15 April 2015

CENTRE FOR POLICY DEVELOPMENT

report

Budgeting smarter, not harder: The failure of long-term thinking in the 2015 *Intergenerational Report*

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Introduction

In March, Treasurer Hockey said that the 2015 Intergenerational Report (IGR) is "an incredibly important document to start a serious conversation about the challenges and opportunities ahead for Australia". (Hockey 2015)

> This report seeks to join the conversation on the IGR.
>
> The starting point for this conversation is that the budget challenge we face is bigger than the IGR suggests – and that we need to budget smarter, not harder, to meet it.

This report seeks to join that conversation on the ground staked out by the IGR. Like the IGR, it begins by looking backwards – surveying the scorched earth of recent budget debates. By incorporating a highly-politicised set of projections into the IGR, the Government sought to highlight the mess it supposedly inherited, its successes so far, and the challenges ahead. Instead it merely refocused attention on the failings of the 2014-15 Budget, and the policy and political bungling that has contributed to prolonged budget deficits.

The starting point for the real conversation is that the budget challenge is bigger than the IGR suggests and we need to budget smarter – not harder – to meet it. The gulf between the IGR's projections and where we actually are highlights the illusory nature of the Government's attempted consolidation. Key drivers of the projected improvement in finances, even if they were capable of being legislated, could not stand the test of time.

Cuts to indexation of pensions and other parts of the safety net would entrench rather than address disparities in living standards even as the country becomes more prosperous. These cuts would come under major pressure as their long-term impacts became clear. Of the policies already on the books, cuts to funding for state expenditure on hospitals and schools and the bracket creep that accrues with taxes set on autopilot are temporary patches rather than sustainable solutions. Overall, the Government's approach succeeded in being harsh on those who can afford it least and shifted costs without solving problems. But the consolidation it forecast was illusory. The real challenges still lie ahead.

The next stage of the conversation should be about alternatives that build on our policy strengths and smarts rather than preying on our weaknesses. A smart approach would be fair, balanced and sustainable. This report outlines a three-pronged framework that will allow Australia to budget smarter and emphasises the challenges that go beyond the narrow fiscal focus of the IGR.

The package presented in this report tackles concerns about age pension costs by re-examining means testing rather than making across the board cuts; adopts the same approach to effectiveness and affordability on the revenue side by examining superannuation and other tax concessions; and advocates a more efficient and sustainable tax base by broadening the Goods and Services Tax (GST). Over time these options, augmented by measures that take the same approach to other taxes and transfers, could achieve the bulk of the structural adjustment required in a way that supports equity, economic growth and wellbeing in the long term. Tackling these long-standing issues would leave the economy, budget and political system better placed to

respond to the next generation of policy challenges, rather than obsessing over the policy debates and politics of the past.

The serious conversation the Treasurer called for requires what the IGR failed to deliver: a broader vision about what matters for growth and wellbeing in the long term. The IGR's clear focus on long-term trends in population, participation and productivity is crucial – but it is not enough. The IGR has little to say about the wide range of forces that will influence these drivers of growth – and less on the even broader array of issues that will shape not only GDP but our quality of life. Its formulaic nine-page foray into 'Preparing for the Future' is a poor substitute for a fully-fledged discussion of what matters to intergenerational wellbeing. This report concludes by sketching out issues and opportunities across five interrelated policy areas that the IGR considers only in passing: childcare, the role of cities, changes in commerce, climate change and Australia's international relations. These issues and many others will be pivotal to Australia's material wealth and our sustainable wellbeing over time. Talking about these issues is crucial to break a cycle that deploys the rhetoric of 'tomorrow' without meeting the challenges head on by sincerely making preparations today.

1. The conversation we have: the budget problem

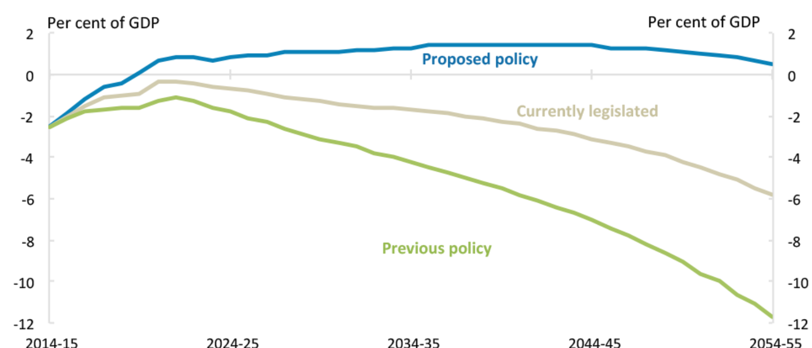
Rather than facilitating a conversation about the future, the 2015 IGR invites a conversation about the policy and political failures of the present and the past. The report sets out our long-term budget challenges – but its most vivid insights are on the inability of successive Governments to rise to those challenges. In particular, the gap between the IGR's proposed policy and currently legislated scenarios emphasise the distance between the current Government's initial attempts at consolidation and the sorts of policies that can deliver sustainable improvement to the budget bottom line. Meanwhile, a more realistic assessment of the likely path of policy indicates that the structural adjustments required to deliver balanced budgets in the medium term are far greater than the IGR suggests.

The IGR provides the latest set of official forecasts that confirm Australia faces a significant medium-term structural budget deficit. This has been borne out in successive IGRs, which have projected significant (but narrowing) fiscal gaps at the end of their forty-year outlook: -5.0 per cent of GDP (by 2042) in 2002, -3.5 per cent of GDP (by 2047) in 2007, and -2.7 per cent of GDP (by 2050) in 2010.

