

# The National Commission of Audit

CEDA Council on Economic Policy (CCEP)

Summary from meeting held 25 July 2014

This document is based on discussions at the CEDA Council on Economic Policy (CCEP) meeting held 25 July 2014. It does not necessarily reflect the views or opinions of any individual in attendance unless specifically cited. This summary does not reflect the unanimous views of all participants. Individual views may differ from the statements made in this summary. <sup>1</sup>

## Guest presentations:

National Commission of Audit, Head of Secretariat, Peter Crone presented [The National Commission of Audit: Overview of Processes and Production of the Report](#).

Australian Treasury, Executive Director Macroeconomic Group, Dr David Gruen

Australian Department of Industry, Chief Economist, Mark Cully

## Introduction

The Australian economy is adjusting to the end of one of the largest resources booms the world has ever seen. This is creating significant challenges for the economy as a whole and for government in particular as it attempts to meet community expectations while potentially facing reduced revenue streams in the future. The National Commission of Audit (NCA) examined federal government expenditure and made 88 recommendations: 16 were accepted in full, 21 in part, 47 are under consideration and two were rejected. The NCA is the first of many reviews and white papers currently underway that could influence the Australian economy for years to come.

CEDA's Council on Economic Policy (CCEP) meeting in July discussed the process, findings and recommendations of the NCA as well as the macroeconomic challenges currently confronting Australia.

## The National Commission of Audit: Process, findings, recommendations and discussion

The NCA, the first federal audit performed in almost 20 years, sought to address what government should do, rather than what it does. While the community may expect that government does certain things, there is a valid question as to what it should actually focus on.

The terms of reference for the NCA asked it to examine Federal Government expenditure with the aim of achieving a surplus of one per cent of gross domestic product (GDP) before 2023-24. Tax receipts were therefore out of scope, and tax expenditures were similarly treated. A criticism expressed in the CCEP was that this limitation meant the fairness of the Budget (such as changes to the safety net, introduced to help meet the budget surplus target) could be contested.

In examining the activities of government, the NCA concluded that the vertical fiscal imbalance, whereby the Commonwealth collects the majority of tax revenue in Australia while the states have the expenditure

obligations, has caused a proliferation of Commonwealth activity. While there was a national agreement to simplify funding arrangements a few years ago, the NCA found they had proliferated, rising from a handful to well over 100. Some agreements were for relatively trivial amounts – as little as \$30,000 – but they require extensive bureaucratic infrastructure to monitor. In addition, there were over 230 separate implementation plans associated with the funding arrangements for state and territory national partnership agreements.

The optimal extent and reach of government is an open question. However, empirical evidence suggests that when government spending becomes more than 35 per cent of the economy it acts as a net drag on growth. When examining the state of the Federal Government's finances, revenue was forecast to peak at 26 per cent – well below the 35 per cent threshold. Australia is not a high taxing or spending country compared with other Organisation for Economic Co-operation and Development (OECD) nations. However, Australia is becoming a high taxing and spending country compared with its historical precedents.

There was considerable discussion about the accuracy of the forecasts of future revenue. While historical data revealed substantial variability, the NCA forecasts were relatively stable. The concern was raised that such stable forward projections conveys a high level of confidence in future outcomes. While the suggestion was made that adding confidence intervals might help guide decision making, it was also discussed how Federal Treasury had modelled the implications of providing bounded confidence intervals on budget projections and found that they were very broad. For instance, at the time of the 2013-14 Budget, the widths of a 70 per cent confidence interval for forecasts in 2014-15 were roughly \$60 billion for receipts, \$20 billion for payments and \$70 billion for the underlying cash balance. Such a wide bound on potential outcomes reduces the value of confidence intervals for decision makers.

Despite some commentary suggesting that the Federal Government is facing an imminent budget emergency, it was widely accepted at the CCEP that this is not the case. The issue is that policy decisions have already been made in a range of areas, from defence to foreign aid and the NDIS, where the expenditure consequences are yet to occur. The policy decisions have been made, but expenditure is not scheduled to start until 2016-17 to 2017-18 onwards. While there is no imminent budget emergency there is a very real medium term problem for government expenditure.

Examining projections, even with all spending reforms identified by the NCA implemented, government expenditure will continue to grow 2.5 per cent every year. Given the forecasts of future revenue, and the gap that is anticipated to emerge, this will result in Australia having the highest level of debt growth in the world. This debt growth will occur as the economy adjusts to the declining mining boom.

It was noted that empirical research suggests foreign capital markets can be highly sensitive to the level of public indebtedness. However, participants pointed out that the only advanced economies to have public debt problems are those without their own currency, such as member states of the European Union. Australia is unlikely to have a problem with public debt for a considerable period. The issue for the nation is that it has very high levels of private debt.

Regardless of the nature of the fiscal challenge, the NCA had a surplus of one per cent by 2024 as a target, and it made recommendations as to how to achieve this outcome. Part of the problem in achieving this goal is that the Federal Government uses cash accounting for its budget forecasts. State governments, in contrast, have moved to accrual-based accounting, while corporations have maintained accounts in this format for a long time. The use of cash-based accounting makes it difficult to have a true picture of the Federal Government's obligations at any point in time. Under an accrual model, the Government should be running surpluses every year.

In discussing expenditure reforms, it was observed that almost 69 per cent of Commonwealth spending is indexed. Altering the indexation would improve the appropriateness of the spending increases. A range of reforms were suggested for retirement income. These include making pension eligibility linked to life

expectancy, simplifying the means test, deeming income from a range of assets, including the family home, among other reforms.

CCEP participants also noted that government spending occurs like sedimentary layers being added to a river bed. While there are many checks in place for new expenditure, once that expenditure is in place its effectiveness is rarely assessed. The Audit office ensures the funds are spent appropriately but does not assess whether they have been well spent. The key performance indicators used by government bodies rarely accurately reflect the performance of the agency. This is an issue the NCA addressed.

In making recommendations about how to structure the activities of government, the NCA found it surprisingly difficult to quantify all bodies and agencies associated with the Federal Government. Many departments were unaware of what agencies they had responsibility for. The NCA recommended privatising 10 different bodies and rationalising a wide range of other bodies and agencies.

A comment made on the NCA process was that it appeared to rely more heavily on first principles arguments than on empirical evidence in making recommendations. It was noted that there was not a lot of consideration of the net benefits associated with programs or agencies that the NCA proposed to abolish, and it was unclear whether the NCA had taken heed of the submissions it received. It was also observed that the timeframe for the NCA was highly constrained and so the final report was not written in such a manner as to reflect the input of all submissions.

The NCA made a series of important recommendations about how to reform the federation. This included fixing roles and responsibilities between the spheres of government. The NCA also sought to address the vertical fiscal imbalance by providing the states with access to income tax. This recommendation would guarantee the states access to a band of income tax – say between 22-to-32 per cent – that would generate approximately \$25 billion dollars. They would then have the discretion to vary this amount, potentially generating competitive tensions within the Federation.

Federalism represents a significant issue for CEDA, and it will be examined in the forthcoming publication, [\*A Federation for the 21st Century\*](#).

<sup>1</sup> Attending the CCEP: Professor Glenn Withers AO (Chair), Geoff Allen AM, Percy Allen AM, Peter Crone, Mark Cully, Dr John Edwards, Hon. Dr Craig Emerson, Dr Vince Fitzgerald, Professor John Freebairn, Dr David Gruen, Tim Harcourt, Dr Alex Heath, Professor Paul Kofman, Professor Warwick McKibbin, Professor the Hon. Stephen Martin, Professor Paul Simshauser, Professor Greg Smith, Nathan Taylor

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