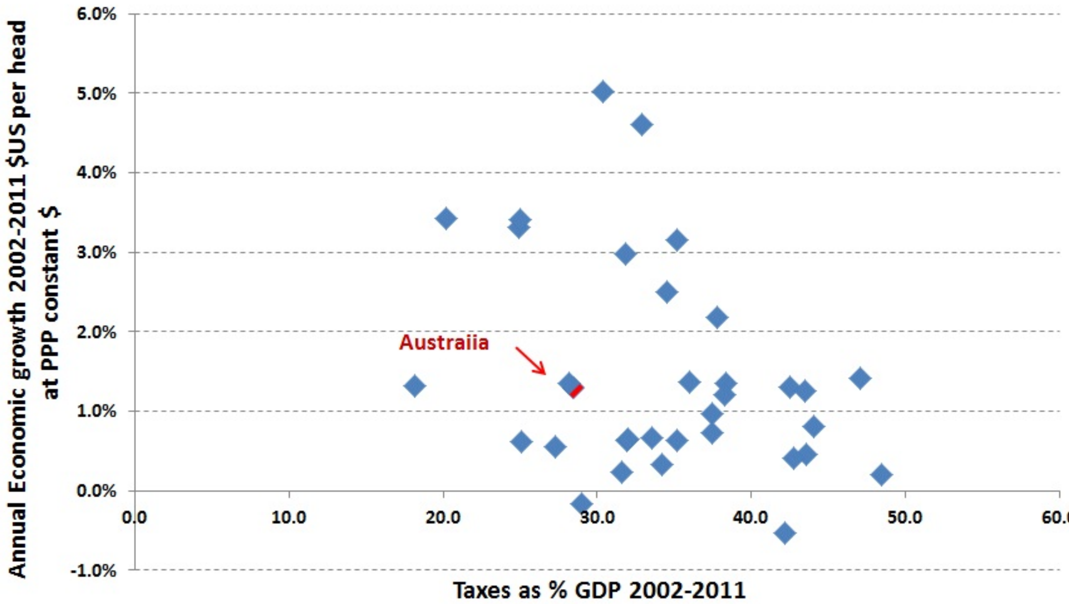
3. Taxation and performance

Taxes and growth

If the idea that taxation is an impediment to economic performance is valid, we would expect countries with high taxes to have the lowest rates of economic growth.

The relationship between taxes and economic growth is plotted in Figure 8, which shows, for all OECD countries, average taxes over the ten years to 2011 (the latest OECD data) on the X axis and on the Y axis real average economic growth per capita over the same period. Australia on this graph is in almost exactly the same place as Switzerland, a country with low taxes (if one ignores compulsory health insurance and various local levies at the cantonment level) and modest growth at 1.3 percent per capita. Those seeking ideological confirmation of their idea of a negative relationship between taxes and growth could envisage a line running downwards across the graph, but that is an illusion caused by the high growth outliers, mainly former centrally-planned economies. There is a negative correlation, but it is vanishingly weak, with a coefficient of correlation (R^2) of only 0.12.

Figure 8: Taxes as percentage of GDP and Economic Growth, OECD countries

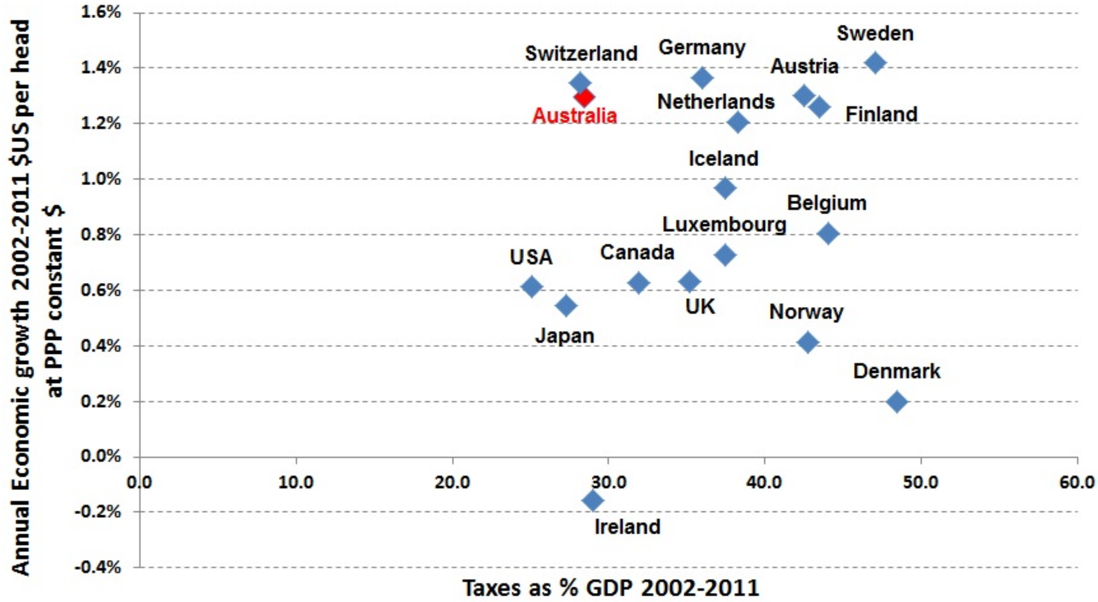


The OECD has become a heterogeneous grouping of nations over the years, now including many countries emerging from the constraints of central planning (e.g. Poland, Slovakia) and countries emerging from poverty (e.g. Chile, Mexico).

Figure 9, over the page, is drawn from the same OECD data as Figure 8, but shows only those countries with per-capita incomes of $US 30 000 or more (in 2005 purchasing power).[27] Note the changed scale on the Y axis. An ideologue on the "left" might be tempted to see an upward sloping trendline correlating high taxes with high growth, but that too would be an illusion, for the coefficient of correlation for this series is also vanishingly small at 0.02. What is notable is that with the exception of Switzerland, the highest growth countries have higher taxes than Australia.

This analysis does not support any economic theory suggesting that high taxes necessarily impede economic growth. The high-growth northern European countries certainly disprove such a proposition. Similarly the poor performance of countries such as Ireland suggests that low taxes, in themselves, do not compensate for other structural or policy weaknesses.