The 2015 IGR projects a surplus of 0.5 per cent of GDP by 2054-55 but with a significant catch. The report incorporates not one but three sets of projections, based on proposed policy, currently legislated policy and previous policy. Proposed policy reflects the Government's policy proposals as at the December 2014 mid-year budget update – many of which remain blocked in the Senate or have since been abandoned by the Government itself. The currently legislated policy scenario incorporates policy that is already on the books, including new measures that have been legislated or can be implemented by the Government without passing new legislation. The previous policy scenario is based on policy settings at the Government's first mid-year budget update in December 2013.

Of the three scenarios, only that of proposed policy delivers a surplus over the 40-year horizon of the IGR. Based on IGR forecasts, the Government's favoured policies would have restored surpluses by 2019-20. More realistic scenarios suggest persistent medium and long-term deficits. Based on currently legislated policies, the IGR projects the deficit to narrow to 0.3 per cent of GDP by 2020-21, before gradually widening over the longer term.

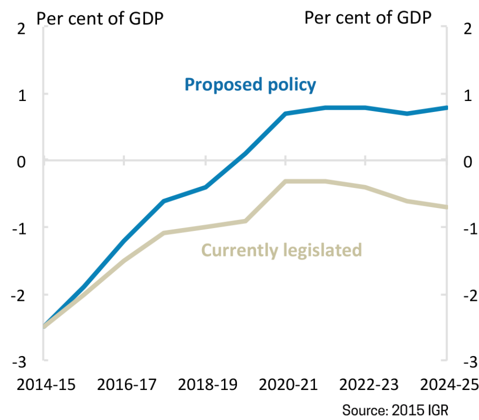
Chart 1 - Underlying cash balance under IGR scenarios – 2014-15 to 2054-55



Source: 2015 IGR

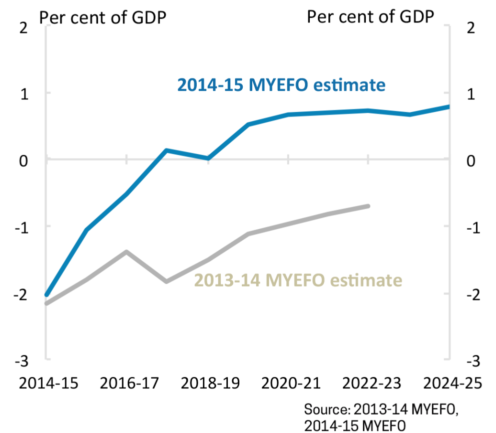
Treasury's recent estimates of the medium-term structural budget balance tell a similar story. Without the proposed but unimplemented changes from the 2014-15 Budget, much of the projected structural improvement in the budget outlook evaporates.

Chart 2 - IGR - Underlying cash balance projection



Source: 2015 IGR

Chart 3 - Treasury structural budget balance estimates



Source: 2013-14 MYEFO, 2014-15 MYEFO

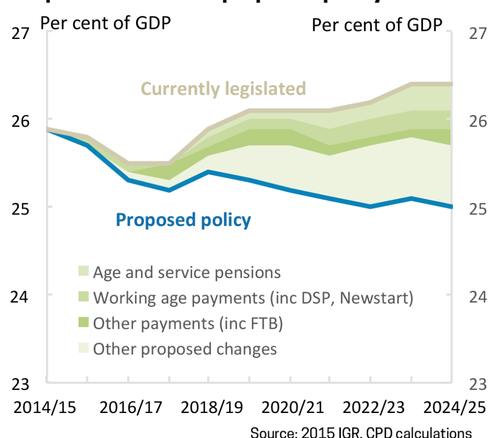
Rather than strengthening the case for the Government's proposed policies, the gap between the IGR's proposed and currently legislated scenarios – and the questionable accuracy of the currently legislated scenario on its own – are powerful reminders of the limits of blunt savings measures in balancing the budget for the long term. The savings measures proposed by the 2014-15 Budget allowed the Government to project significant fiscal repair in in the near term, and budget balance on the longer time scale of most interest to the IGR. Yet much of the progress has been exposed as illusory. The consolidation path traced out in the IGR relied significantly on three things:

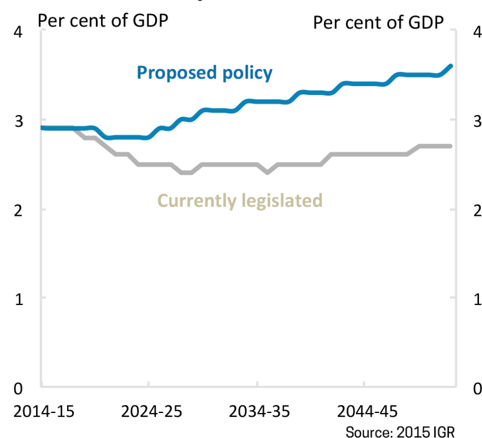
- Lower indexation rates for pensions and other income support payments, which focused the brunt of consolidation on the most vulnerable and – if it can even be legislated – would be come under significant pressure over time.
- Disappearing Commonwealth funding for key public services delivered by states – in full knowledge of the higher costs that will be required to sustain service delivery and the extreme pressure down the track for states attempting to meet them.
- Baked-in bracket creep, which undermines the progressivity of the tax system and has historically been returned to taxpayers at regular intervals.

Over the next decade, the 'proposed' consolidation path presented in the IGR hinges on a Government expenditure falling to 25 per cent of GDP – 1.4 percentage points lower than projected current policy. Unlegislated changes to payment indexation rates, freezes on the indexation of income and asset tests and revised eligibility requirements for some benefits – in combination with the lower debt servicing costs associated with smaller projected deficits – drive much of this fall in government spending. Adjusting indexation arrangements is a particularly powerful tool for projecting long-term savings, and has the political advantage of having relatively small near-term impacts on recipients (although for those who rely most on welfare payments, which are set at levels that some argue to be consistent with poverty, the

impact of even small changes in payments will be high). Yet even if legislated, the difficultly of sustaining such savings would only increase over time as their effects become more pronounced.

