SAUL ESLAKE
CORINNA ECONOMIC ADVISORY

Reflections on the 2021 Intergenerational Report

The fifth Intergenerational Report (IGR) presented by Treasurer Josh Frydenberg last Monday suggests that if the most important long-term determinants of Australia's economic growth revert to their longer-term, pre-Covid trends, once we've returned to as close to 'normal' as we're ever going to after Covid, and if nothing else happens and nothing else is done, Australia will be running budget deficits of, on average, around 2% of GDP over the next 40 years, with the result that (Commonwealth) net debt will reach almost 35% of GDP in 40 years' time.

That's a lot less than was projected (for 2040-41) in the first IGR, almost 20 years ago, but more than in the three subsequent ones – in particular, the last one in 2015, which projected that if all of the measures included in the Abbott Government's 2014-15 Budget were to have been enacted, the Commonwealth Government would have been a net creditor from 2030-31 onwards.

It's of course also a much less worrying prospect than that facing most other 'advanced' economies, which according to the IMF have government net debt averaging 94% of GDP already.

Although the IGR says that "a stable debt-to-GDP ratio is generally consistent with fiscal sustainability" and that "lower debt levels are generally more sustainable than higher debt levels", it *doesn't* say that Australia's projected fiscal position is "unsustainable". On the contrary, it suggests that the small 'primary surpluses' (that is, excluding net interest payments) which it projects will be run between 2033-34 and 2047-48, and the small primary deficits which will be incurred thereafter, indicate that Australia's fiscal position *is* "sustainable".

Nonetheless, the IGR suggests that "it will be prudent to strengthen the budget over time to ensure Australia is prepared for known pressures and unexpected risks": and, to that end, "the focus" of policy "will move to debt reduction once the economic recovery is secure to ensure ongoing fiscal sustainability".

One relatively painless way of "ensuring ongoing fiscal sustainability" would be to engender a faster rate of productivity growth. The IGR assumes that productivity growth will revert to its 30-year average of 1.5% per annum after 2030-31. But it also shows that if it doesn't – if it remains at 1.2% per annum from 2024-25 onwards – then the budget deficit would reach 4.5% of GDP in 40 years' time, and net debt would be over 57% of GDP.

This implies that if we could lift productivity growth to 1.8% per annum over the next ten years and keep it there for the following three decades, the budget could be returned to a sustainable surplus without the need for any 'politically challenging' policy decisions.

But the IGR doesn't contain any prescriptions for how we might achieve that: and governments (and prospective governments) at all levels have shown little appetite for the sort of reforms proposed by the Productivity Commission and others which might help us get there.

© Copyright, 2021, Saul Eslake

In the absence of a faster rate of productivity growth, the IGR also makes it clear that the principal reason for the deterioration in the budget 'bottom line' after 2036-37 is the 'cap' on taxation revenue as a proportion of GDP at 23.9% of GDP, which is expected to be hit in 2035-36.

Outlays are projected to increase by 1.5 percentage points of GDP between 2024-25 and 2060-61: but because of the 'tax cap' (and the projected declines in state contributions to the NDIS and Future Fund earnings), total receipts are projected to decline by around 0.5 percentage point of GDP from their peak in the second half of the 2030s through to 2060-61.

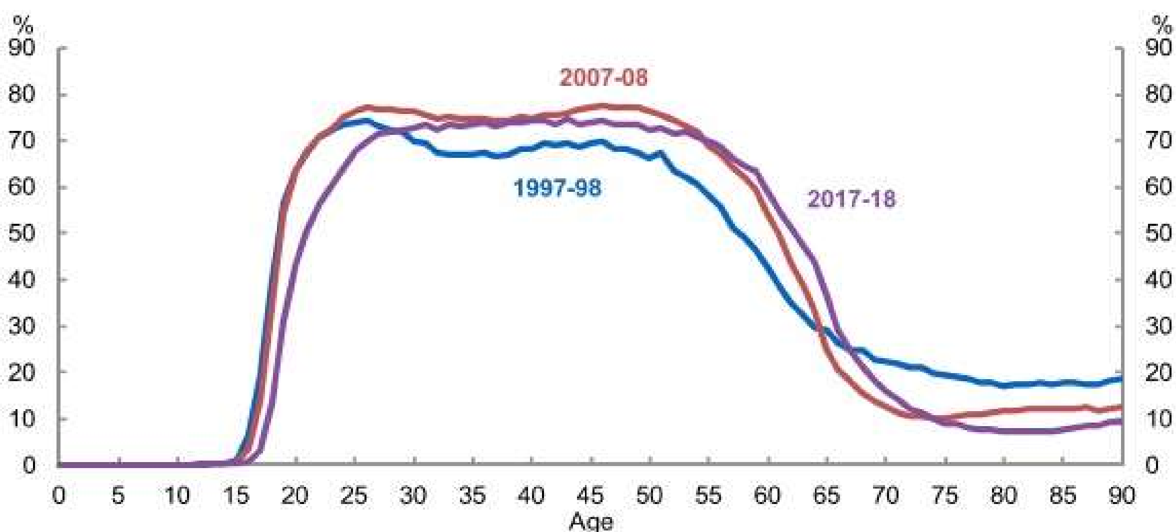
This 'tax cap' is entirely arbitrary. It is, as the IGR notes, simply the average of the tax-toGDP ratio between the introduction of the GST and the global financial crisis. There is no reason why it should be accorded the status of Holy Writ – and no reason has ever been given.