Figure 9: Taxes as percentage of GDP and Economic Growth, high income OECD countries



In fact, notable absences from the chart are the Mediterranean countries which once would have been included in a "high income" group, but which have fallen behind. Their economic malaise can be attributed to several causes, but of the four countries – Portugal, Spain, Italy and Greece – only Italy has had reasonably high taxes over this century (42 percent of GDP). The other three countries have had taxes in the 32 to 34 percent range. Their economic problems have resulted from fiscal imbalances – in Spain's case the result of the Government having to take on unsustainable private debt. That fiscal imbalance – the gap between revenue and expenditure – has been their fundamental problem.

An ideological interpretation of a fiscal imbalance is to declare it as an expenditure problem, while an objective interpretation is that if these countries want a high level of public services and social welfare benefits, then they, like the people of the northern European countries, should be willing to elect governments which raise the taxes to pay for them. It is just as reasonable to interpret the problems of the Mediterranean countries in terms of inadequate taxation as it is to interpret them in terms of excess expenditure.

The most plausible explanation of the relationship between taxes and economic growth, or rather the apparent lack of relationship revealed in Figure 7, is that as people advance in prosperity they choose to spend more on public goods and relatively less on private goods, confirming the "satiation" notion mentioned in the previous section.

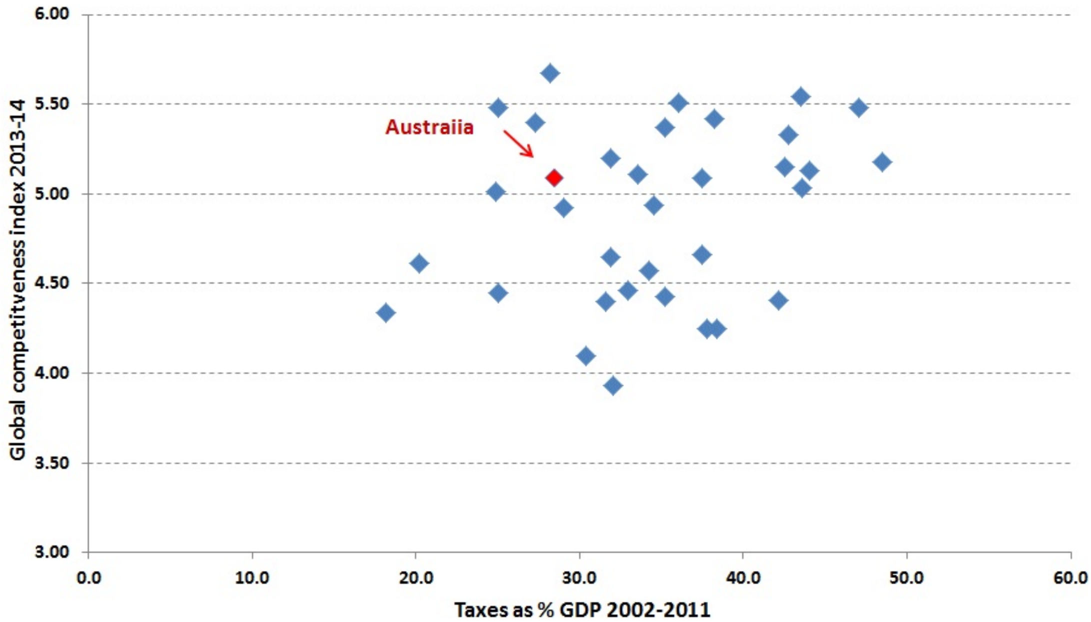
Of course this data is retrospective. Is there anything to be said about the relationship between taxes and future economic performance? Are countries with low taxes more competitive?

Taxes and competitiveness

The World Economic Forum (WEF) produces a composite indicator of competitiveness, based on “twelve pillars of competitiveness”.[28]

When we plot the WEF competitiveness scores against taxation for OECD countries, shown in Figure 10, there is no clear pattern. There are countries with all combinations of competitiveness and taxation.

Figure 10: Taxes as percentage of GDP and Competitiveness -- OECD countries



This is hardly surprising, given that taxation is but one of many factors making for business competitiveness. The WEF’s twelve pillars, the quality of which contribute to competitiveness are “Institutions”, “Infrastructure”, the “Macroeconomic environment”, “Health and primary education”, “Higher education and training”, “Goods market efficiency”, “Labor market efficiency”, “Financial market development”, “Technological readiness”, “Market size”, “Business sophistication”, and “Innovation”. These in turn are broken into 112 indicators, only three of which relate to taxation: “Effect of taxation on incentives to invest”, “Total tax rate, % profits”, and “Effect of taxation on incentives to work”; and two of which relate to fiscal management: “Government budget balances, % of GDP” and “General government debt, % of GDP”.

This is not to say taxes are unimportant in determining competitiveness. But there are many other factors, and when we look at the competitiveness data for all 148 countries surveyed, three patterns are evident.

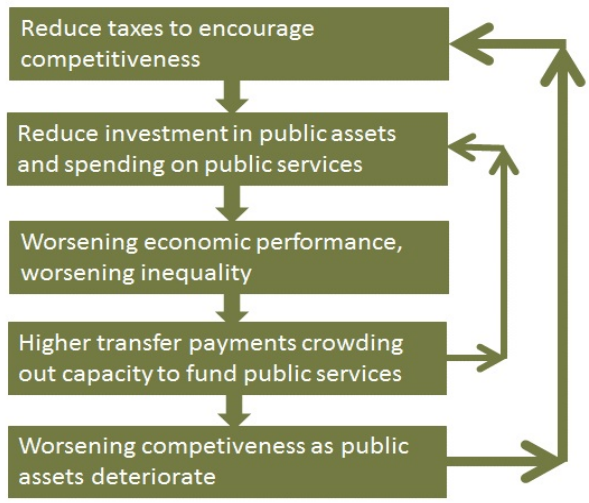
> First, the countries which score most positively on the basis of low taxation are the oil-rich countries of the Middle East. Unlike the OECD countries they have non-tax sources of public revenue, such as royalties and profits of nationalized energy industries.

Second, low taxes seem to be an inducement to investors compensate for shortcomings in the 105 non-tax indicators. Some very poor countries score very well on tax indicators. Timor Leste, for example, has almost the best score for "total tax rate", just behind Macedonia and the oil-rich countries with low corporate taxes.

Third, several competitive factors are dependent on public spending. These include infrastructure, health, and education.