The Government's proposal to index age pensions to the consumer price index (CPI) rather than by reference to a combination of CPI and average male weekly earnings is particularly relevant in the demographic context of the IGR. Based on the IGR's projections, combined with adjustments to indexation of assets test thresholds and changes to deeming rates for the income test, this measure would reduce government expenditure by 0.3 per cent of GDP by 2024-25. However, these savings are premised on a safety net that becomes systematically less generous to recipients as society becomes more prosperous over time, with pensions fixed in real terms at current levels rather than growing over time to reflect rising productivity and living standards across the broader community. This would have seen the base rate of the pension fall from around 28 per cent of average male weekly earnings in 2014-15 to around 24 per cent in 2027-28 (Whiteford 2015), and significantly further if revised indexation arrangements were maintained into the long term.





> Adjusting indexation arrangements is a particularly powerful tool for projecting long-term savings… Yet if the result is a safety net that becomes progressively more out of step with social expectations, the savings achieved in this manner are unsustainable.

As with measures to index other social security payments to CPI, reducing pension indexation rather than engaging in more comprehensive reforms to better target or reduce the overall reliance on government transfers shifts the burden of fiscal adjustment squarely on to those who can least afford it, while doing little to address underlying causes. Yet if the result is a safety net that becomes increasingly out of step with social expectations, the savings achieved in this manner are unsustainable. Any savings delivered in the interim come at the expense of masking the need for dialogue and reforms that go beyond merely tinkering with payment rates.

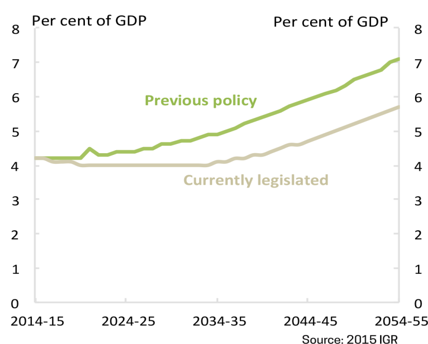
To the extent that these and a raft of other proposed but unimplemented policies are included in the 2015-16 Budget baseline, the near and long-term fiscal outlook will continue to vastly overstate the extent of improvement that has been made. Significantly, policies and measures with questionable long-term staying power also feature prominently in the IGR's 'currently legislated' scenario – implying that the overall consolidation task will be harder than even this middle scenario suggests.

Large cuts to Commonwealth funding for state government expenditure on public hospitals are a prominent and contentious example. Major projected savings in health expenditure are premised on Budget measures that would ensure Commonwealth funding to states that does not grow in line with historical trends or respond to forecasts for rising health care costs. The IGR forecasts that the Government's current policy settings will see health expenditure fall from 4.2 per cent of GDP in 2014-5 to 4 per cent by 2024-25, rather than increasing to 4.4 per cent of GDP under previous policy. This reflects the immediate reversal of earlier funding arrangements designed to determine efficient prices for hospital services and broaden access to preventative health, and moves to make real per person Commonwealth funding for public hospitals constant from 2017-18.

This saving works precisely because the actual cost of hospital services is expected to rise at a much faster rate – a trend that, along with broader costs growth in the health system, will continue to be a key driver of longer-term fiscal pressures in Australia and many other advanced economies. It lowers projected Commonwealth outlays by assuming costs over and above inflation can and will be borne by state budgets. Yet there is no agreement in place as to how states will carry the load in the absence of major cuts to services or new revenue sources, and no realistic indication that the full 'savings' to the Commonwealth suggested by these measures can actually be imposed or sustained. Similar changes for funding to states for public schools mean projected increases in funding forecasts (beyond those associated with inflation and higher enrolments) have been curtailed, shifting more of the burden of further growth in costs to states.

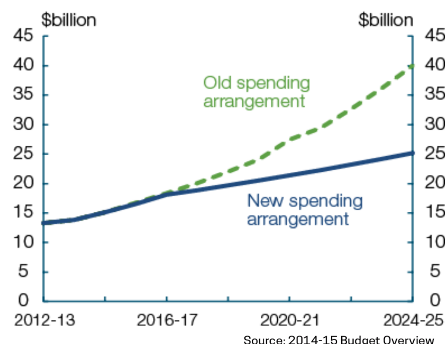
Rather than representing a genuine long-term saving, these measures simply shift the burden onto states without providing any sustainable solutions about funding the rising costs of public services. In the case of health, the IGR methodology recognises this limitation by projecting that Commonwealth healthcare costs will revert to growth at historical rates observed on a 'whole of government' basis from the 2030s. This means that the IGR does not just fail to account for the existing impact of demographic pressures on state budgets. Rather, it projects an 'improvement' that relies heavily on shifting even more of these costs away from the Commonwealth and onto the states over time.

Chart 6 - Health expenditure - 'currently legislated' vs. 'previous policy'



Source: 2015 IGR

Chart 7 - Commonwealth funding to public hospitals - 2014-15 Budget



Source: 2014-15 Budget Overview

On the revenue side, most of the recovery that contributes to the narrowing of 'currently legislated' deficits in the medium term depends on unmitigated bracket creep. Tax receipts are projected to rise from 22.0 per cent of GDP in 2014-15 to 23.9 per cent in 2021-22 (at which point they are assumed to be capped). According to the IGR, this will be "largely driven by bracket creep", which occurs when rising incomes push an increasing portion of taxpayers' incomes into higher income tax brackets over time, increasing average (and sometimes marginal) tax rates over time. Left unchecked over the next decade, this would see over two million additional taxpayers in the second-highest tax income bracket (between $80,000 and $180,000) by 2024-25 (Tax Discussion Paper, 2015).