If the Australian community *wants* the Federal Government to spend 1½ percentage points more of GDP on its behalf in 40 years' time, why should it be assumed that it would not also want to collect (and pay) a similarly higher proportion of GDP in tax?

Of course, that leaves open the question as to from whom that higher proportion of GDP should be collected in taxation.

The IGR actually gives us a plausible answer to that question. It shows that most of the projected increase in outlays over the next forty years is attributable to increased spending on health and aged care: the principal beneficiaries of which will, of course, be older citizens. But it also shows that, in the absence of any changes to the personal income tax system, older Australians will be contributing very little towards paying for that increase in spending (see Chart 1).

Chart 1: Proportion of Australians who pay income tax, by age



Source: Australian Government, *Intergenerational Report 2021*, page 136.

© Copyright, 2021, Saul Eslake

The IGR notes that "the majority of Australians of retirement age pay little or no income tax, and the proportion of older Australians who pay personal income tax has generally declined over time, largely due to the introduction of age-related tax offsets and changes to the taxation of superannuation income".

It flows logically from that observation that one way of improving "fiscal sustainability" – without adversely affecting incentives to work – would be reduce or eliminate those age-related tax offsets, and to make further changes to the taxation of superannuation income.

The case for pursuing the second of those options is further strengthened by the IGR's observation that from 2040 onwards, "the cost of superannuation tax concessions will exceed the cost of age pension expenditure".

Another way of making older Australians (which, I should note, includes this writer) contribute more to the cost of providing the services from which they will disproportionately benefit would be, as Robert Breunig suggested in these pages on 27th June, to shift some of the burden of taxation away from income and on to wealth.

The most recent ABS *Finance and Wealth* Accounts show that over the past 20 years, household net worth has increased by over 350% - compared with an increase of just under 190% in household 'primary income' (that is, income before income tax and transfer payments). And the most recent ABS *Household Income and Wealth* survey tells us that the share of household net worth owned by people aged 65 and over rose from 25% to 33% between 2003-04 and 2017-18, and that their median net worth increased by over 120% over this period, roughly twice as much as for people aged between 15 and 65.

Yet wealth (and increases in wealth) are relatively untouched by Australia's taxation system, whereas (by contrast), Australia's taxation system takes a very large bite out of personal incomes, especially (by international standards) of incomes which are more than twice average earnings.

Australia is among the minority of OECD countries which don't levy any kind of tax on inheritances or bequests. An OECD report published in May this year argues that "welldesigned inheritance taxes can raise revenue and enhance equity, at lower efficiency and administrative costs than other alternatives", noting that "inheritance taxes tend to have more limited effects on savings than other taxes levied on wealthy taxpayers" and that they have "positive effects on heirs' incentives to work and on donors' charitable giving".

Another way of improving the efficiency and equity of Australia's taxation system is of course to replace stamp duty on property transfers with a more broadly-based land tax (from which the 'family home' is not automatically exempt'), as advocated by (among others) the Henry Review, the Productivity Commission and the Thodey Review for the NSW State Government (which, to its credit, the NSW Government is seeking to implement).

© Copyright, 2021, Saul Eslake

It's very much to Treasurer Josh Frydenberg's credit that he's allowed Treasury to include in the most recent IGR information and analysis which allows others to point to options for addressing the challenges which the IGR identifies.

It's much to be hoped that the Treasurer will be able to restrain his colleagues from their instinctive knee-jerk reactions to any broader discussion of those options.

Saul Eslake
Corinna Economic Advisory

© Copyright, 2021, Saul Eslake