In short, countries with sound institutions and good public assets do not have to compete on the basis of lowering taxes, and if they do there is a risk that a consequence will be a failure to make those public investments which sustain the quality of those public assets. A low tax policy can result in a destructive loop of positive feedback as illustrated alongside in Figure 11.

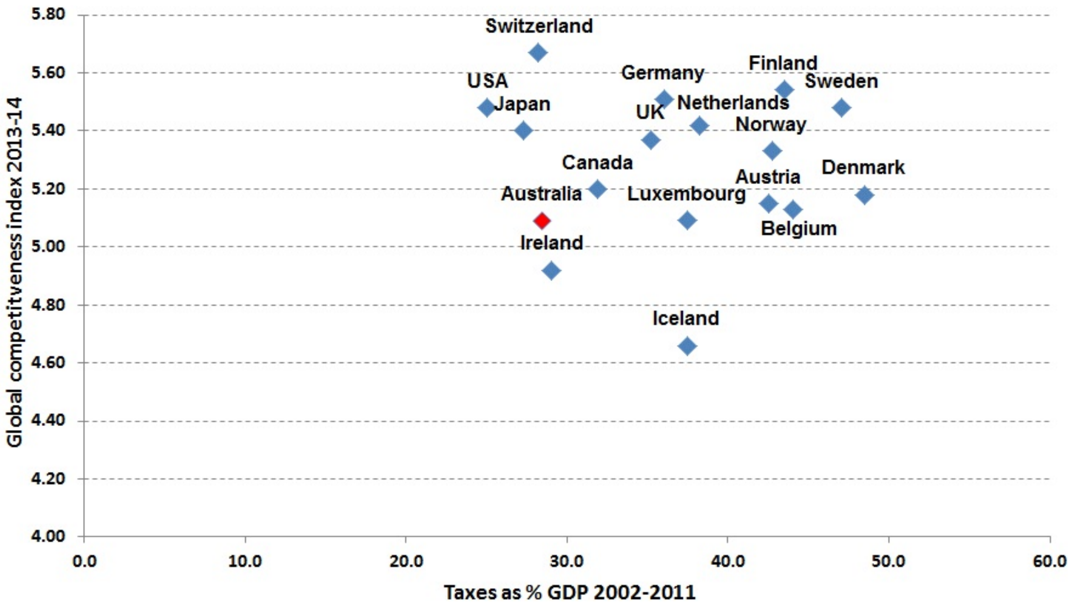
Figure 11: A "low tax" loop to economic decline



Again, it is useful to narrow our focus and to look at countries similar to Australia – the same 17 countries as are shown in Figure 9. This presentation is in Figure 12 below.

Notably, there is no clear pattern. Australia is in almost the worst situation – the corner of low competitiveness and low taxes.

Figure 12: Taxes as percentage of GDP and Competitveness -- high income countries



In terms of the specific WEF issues to do with taxes, we rank close to these other 16 countries. Comparative scores are shown in Table 1. We are a little below their score on incentives to invest – which, in light of the huge investment inflow associated with the mining boom and its effect on the exchange rate, has not necessarily been a bad policy setting. Our total tax rate is reasonably high, but many countries have higher taxes on corporations. Inclusion of state government payroll tax undoubtedly is one explanation for this high figure. On incentives to work, we are about average. In this regard, it is notable that the MYEFO specifically mentions disincentives to participate in the labour force as a reason for not raising taxes, but on this score we are not out of line according to the WEF – our score is right on the average. In any event, a tax disincentive to work can easily arise from the interaction of income taxes and social security benefits, and Australia, in comparison with European countries, has a targeted rather than a universal set of benefits. One almost inescapable result of targeting benefits through means-testing is that poverty traps, which put a barrier to transition to work, are inevitable, and the taxation system in terms of its brackets, rather than its absolute rate, has to bear some responsibility for this problem. Poverty traps could be avoided with more universal benefits funded by higher taxes, but few economists advocate such a policy for Australia.

Table 1: Australia's competitiveness on WEF tax criteria – 17 prosperous countries

Criterion	Australia's average score	Other 16 high income countries' average score
Effect of taxation on incentives to invest (high score = more competitive)	3.7/7.0	4.1/7.0
Total tax rate* (low score = more competitive)	47.5/100.0	39.9/100.0
Effect of taxation on incentives to work (high score = more competitive)	3.8/7.0	3.8/7.0

* "Total tax rate" refers to all taxes paid by business as a percentage of profits.

Where Australia's competitiveness falls down in comparison with these other countries is in a set of indicators to do with business-government relations. We do very poorly on "Burden of government regulation" and not so well on "Wastefulness of government spending" – possibly a reflection on the complexities and overlaps in Commonwealth-state policies.

Interestingly, we rank poorly in relation to a set of indicators labelled "Diversion of public funds (to businesses, individuals or groups due to corruption)", "Public trust in politicians", "Irregular payments and bribes" and "Favoritism in decisions of government officials". Our scores on these indicators are high on a world standard (we do well in comparison with Nigeria), but not high in comparison with other high-income countries. These indicators, as well as the indicator on wastefulness of government spending, suggest that there are public policies which results in money being spent in the wrong places, such as grants of favours to politically-favoured interests. As pointed out in Part 2, waste in some areas of public spending is not, in itself, an indication that overall public spending is too high. Misers can be wasteful. For example, Australia scores badly on WEF findings on surface transport infrastructure – roads and railroads – suggesting an area of neglected government spending. We also do very badly on WEF scores on “Technological readiness”, including broadband subscriptions and internet users. Surely our competitiveness would be improved more by keeping in place the previous Government’s plan to catch up on our broadband infrastructure than by keeping taxes low.

The general point made by the WEF is not that taxes should be at any particular level. Rather it is that they should not distort resource allocation, and should be used for productive purposes. That’s a great deal more sophisticated a policy principle than a “small government” ideology. As the next section illustrates, “smaller government” can mean that important services, once privatized, become much more costly.

4. More expensive services – the consequence of government abandonment

The "textbook" clause in the Commission's brief

The Commission of Audit's terms of reference is a strange document, for within its "smaller government" framework is the statement that "government should do for people what they cannot do, or cannot do efficiently, for themselves, but no more".