Bracket creep has been leaned on heavily in recent years to prop up revenues that have been hit by weakening indirect tax collections, supressed capital gains tax receipts and a return to lower levels of company tax receipts following the mining boom. Historically, bracket creep has been returned to taxpayers at regular intervals by increasing the thresholds at which marginal tax rates apply. Allowing bracket creep to drive the majority of the recovery in revenues over the next decade by default would raise serious equity and efficiency concerns. It works against the progressivity of the tax system by disproportionately impacting those on lower and middle incomes, who face steeper increases in average tax rates than high income earners. It also increases the overall reliance of revenues on an income tax base that imposes greater economic costs (including by discouraging participation) and will be shrinking in relative terms over time as the working age population narrows. These costs would have to be weighed against the economic and social impacts of revenue measures that could replace bracket creep, as well as the political prospects for their implementation.

The IGR assumes that bracket creep will be paid back from 2021-22 by capping tax to GDP at 23.9 per cent of GDP. The reality is that there will be substantial pressure on future Governments to offset at least some of the impact of fiscal drag before then. While some of the difference could be made up by faster recovery in other revenue sources over time, this would increase the overall consolidation task in the interim.

This analysis suggests three crucial reference points for the conversation inspired by the IGR.

The first is that on a more realistic assessment of the future path of policy, the structural adjustments we face over the next decade are bigger than the IGR's projections imply. The Government has already abandoned key planks of the 'proposed policy' scenario due to entrenched political opposition. Key sources of support for the 'currently legislated' consolidation path, including severely curtailed public hospital funding and unmitigated bracket creep, will be extremely difficult to sustain as the IGR optimistically projected over the medium term. This means that the remaining adjustments needed to return the budget to surplus are much steeper than the currently legislated scenario allows, with the deficit likely to be closer to 1 per cent of GDP in 2021-22.

A range of other factors could make the adjustment even more challenging. These include:

- The sustainability of other currently legislated policies: While the slower indexation of aged pensions has not been implemented, other changes made by current and former Governments (including the indexation of FTB and Australia's aid budget to CPI) are already incorporated into the budget baseline. Maintaining zero real growth in payments as broader living standards increase will be challenging in the medium term, particularly with key parts of the safety net (such as support for the unemployed) already widely regarded as inadequate.
- Slippage in policy implementation or cost: To take one example, the Commonwealth Government is responsible for a substantial portion of any cost overrun in the rollout of the NDIS over the medium-term.
- New spending commitments or tax breaks: Existing and new policy priorities are likely to place additional pressure on expenditure and revenues into the medium term. The Government has already flagged increased expenditure on childcare and early childhood education and small business tax cuts as priorities for the 2015-16 Budget.
- Economic factors: Weaker economic growth, a slower-than-expected return to full employment or persistently lower commodity prices could continue to put additional pressure on the budget bottom line on a year-to-year basis. Between May 2014 and December 2014 alone, changes in economic parameters (including further weakness in the terms of trade and slower wages growth) led the forecast 2014-15 deficit to blow out by 30 per cent, and worsened the cumulative four-year deficit by more than $40 billion.

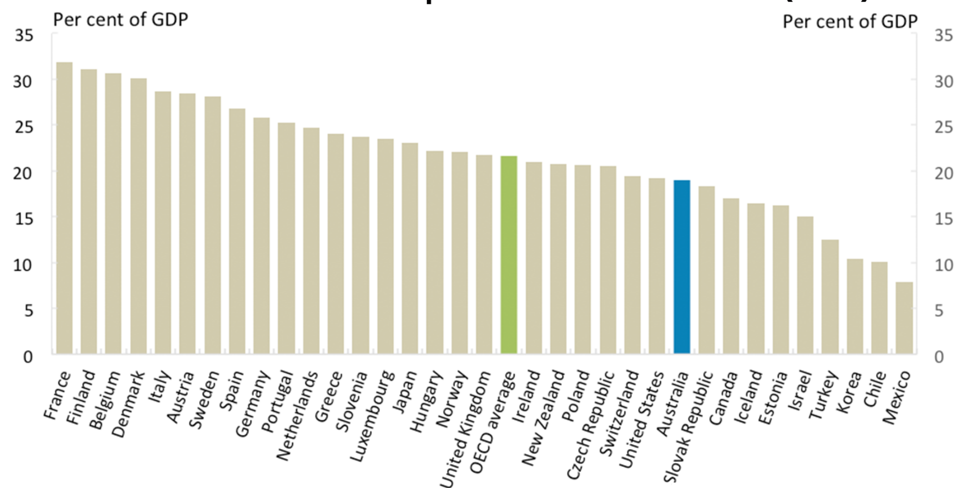
On top of all this, the budget target is likely to go beyond simply eliminating the deficit. Consistent with its predecessor, the Government's fiscal strategy calls for surpluses on average over the medium-term. A specific target of attaining a surplus of 1 per cent of GDP by 2023-24 was outlined in the 2014-15 Budget. Meeting this target would require legislating and sustaining expenditure and revenue measures that substantially outperform the Government's unlegislated 'proposed policy' scenario in the medium-term.

The second point is that the policies employed by successive Governments have been worryingly ill-suited to achieving sustainable consolidation, as opposed to merely projecting it. While the Government intended to highlight the contribution its policies have made 'repairing' the budget, the clearest point emerging from the IGR is that much of the supposed progress has been illusory. Rather than entrenching sustainable savings, many of the key drivers of consolidation merely bake in fiscal challenges that will have to be resolved by future Governments (and taxpayers), without addressing underlying problems or engaging with the underlying policy issues. This was an attempt at consolidation that puts the conversations we need into the too-hard basket, electing instead for blunt measures that hit hardest on the most vulnerable.