That's virtually a textbook definition of the role of government, and significantly it's in two parts – referring to that which people cannot do for themselves, and that which people cannot do *efficiently* for themselves. It's an important division, and if interpreted objectively would guide the Commission to areas where governments should be involved but are not. It contradicts the Commission's cost-cutting emphasis.

> The first part refers to a set of activities which in no practical way can be provided by private markets. These include a set of what economists refer to as "pure" public goods, where non-payers cannot practically be excluded and where one person's use does not detract from another person's use.[29] Defence, country roads and public health campaigns are common examples. Some such goods may be funded by government but provided by the private sector under contract. The general point, however, is that such goods will not be provided at all unless the government takes responsibility for their supply. This class of public expenditure is relatively non-contentious: even the most ideologically right-wing governments in the world have little difficulty with spending on defence and roads.
>
> The second part refers to a set of goods which the private sector *could* provide, and in many cases does provide, but does so inefficiently. Inefficiency in this economic context does not refer to bad business practices – in a competitive market competition eventually forces inefficient operators to adapt or to make way for newcomers. Rather, it refers to conditions of "market failure", where because of certain conditions, even the best-managed private firms cannot provide services as efficiently as governments.

The conditions for markets to operate efficiently are many – no barriers to entry, room for many suppliers, many customers, well-informed suppliers and customers, rational behaviour by all actors, the capacity to charge for services, the absence of spillovers ("externalities" in economic terminology), well functioning financial markets – to name the main conditions. Competition, rather than some magic associated with ownership, is what drives efficiency in the private sector. When some of these conditions supporting competition are absent there is some degree of market failure.

Not every market failure calls for government intervention. As a general principle, governments should intervene only when the cost of the market failure is greater than the cost of the intervention. In some cases intervention can be by regulation, which is the usual way of dealing with potential monopolisation. Sometimes there are spillovers, such that actors' market activities have costs or benefits which are not covered in prices paid in market exchanges. The textbook cases are negative environmental externalities, where unregulated market transactions cause costs borne by the wider community: CO_2 emission is the most pressing issue of our times. The normal approach to such distortions is for governments to impose a charge on market transactions to try to bring those costs to account, and that is the essence of carbon taxes and emission trading schemes. They are interventions designed to emulate what would occur in markets which brought all costs to account.

Governments often ignore market failures, sometimes in an ideological belief that there is nothing the government does that the private sector cannot do better. In academic terms, this is known as “private sector primacy”[30] – if the private sector *can* do it, then the private sector *should* do it. (More colloquially it is known as “Yellow pages” decision making – if it’s in the Yellow Pages than the government should leave it to the private sector.)

Thus, for example, we have seen a proliferation of toll roads in Australian cities over the last thirty years. Tolls are an economically inefficient way to fund such infrastructure. There are costs in collecting tolls, and toll roads tend to be under-used at off-peak times as people use “rat runs” to avoid the tolls. This means an expensive piece of infrastructure that could bring benefits in terms of travel time, vehicle wear, and reduced pollution lies under-utilized. (Such waste is known to economists as “deadweight loss”.) And the costs incurred by the private sector (and passed on to users) are higher than would be incurred by the government, because the private sector has to bear the risk that government policy might change, rendering the infrastructure unprofitable. In order to cover such risks toll road contracts often involve deals which prohibit the government from building competing infrastructure – that’s why there is no rail or tram line to Tullamarine Airport in Melbourne. Even then private investors in infrastructure often require a high rate of return on their investments to cover the possibility that the government may renege on its agreements.

Residents of Sydney would be aware of the waste of under-utilization of private infrastructure, for they have two very expensive examples in their midst – the subway to the airport and the cross-city tunnel. In both cases user charges are so high that many potential users are put off. Empty trains and deserted tunnels are classic manifestations of deadweight loss.

Four sources of inappropriate privatization

Such poor decision-making can come about in a number of ways. One may simply be ignorance. Politicians are not economists, and if they have been conditioned to believe in the intrinsic efficiency and virtue of the private sector, the notion of market failure may seem unreal to them.

A second driver of unwise privatization is a notion that government expenditure or taxes must be kept to a certain arbitrary level – X percent of GDP. In its budget papers the Rudd-Gillard Government consistently stated an objective of keeping Commonwealth taxes below their 2007-08 level (23.7 percent of GDP), as if it was necessary for Labor to prove its economic competence by setting lower taxes than the Coalition. At present the Centre for Independent Studies, an organization based on a belief “that smaller government is the key to unlocking individual responsibility, liberty, choice and enterprise” is pursuing a “Target 30” campaign, to reduce the “size” of government (all levels) to 30 percent of GDP – a campaign rich in rhetoric about “big and growing government” and the “tax burden” but wanting in research or argument. The political appeal of such views relates to an impression that taxes are already higher than the community can bear – for example, contrary to readily-available evidence, around two thirds of Australians believe that in comparison with other countries ours is a high-taxing/high-spending country.[31]

A third source of inappropriate privatization is corruption: privatization opens up many opportunities for profits, particularly if it involves putting a private supplier into a position with some protection from competition. Corruption in a country like Australia is more sophisticated than handovers of cash in brown-paper envelopes – as any observer of the NSW ICAC processes observes.

A fourth source of privatization and of poor economic decision-making generally is a tendency for governments to define their economic responsibility only in narrow fiscal terms, rather than by taking the wider responsibility of seeing that all the economy's resources are allocated efficiently – what George Brockway called a "triumph of finance over economics".[32] This narrow fiscal definition is most commonly revealed in statements that certain programs are "unaffordable", and must therefore be handled over to the private sector.

Health care is the most commonly mentioned program in this context. Projections in the *Intergenerational Report* show that due to ageing and increasing use of new procedures, Commonwealth government spending on health care will almost double from 4 percent of GDP to 7 percent by the middle of the century.[33] When adding state expenditure, assuming relativities are maintained, that would imply total spending of around 9 percent of GDP by 2050. Such projections lead to claims that this growth is unaffordable (even though governments of many countries are already spending 7 to 9 percent of GDP on health care).[34] The reasoning goes that because we cannot increase taxes, any increased public spending for health would have to be funded from savings in other desirable areas such as education. Therefore, the argument runs, some responsibility for funding health care must be passed to the private sector.

It's an argument with glib appeal, particularly to those with a financial stake in privatization, including the health insurance companies.