The third is that budget reform is not simply about being tough or fair; it is about being smart. It is one thing to frame a conversation around whether it is fair or unfair to premise fiscal consolidation on a widening gulf in living standards between the average earner and pensioners, carers and the unemployed, or on paying States less to deliver key public services despite rising costs. Fairness aside, it has clearly not been a smart or effective approach. On the contrary, the political infeasibility of proffered approaches to consolidation and failure to deal purposively with major structural divers of our budget problems merely exacerbate the vulnerabilities that a structurally weak budget position creates. Australia is still well short of a true budget emergency – but our inability to deliver the required fiscal adjustment is prolonging our vulnerability to global shocks. In the meantime, these failures have further compromised the politics of future reform in key areas of government expenditure and Commonwealth-State relations, worsening an already complicated environment for major reforms.

The Government's initial approach also moved away from one of the traditional strengths of Australia's budget conversation and policy design; the importance of designing a targeted and effective social safety net. Effective targeting of expenditure through means testing and eligibility requirements has been one of the hallmarks of Australia's safety net, which runs at a cost that is much lower a share of the economy than in most other Organisation for Economic Cooperation and Development (OECD) countries. This has been achieved by engaging with complicated questions of priorities, policy design and politics to ensure that outlays are directed to those that need them the most, while limiting adverse impacts on incentives to participate, rather than simply by being less generous to the least well off.

Chart 8 - OECD social expenditure as a share of GDP (2014)



Source: OECD 2014

2. The conversation we want: smart and sustainable budget policy

By emphasising the gap between proposed and currently legislated policies, the IGR also issued an explicit challenge to the Opposition and policymaking community: fill it. A conversation that moves beyond the failings of the last Budget and openly discusses the alternatives will be particularly crucial this year, as major reviews of the tax system and Federation coalesce to open up far-reaching opportunities for reform. It is vital that policymakers seize the opportunity to turn good ideas into good policy – and to bring forward new ideas for even more far-reaching change.

In this context, CPD suggests three priorities that should guide Australia's conversation about, and approach to, the package of measures needed to complete the task of strengthening Commonwealth finances in a manner that is conducive to longer-term priorities.

Effectiveness: The first priority should be to ensure government payments are targeted according to need and effectiveness across all major categories of government spending. This will ensure budget repair on the expenditure side that is consistent with our values and plays to our strengths and our smarts in policy design. Central to this approach is engaging with more complicated questions of means testing and eligibility for payments like the age pension, rather than relying on broad cuts to payments that force the burden of adjustment onto the very citizens whom the system is designed to protect.

> "Fiscal repair guided by these three priorities would prepare Australia for the future without undermining features of our tax and transfer system that work well, overlooking aspects of the status quo that counteract long-term goals, or entrenching inequitable distortions that will have to be reversed."

Balance: The second priority is to extend this measured approach to the revenue side of the budget. This includes ensuring that tax concessions or loopholes that disproportionately benefit the most well off at significant fiscal cost are a crucial part of the discussion for improving the structural position of the budget. Such concessions serve other important (although not always consistent) policy purposes. But there is no reason that the costs they incur should not be examined as carefully as those stemming from direct government expenditure. This should include careful assessments of effectiveness and distributional implications.

Sustainability: The third priority is seizing broader opportunities to prepare and implement longer-term reforms to promote adequacy, efficiency and sustainability in the revenue base over time. This requires modernising and strengthening Australia's tax base, which is insufficient to meet expenditure priorities that (as the IGR shows) are rising over time, and inefficient and unsustainable in its antiquated bias towards income-based taxes.

Fiscal consolidation guided by these three priorities would prepare Australia for the future without undermining features of our tax and transfer system that work well, overlooking aspects of the status quo that counteract long-term goals, or entrenching inequitable distortions that will have to be reversed. There is a package of policies that

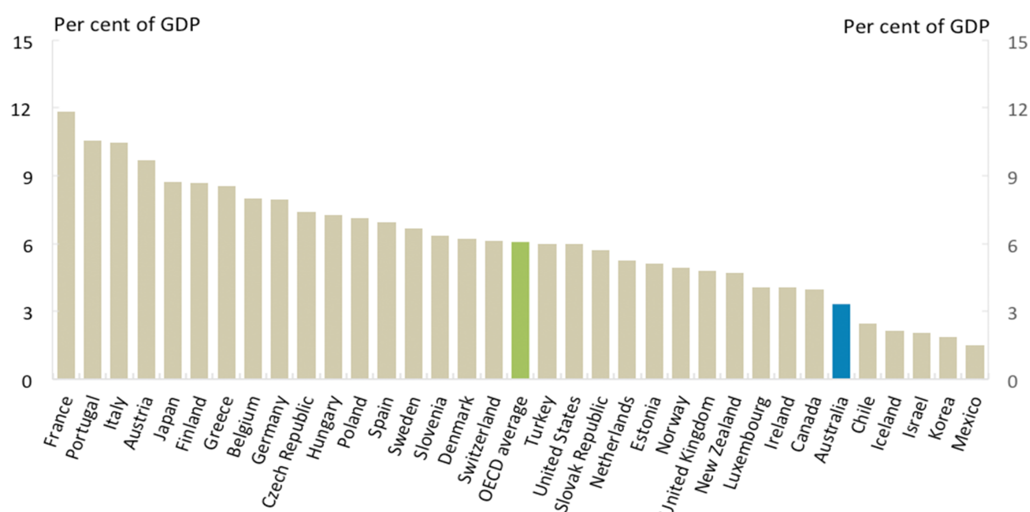
accord with these priorities and would make a strong start towards the required fiscal consolidation in a smart, purposeful way.

Guided by these priorities, this section discusses three main policy issues that must be at the forefront of any discussion about a medium-term solution to the fiscal pressures outlined in the IGR. These are eligibility for the aged pension, superannuation tax concessions and the GST.

Issue one: eligibility and means testing of the age pension

The IGR emphasises that the cost of sustaining age and service pensions is growing – but this should be seen in its broader context. Based on current policy, spending on pensions will reach 3.6 per cent of GDP by 2054-55 as the age structure of the population changes. Even at these higher rates, Australia's public expenditure on pensions would remain extremely low compared to almost all other countries in the OECD. This reflects the relative moderateness and extensive means testing of our age pension compared to overseas models that base pension benefits on prior rates of earnings.

Chart 9 - OECD cash spending on age pension as a share of GDP



Note: Data is for 2011

Source: OECD 2014

Australia should strive to strengthen the pension system by building on existing strengths in eligibility and means testing, rather than simply cutting what is already a basic level of financial support for those relying solely on the full age pension. Part of the equation is gradually shifting the retirement age, which on current legislation will increase to 67 by 2023. As well as reflecting greater life expectancy these changes will make a contribution (albeit a relatively small one) to participation and GDP, as well as to income tax receipts.

The key focus for further savings should be reviewing current asset and income test arrangements, including measures to remove or modify the current exemption of the family home from the assets test, lower thresholds at which other assets trigger lower

pension payments and increase the rate at which payments taper off past these thresholds. Variations on this approach have been advocated by a wide range of reviews, from the Henry Tax Review to the Commission of Audit. Pensioners who do not own property are far more vulnerable financially than those who do, but current arrangements make no distinction between their eligibility to receive the age pension. The exclusion of the primary residence from means testing (apart from triggering a lower threshold for other aspects of the means test) means that older Australians with very valuable housing and other assets can continue to draw a full or part pension (and associated concessions) with no requirement to mobilise savings bound up in their housing health. As the IGR noted, home-owning pensioners can continue to receive partial payment with non-primary residence assets up to $771,750 for single homeowners, and $1,145,500 combined for couples who own homes.

There are various measures available that would ensure savings made through pension reforms are made at the expense of those with the greatest private means and living standards rather than focusing the burden of adjustment on those who are most vulnerable. These include changing means testing to include the family home above a high threshold or increasing the rate at which pension payments taper off for recipients with assets and incomes above given thresholds. In contrast, reducing the base rate of the pension disproportionately impacts those who have few or no other assets. It should be understood that these changes would be unlikely to play a significant role in near-to-medium term consolidation, given political constraints to making changes that impact the current generation of pensioners. Incremental implementation is vital. Nevertheless, delay in doing so is unthinkable. Changes will become more difficult over time as the costs of the system and relative number of recipients grows.

A related point is that, notwithstanding opportunities to make savings through tighter eligibility and means testing arrangements, opportunities to make extensive savings by targeting the pension system *alone* are limited. This does not mean that payments should simply be cut; rather, that there should be an increased emphasis on delivering results through interconnected parts of the retirement income system. In particular, this includes reform to ensure a superannuation system that delivers on its promise to support adequate retirement incomes and reduce reliance on the aged pension system.

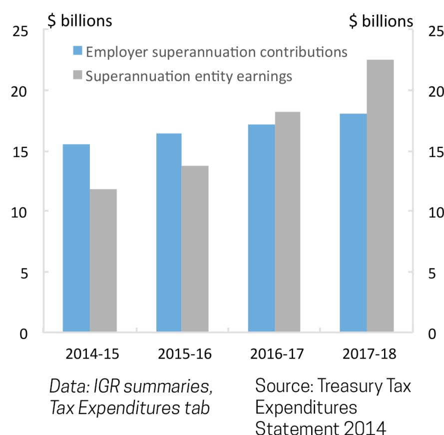
Issue two: superannuation tax concessions

The superannuation system is a cornerstone of Australia's approach to retirement incomes. However, its failure to deliver a lasting reduction in the share of the population drawing full or part pensions suggests it is not delivering returns that are commensurate with its high costs.

Treasury's yearly Tax Expenditures Statement shows that tax breaks that are provided to support superannuation are the most costly of Australia's extensive array of tax expenditures. Significant tax concessions on super contributions and investment earnings, as well as tax-free treatment of superannuation income streams in the pension stage, are key features of the system. These concessions help to facilitate the accumulation of larger balances and provide additional incentives to contribute to

super for those who can afford to do so. However, they also forego a significant amount of income tax revenue (albeit in a manner that aims to partially offset this cost by reducing reliance on government-funded age pensions).

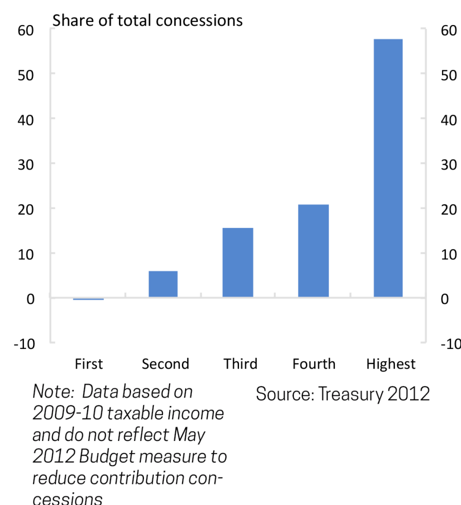
Chart 10 - Major superannuation tax concessions - Treasury estimate of 'revenue foregone'



Data: IGR summaries, Tax Expenditures tab

Source: Treasury Tax Expenditures Statement 2014

Chart 11 - Share of superannuation tax concessions by income group



Note: Data based on 2009-10 taxable income and do not reflect May 2012 Budget measure to reduce contribution concessions