Funding health care – the case for government

The flaw in the "unaffordable" argument is that even if the government withdraws from funding, we still have to pay for health care, and all the evidence from other countries' experience shows that if the government abandons responsibility for funding health care, we will end up spending a greater amount for the same or a lower quality of care.

In all probability Australians want to share the bulk of our health costs with one another. Across all OECD countries people pay only about 20 percent of health costs from their own pockets – that is through payments at time of service delivery and in amounts not covered by insurance. In Australia, at 19 percent, we are just below that average. In developed countries most health care costs are paid through insurance – either a government insurer or competing private insurers.

Even if, as is likely, we accept a need to pay more from our own pockets, we will continue to seek insurance cover for large outlays. We may be willing to take our chances in many aspects of life, but when it comes to health care we have little to guide us about our future needs.

Policies which shift funding responsibility from government programs, such as Australia's Medicare, on to private health insurance (PHI) have a short-term attraction to a government concerned with containing fiscal outlays. But even the best designed policies to entice or force people into PHI are costly and inequitable.

For a start PHI involves high administrative costs. In Australia only 84 cents in every dollar paid to PHI is returned in terms of payment for services. The rest goes to administrative costs and corporate profits. By contrast, Medicare has administrative costs of about 5 percent, and another 1 percent in Tax Office collection costs. That means that Medicare returns 94 cents in the dollar as health services – a ten cent difference in comparison with PHI.[35] The USA, highly dependent on PHI, provides the standout example of administrative overheads. Only 69 cents in every dollar Americans spend on health care comes back in terms of services.[36]

Second, and more important, when there are competing private health insurers they have little ability to control the prices demanded by service providers. If one insurer tries to bargain hard with hospitals to keep prices down, the hospitals will simply choose to do business with another insurer. The insurers have about the same power in the market as consumers do when they are dealing with powerful oligopolies such as banks. By contrast a single national insurer, usually a government agency, has the market power to put some discipline into prices and utilization.

Evidence from international experience bears out these points. When countries rely on PHI to fund health care they pay more for it, without necessarily getting any better health outcomes. To quote at length from the OECD:

> Private health insurance markets have resulted in increased overall health costs in several OECD countries. First, by bringing more financial resources into the health care system, it raises total health expenditure. Second, cost-control measures – such as global budgets, price regulation and capacity controls – have been applied to the public sector in virtually all OECD countries. Conversely, the private financing sector in virtually all OECD countries, except the Netherlands, has not been subject to such centralised, governmental cost controls. This has resulted in less tight control over activities and prices in the private sector. Third, private insurers in most OECD countries do not have the same bargaining powers over the price and quantity of care provided to insurees as public systems do, although within concentrated PHI markets insurers can exert stronger pressure, as in the case of Ireland. Payment options such as global budgets that have helped public systems to contain costs in several countries are hard for private insurers to negotiate – or may not be options at all. PHI carriers have generally exerted little leverage over costs – as they might if they engaged in more selective contracting.
>
> In the United States, private insurance has been less effective than the public Medicare programme in controlling costs. Growth in per enrolee payments for a comparable set of services in private health insurance outweighed Medicare over the period 1970-2000, reflecting the higher payment rates to providers paid by private insurers. While “managed care” delivered some cost control in the 1990s, PHI premiums have resumed double-digit growth since 2001.
>
> Cost control is also more problematic to achieve in systems with multiple competing payers, including most PHI markets. Not only their purchasing position relative to providers is weaker, but also shifting cost onto other purchasers, whether public systems or other private insurers, is a more attractive strategy for insurers than restraining cost. [...]
>
> PHI also risks increasing public expenditure on health. This is because, while PHI may serve as an independent source of health funding, its effects are rarely entirely disconnected from the publicly funded system.
>
> Subsidies to private health cover, as in Ireland, Australia and the United States, increase public sector expenditure and have an opportunity cost, sometimes increasing overall utilisation levels as well. Even in the absence of direct or indirect subsidies, PHI has given rise to higher public cost in several countries with a significant PHI market because of the way it interacts with the public system.[37]

This is borne out empirically by data from the OECD, shown in Figure 13, which for 2011 (or the latest year available), plots health care expenses from all sources as a percentage of GDP against the proportion of health care funded through PHI. The message is clear: the more governments rely on PHI to fund health care the more is the total cost of health care. In this case the impression of a correlation conveyed by the scatter diagram is confirmed mathematically – the coefficient of correlation is 0.37.

Figure 14 shows the same data for the more restricted set of 17 high income OECD countries. For this group the correlation is even stronger, with a coefficient of correlation of 0.62. These are all high income countries, with little difference in health outcomes.

Figure 13: National Health Expenditure and Funding through Private Health Insurance -- OECD countries

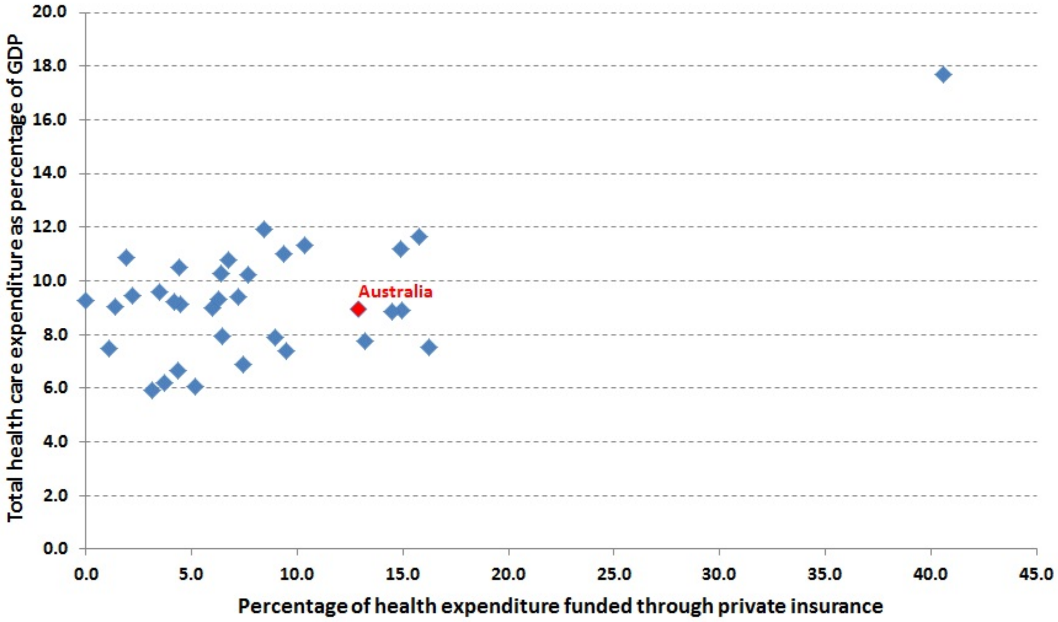
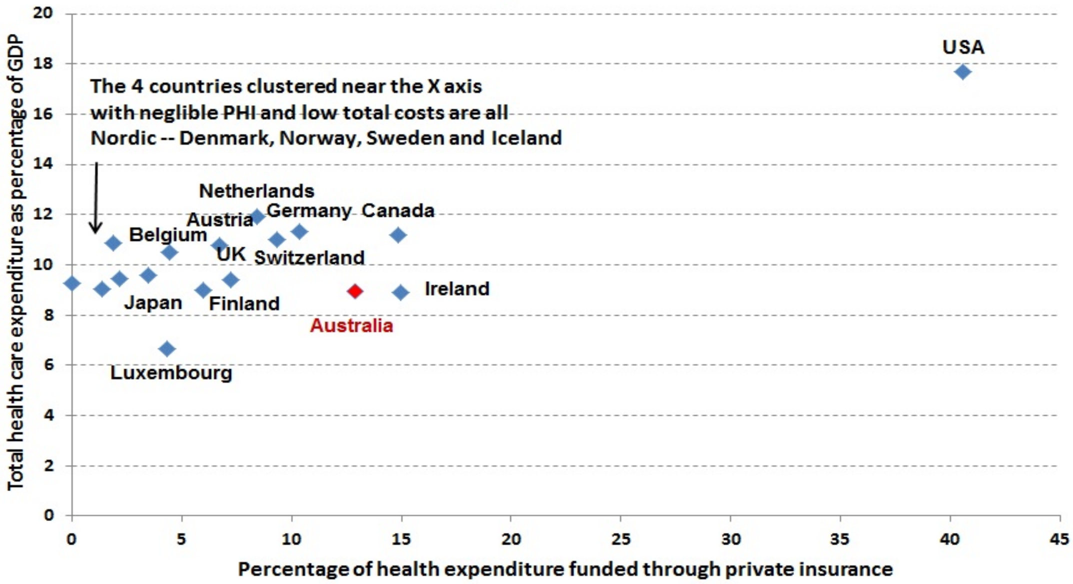


Figure 14: National Health Expenditure and Funding through Private Health Insurance -- High income OECD countries



As with administrative costs, the stand-out case is the USA, where health care costs are now almost 18 percent of GDP. (Even when the USA is excluded there is a positive relationship, and it is too big to be considered a statistical aberration.) As a consequence of America's longstanding dependence on PHI – a dependence which could intensify with Obamacare – its government programs, Medicare and Medicaid, now cost around 8.5 percent of GDP. This is more than the governments of Sweden, Norway and Iceland pay for their comprehensive public insurance programs, and more than the governments of UK and Canada pay for their near-universal public programs.

In an attempt to avoid universal public funding, the USA has developed a system which now incurs *higher fiscal costs* than they would have incurred had they pursued a single insurer option. That is because the government Medicare and Medicaid programs have become passive price-takers in a market where prices are set by powerful service providers. Even here in Australia, because of the generous way we subsidize PHI, those subsidies are costing more than they are saving government outlays. Reducing subsidies for PHI would result in some reduction in membership and therefore more government expenditure on health care, but there would be significant net public savings.[38] The Grattan Institute, for example, estimates that even with offsetting compensation to public hospitals removing the PHI rebate could save public budgets $3.5 billion a year.[39]

Simply ending subsidies for PHI is only part of necessary funding reform. The whole way health care is funded needs to be reviewed – a task well beyond a body such as the Commission of Audit. As a case in point, there needs to be rationalization of co-payments, so that they can serve to bring the benefits of market discipline into health care, rather than encouraging patients to seek "free" services to avoid co-payments. Our present division between "free" services, covered by Medicare or PHI, and paid service, is haphazard.[40] Examples abound: public hospitals are "free" while pharmaceuticals incur co-payments; it can be cheaper for a consumer to leave tooth decay until it needs treatment in hospital than to seek paid preventative dental care early on; PHI and Medicare often cap the number of paid services in areas such as physiotherapy, leaving the patient with open-ended risk. Besides savings from scrapping the PHI rebate, the Grattan Institute estimates there are additional savings of around $6 billion a year to be found without comprising the quality of care.[41]

Improving technical efficiency in health care

A combination of the market power of a single national insurer and the discipline of price signals for uninsured transactions should result in better allocative efficiency in health care: that is, ensuring that scarce resources are used where they can be most effective.

There is also scope for improvements in technical efficiency. Areas for improvement include:

Structures. Most notably the division of responsibilities between Commonwealth and state governments leads both to gaps and to duplication in services, ties up resources in "gaming" the system, and can result in high cost care when lower cost care would be more appropriate (e.g. keeping patients in hospital because of shortages of nursing home places.

Remuneration systems. Fee-for-service remuneration medicine encourages a high turnover in the form of short consultations, and does not encourage early intervention or comprehensive and preventative care.

Workforce practices. Our health system is not structured to support efficient use of the workforce. Particularly in primary care, there are many doctors working alone and providing services that could be more efficiently provided by a practice nurse or allied health worker.

The national insurer, of course, needs to use its purchasing power to contain costs. In this regard the Commonwealth, once highly effective in negotiating low pharmaceutical prices, as a result of a series of concessions to pharmaceutical firms is now paying more than many other countries for pharmaceuticals. Government purchasing and price negotiation are areas with potential savings.

Replacing PHI with a strong, single national insurer removes incentives for over-servicing and over-pricing, but there are savings in private and public costs if there is less need for health care in the first place, through investing in preventive services.[42] Preventive health measures, such as anti-smoking initiatives, deliver high returns, in terms of long-term health outcomes. However, Australia currently allocates less than two percent of the total health budget to preventive health.[43] Investing in early childhood health and education is also a proven and cost-effective strategy to prevent the development of a range of lifelong social and health problems, but Australia also falls short in this area: almost one-quarter of children are developmentally vulnerable at school entry with Aboriginal and Torres Strait Islander children and children in socioeconomic disadvantaged areas most likely to fare worse across a broad range of health and social indicators.[44] Failure to fund preventive, public health and early childhood programs adequately represents a wasted opportunity to direct resources to achieve maximum benefit. These are functions which, if abandoned by government, will not be performed by the private sector.