Source: Treasury 2012

Ensuring that this expensive investment in superannuation through the tax system is achieving strong results for retirement incomes and the budget is as crucial as targeting effectiveness of direct government expenditures. But as the 2014 Financial System Inquiry (FSI) emphasised, super tax concessions are not well targeted towards improving retirement incomes for those most likely to rely on government support. They also create distortions that impact upon the adequacy and efficiency of the rest of the tax system (FSI 2014). In particular, the flat 15 per cent tax on super contributions up to a certain threshold (as well as options for securing tax-free income streams in the pension stage) make superannuation a particularly attractive savings and wealth management vehicle for high income earners who would otherwise face much higher marginal tax rates on their income. The FSI highlighted earlier Treasury estimates that more than half of superannuation tax concessions accrue to top twenty per cent of income earners, heavily favouring those who have highest means to provide for their own retirement. This is compounded by the fact that the much smaller relative contribution to those with low incomes and retirement savings indirectly facilitating greater reliance on the aged pension and greater strain on government spending.

These are widely recognised. Alternatives for refining the structure of concessions have been a focal point in calls for budget reform. While for political and behavioural reasons the savings to the budget from reforms to concessions are likely to be much smaller than the total cost reflected in Tax Expenditures Statement estimates, even relatively modest reforms could make a major contribution to fiscal consolidation. The Grattan Institute has estimated that reducing the threshold for concessional taxation of contributions to $10,000 per year and taxing super income streams at 15 per cent in the withdrawal phase would increase revenue by up to $9 billion per year (Daley 2013). A recent proposal by the Australian Greens to tax super contributions according to a progressive scale (that preserved marginal tax rate concessions for super

contributions across all income levels) would raise $3.4 billion per year (The Australian Greens 2015).

Any reforms to taxation arrangements could be augmented by further gradual increases in the superannuation preservation age (currently 60) towards consistency with the age of pension eligibility. This would further reduce reliance on age pensions and create additional revenue from higher participation. Other key priorities for reform include achieving greater competition and efficiency in the superannuation industry to lower fees (these counteract accumulation) and facilitating the development of comprehensive retirement income products that enable superannuation balances to support a more reliable stream of retirement incomes.

Issue three: Broadening the GST

Reform to the GST is inevitable. In the long term, this means increasing the rate, shifting to more comprehensive coverage, or actively moving away from reliance on a narrowing GST as a key feature of the tax system and federal financial relations. Muddling through with a GST that becomes more distortionary and less adequate, and represents a major impediment to broader tax reform, is not a sustainable option. Continued structural weakening of the GST merely imposes strains on other parts of the tax system, and indirectly creates pressure on government expenditures and public services that are relied on disproportionately by lower income households.

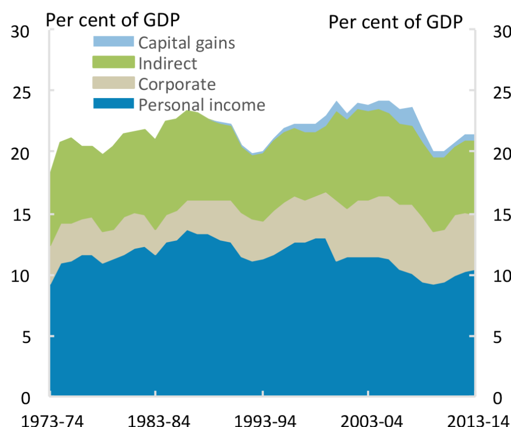
The introduction of the GST recognised the need to shift the tax mix towards broader tax bases such as consumption and leveraged an opportunity to replace economically and administratively inefficient taxes levied by the States. However, indirect taxes as a share of the total tax receipts has declined significantly since the early years of the GST. In part, this reflects the fact that several large components of consumption that the GST does not apply to –including education, health and fresh food – have grown as a share of overall consumption expenditure. In total, according to the Government's Tax Discussion Paper, the GST only applies to around 47 per cent of Australia's national consumption under current arrangements.

> "Reform to the GST is inevitable. In the long term, this means increasing the rate, shifting to more comprehensive coverage, or actively moving away from reliance on a narrowing GST as a key feature of the tax system and federal financial relations."

This is part of a broader trend, clearly highlighted in the IGR projections, of Australia's tax mix evolving in the wrong direction, towards a greater reliance on distortionary income taxes levied on mobile and narrowing tax bases and away from taxes on less mobile bases such as land and consumption. This means that the overall impacts imposed by the tax system are becoming more negative over time due to the higher 'marginal excess burden' imposed for each dollar of revenue raised for other major tax bases such as stamp duty and income tax.

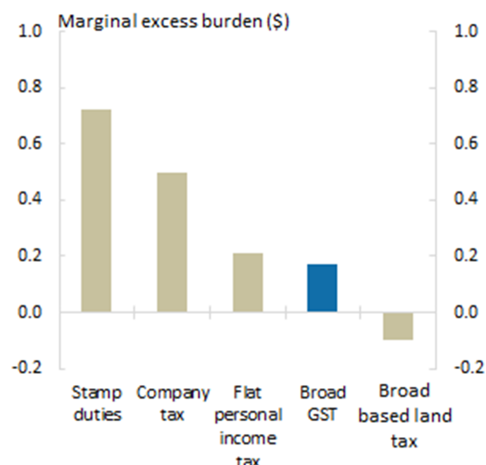
Reforming the GST is one of few plausible options for counteracting this trend and contributing to the longer-term adequacy, efficiency and sustainability of the revenue base.

Chart 12 - Evolution of Australia's tax base over time



Source: Tax Discussion Paper 2015

Chart 13 - Marginal excess burden estimates



Note: Personal income tax marginal excess burden based on impact of flat rate tax at average rate on personal taxable income in 2011-12 (around 21.5 per cent). GST estimate is for a broad based GST - estimates based on current GST structure indicate a slightly higher marginal excess burden (0.19).