Small fiscal savings, high economic costs

Private health insurance is a case study in the consequences of governments becoming too narrowly focussed on fiscal costs, and losing sight of their broader responsibilities to attend to all costs in the economy. There is no point in saving taxpayers $1.00 in taxes if, in order to compensate for that saving, they have to pay $1.10 or $2.00 for the same service, without any better outcomes. PHI is essentially a privatized tax, paid through health insurers rather than the official tax office. In economic terms, when compared with public insurance, PHI fails on all criteria – technical efficiency, allocative efficiency and equity.

The Commission of Audit will probably come under pressure, however, to shift health funding "off budget" to PHI, regardless of the economic costs to the nation, and there are those in Government who believe the case is so self-evident it need not even be argued – the Prime Minister is on record as saying of the PHI rebate that it "is an article of faith for the Coalition. Private health insurance is in our DNA".[45]

Rather than yielding to such lobbying the Commission would do well to focus on areas where there are clear productivity improvements to be made in health care, particularly in areas such as fragmentation of programs and duplication (including between the Commonwealth and states) and in restrictive work practices. Without even going into these politically-charged issues the Productivity Commission has identified possible annual savings of $3 to $4 billion, by employing standard productivity measures and better practices.[46] At the same presentation in which Peter Harris, Chair of the Productivity Commission reminded us of that figure, he is recorded as warning the Commission of Audit that:

> ... the "Productivity Commission does not anticipate any single or simple solution to the problem of increasing health productivity. While this will not be news to experts in the field, it does surprise those outside it, including Government ministers when they ask the Commission to solve the problem at a stroke.[47]

Public funding *is* affordable

We have singled out health care[48] because after “social security and welfare” it is the largest area of Commonwealth spending, and every forecast and long-term projection sees it continuing to grow. It is the area of spending most at threat of an inappropriate and costly transfer of funding responsibility to private sources.

The “unaffordability” argument supporting such a shift has no validity. For that part of our health expenses we choose to share (rather than to finance from our own pocket), whether we do so through the private or public sector we still have to pay for it. The policy question should be which is the more efficient and equitable way to do this.

The Commonwealth, however, does not think this way, or at least hasn’t thought this way for many years. In general terms, the budgetary process starts with an assessment of government revenue as a “given”. There is then an estimate of the impact of demand-driven programs – mainly age pensions. Then, what is left over has to be allocated to the Commonwealth’s “own purpose” programs. Health care has to struggle within this fixed pool of funds.

This process gives priority to fiscal management, rather than to economic management. Health care is seen not so much as a service to be provided and appropriately funded in line with the community’s desires – although no doubt many politicians and public servants may have such a service view – so much as a set of fiscal demands for pharmaceuticals, medical benefits and payments to the states for hospitals.

To take a business analogy, it’s as if management has told its sales department that they are to make no more sales because the firm’s production budget is fixed, even if there is unmet demand and sales are making a good contribution.

Occasionally there is a break from this process, as has occurred with the National Disability Insurance Scheme, which has seen easy acceptance of a tax levy to finance it. There is no reason to think the same cannot apply to health funding.

5. Conclusion

If the Commission of Audit were to abide by the principles outlined in its guidance that "government should do for people what they cannot do, or cannot do efficiently, for themselves, but no more" it would identify areas not only where governments should withdraw, but also areas where governments should take over responsibilities from the private sector, where private sector efficiency is badly compromised by market failure.

We doubt that it will do this, however. In fact, at the Senate Committee's hearing into the Commission of Audit, the Commissioners made it quite clear that they were looking at opportunities to cut outlays, rather than at areas where public funding needs to be expanded.

That textbook principle of public funding, which also appeared (in a slightly expanded form) in the brief for the 1996 Commission of Audit, sits oddly with other aspects of the Commission's instructions. Was it included to give the document academic respectability, ensuring accordance with conventional economic principles, but not to be taken too seriously? Has the Commission overlooked it? Or has the Commission interpreted its brief as satisfying the wishes of a government with a predilection to transfer functions to the private sector, regardless of the cost?

The Commission's brief, as it turns out, is paternalistic. Regardless of the public's wishes for expanded government services and their willingness to pay for them, we are to be forced into a capping of public expenditure at a level far below that in comparable economies. Similarly a "small government" imperative is to override economic principles which guide the public/private division of funding and service delivery.

Policy review is an important function, best carried out by bodies with established expertise, which use an open process, and which are trusted by the community. We already have the Productivity Commission and the Australian National Audit Office undertaking those tasks, and of course there are Parliamentary Committees, such as this one, also involved in this process.

We believe that although the Commissioners and their secretariat will act with diligence and effort, because of the constraint of their brief and the expectation that its task is confined to fiscal savings, little of value will come from the work of the Commission of Audit.

Endnotes

1. World Bank *Worldwide Governance Indicators* (2012) http://info.worldbank.org/governance/wgi/index.aspx#reports

2. Christopher Stone *False Economies: Bang for our bucks* Centre for Policy Development Occasional Paper 33 November 2013.

3. For a recent critique see Mark Blyth *Austerity: The history of a dangerous idea* Oxford University Press 2013.

4. For example, on 6 January 2014 ACCC Chair Rod Sims, in an interview on ABC News, said "If all you're after is maximum efficiency then there's no question that you'd have those assets owned by the private sector." http://www.abc.net.au/news/2014-01-06/accc-chairman-sims-floats-privatisation-of-power-post/5185970

5. Chris Watson, CEO Professionals Australia, 10 January 2014 http://www.professionalsaustralia.org.au/newsviews/latest/

6. Tim Roxburgh "Public works need public sector skills – the lost lessons of the BER program" Centre for Policy Development Occasional Paper 21 2012.

7. Advisory Group on reform of Australian Government administration "Ahead of the Game: Blueprint for the reform of Australian Government administration" 2010.

8. Finance Minister Nick Minchin *Australian Financial Review* 5 Oct 2002.

9. John Quiggin "How cable tied profits in knots" *Australian Financial Review* 26 March1997.

10. Gary Banks "Successful Reform: Past Lessons, Future Challenges" Keynote address to the Annual Forecasting Conference of the Australian Business Economists December 2010. http://www.pc.gov.au/speeches/gary-banks/successful-reform

11. In this submission we are using the term "public goods" in its broadest sense, to include not only those defined by criteria of non-rivalry and non-excludability, but also those provided to compensate for other forms of market failure, especially social insurance.

12. Richard Lipsey and Alec Chrystal *Economics* (12th edition) Oxford University Press 2011.

13. The main surveys are:

    Per Capita surveys: Katherine Gregory and David Hetherington *Per Capita Tax Survey* 2010; David Hetherington *Per Capita Tax Survey,* 2011; David Hetherington *Per Capita Tax Survey,* 2012;

    Glenn Withers, David Throsby and Kaye Johnston *Public Expenditure in Australia* Economic Planning Advisory Commission 1994;

    Shaun Wilson, Rachel Gibson, David Denemark and Mark Western(eds.), *Australian Social Attitudes: The First Report*, UNSW Press 2005;

    ACTU "Myths and realities; The tax system & attitudes to taxation" ACTU 2011;

    James Whelan State of the Public Service: An Alternative Report" Centre for Policy Development 2011.

14. Paul Samuelson "The Pure Theory of Public Expenditure" *Review of Economics and Statistics* (34) 1954 36 (4): 387–389.

15. America's tax-to-GDP ratio over the ten years to 2011 was period is 25.1 percent, while ours was 28.4 percent, but over that period their Federal budget deficit has averaged 3.7 percent of GDP, while ours on average has been a small surplus of 0.3 percent of GDP. In other words, in order to sustain their public expenditure, America would have to raise taxes from 25.1 percent of GDP to 29.1 percent of GDP. By running a high deficit all they are doing is deferring their tax liability to the future.

16. A "tax", by definition, is not linked to direct personal benefits. Our superannuation, based on personal accounts, has a strong link between contributions and benefits.

17. According to OECD figures, health insurance in Switzerland and the USA accounts for around 8 percent of GDP. The employer-financed component of Australia's superannuation contributions in 2012-13 was $78 billion (APRA). GDP that year was $1516 billion (ABS).

18. Whether this is sustainable in terms of scarce natural resources is another matter.

19. This explanation is spelled out by Avner Offer "Why has the public sector grown so large in market economies: The Political Economy of Prudence in the UK c 1870 -2000" – Oxford University Press 2001.

20. For an explanation of the growth of government transfers, particularly in those countries with "right" leaning governments, see Alberto Alesina and Dani Rodrik "Distributive Politics and Economic Growth" *Quarterly Journal of Economics* Vol 109, #2 May 1994. Societies with high levels of inequality have to spend heavily on personal transfers to alleviate poverty.

21. Parliamentary Budget Office "Australian Government spending Part 1: Historical trends from 2002-03 to 2012-13." 2013.

22. Many economists have written on the structural deficit. For a short description, see Phil Lewis of the University of Canberra "PBO and Treasury reports confirm it – the deficit is unsustainable" *The Conversation* 23 May 2013. For a more thorough analysis see Deloitte Access Economics "Risks around Australia's Fiscal Position" 2013.

23. Calculated from data in Table 3.20 in MYEFO.

24. Prime Minister and Treasurer "Stronger, fairer, simpler: a tax plan for our future" Press release 2 May 2010.

25. Average income derived from ABS 6302.0 "Average Weekly Earnings. Figures used are full-time adult ordinary-time earnings, November each year, using trend series.

26. For a detailed analysis of the distributional impact of GST, as well as references on the acceptability of taxation, see Ian McAuley "Taxes – our payment for civilization" Paper to accompany presentation to South Australia Council of Social Services AGM, 25 November 2013.

27. US dollars in 2005 prices.

28. World Economic Forum *The Global Competitiveness Report 2013–2014* 2013.

29. The economic criteria of *non-excludability* and *non-rivalry*.

30. A term coined by Professor John Halligan of the University of Canberra.

31. Per Capita 2012 *op. cit.* and The Australia Institute "Is Australia a high tax country?" 2012 http://www.tai.org.au/content/australia-high-tax-country.

32. George Brockway *The End of Economic Man* W W Norton 1993.

33. *Australia to 2050: Future Challenges 2010*, Department of Treasury.

34. Our state governments spend another 2 percent of GDP on health care (not including Commonwealth hospital grants), so our total current public expenditure on health care is around 6.0 percent of GDP, aligning with OECD figures.

35. Figures taken from John Menadue and Ian McAuley *Private Health Insurance: High in cost and low in equity.* Centre for Policy Development 2012.

36. Henry Minzberg “Managing the myths of health care” *World Hospitals and Health Services* Vol 48 # 3, 2012.

37. Francesca Colombo and Nicole Tapay “Private health insurance in OECD countries: the benefits and costs for Individuals and health systems” OECD Health Working Papers No. 15, 2006.

38. Terence Cheng *Does reducing rebates for private health insurance generate cost savings* Institute of Applied Economic and Social Research, The University of Melbourne, July 2013.

39. John Daley *Balancing Budgets: Tough choices we need* Grattan Institute 2013.

40. See, for example Jennifer Doggett “Out of Pocket: rethinking health copayments” Centre for Policy Development Occasional Paper 2009.

41. John Daley, Grattan Institute *op. cit*.

42. World Health Organisation. *Key components of a well functioning health system*. May 2010.

43. Australian Institute of Health and Welfare *Health Expenditure Australia 2011-2012*.

44. Australian Institute of Health and Welfare *A picture of Australia’s Children* 2012.

45. “Tony Abbott to axe health insurance means test 'as soon as we can'” *The Australian* 15 February 2012.

46. Peter Harris, Chair of Productivity Commission, report of presentation “Health Reform: No Silver Bullet” at Australian Centre for Health Research Ltd “workshop” “Building a sustainable Australian Health System” 5 December 2013.

47. *Ibid.*

48. Note that the case is for public *funding* of health insurance – a single tax-funded health insurer. Often, either through misunderstanding or deliberate misrepresentation, this argument is construed as a “socialization” of health care. Whatever funding model is employed, there are good reasons for the *provision* of health care to be mainly through non-government mechanisms.