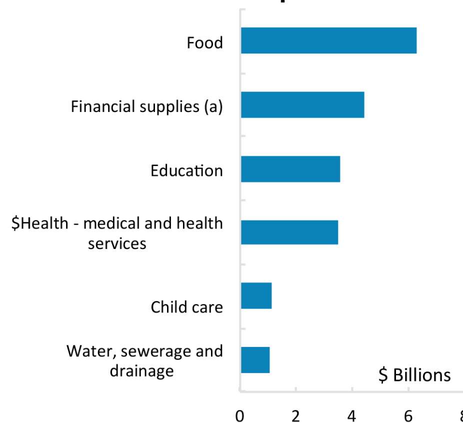
Source: Treasury 2015

Raising the rate of GST as it currently applies would sharpen existing distortions caused by different treatment of exempt and non-exempt categories of expenditure, without reversing the narrowing of the GST base over time as the composition of expenditure changes. Alternatively, selectively broadening the application of the GST would work against these trends. Treasury's tax expenditure data suggest the non-applicability of the GST to the six biggest classes of exempt expenditure reduces revenues by almost $20 billion per year. Imposing the GST across some of these expenditures would support revenues and broaden the overall tax base, as well as reducing distortions and complexities associated with only applying consumption taxes to *some* goods and services.

Significantly, because the wealthiest households have the highest absolute levels of expenditure on GST-exempt goods and services, most of the additional revenue raised by broadening the GST would flow from those with higher incomes. This means that even with measures to fully compensate lower income earners and to offset increased costs in public services like health and education, the revenue raised from a broader GST could make a significant contribution to strengthening the budget in the medium-term. Alternatively, additional GST revenues could be used to fund the removal of highly inefficient state taxes such as stamp duty, increasing the efficiency of the tax system overall.

Broadening the GST will be challenging both as a matter of politics and policy design. The regressive nature of the GST, and in particular application of the GST to food and necessities that make up a greater share of the expenditure and earnings of low income households, has justifiably been a major contention in arguments about the GST for more than two decades.

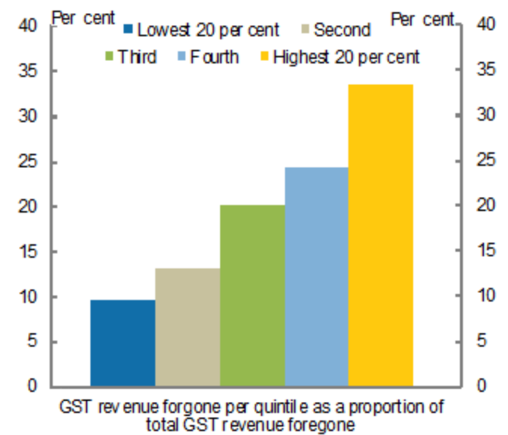
Chart 14 - Impact of major GST exemptions



Note: Financial supplies inlcudes 'input taxed treatment' and 'reduced input tax credits'. Food, education, financial supplies - input taxed treatment refer to estimates of 'revenue gain', while others estimate 'revenue foregone'.

Source: Treasury Tax Expenditures Statement 2014

Chart 15 - GST revenue foregone by income group



Source: Tax Discussion Paper 2015

It will continue to be an extremely difficult issue for any Government to tackle. There are legitimate concerns about the extent to which compensation to lower income earners would be sustained over time, the impact of price changes on demand for previously exempt goods and services, the fiscal interaction with government subsidies in areas such as health and education and the broader issue of achieving a sustainable compact between the Commonwealth and States on the distribution of the GST and the delivery of key public services.

Notwithstanding these concerns, broadening the GST is the most plausible option for reorienting the tax base to support growth in the economy and living standards over the long term and to preserve policy priorities (including transfer payments and public services) fundamental to Australian values. Political and administrative barriers to alternatives such as greater reliance on land tax mean that more appealing options from a tax efficiency perspective are likely to prove even tougher than broadening the GST. Defaulting towards greater reliance on existing tax bases through higher personal or company income tax rates would work against the longer-term efficiency and sustainability of the tax system.

When considered in isolation the distributional impacts of broadening the GST should be concerning. However, considered in broader context, the case against broadening the GST on this front is less clear cut. While the distributional concerns about the regressive nature of the GST are real, so too are the distributional impacts of a less efficient tax mix and typical 'savings measures' like bracket creep, social safety net cuts and reduced expenditure on essential public services. Alone, a broader GST would

make after-tax incomes less equal. However, overall impact of the new GST would continue to be dominated by support to gross incomes from cash transfers, and the significant impact of progressive income taxation and 'transfers in kind' from Government in the form of service provision, all of which in combination have a substantial positive effect on income equality (McAuley, 2013). Additional GST revenue used for expenditure on services like health, education and housing would contribute to the social wage, partially offsetting the detrimental impact (and reducing the need for direct cash compensation).

Adequate and sustained compensation through other parts of the tax and transfer system can offset the larger relative impact of a broader GST on lower and middle income earners, while winding back (what is in absolute terms) the very large tax break for the best-off households. This is consistent with the principle that what matters in assessing equity and progressivity is not the isolated impact of any one measure (such as the GST) but the overall impact of the entire tax and transfer system. As the Henry Tax Review emphasised, personal income tax rates and transfer payments can be expected to shoulder most of the load in ensuring that the system remains progressive.

In this context, the biggest obstacle to broadening the GST is not the inherent regressivity of the tax when viewed in isolation. The chief impediment is the concern that compensatory changes to tax thresholds and transfer payments to protect the living standards of low-income earners could be wound back by future Governments, either as a matter of fiscal expediency or ideological malevolence. This concern is justifiable and made more acute by contemporary approaches to consolidation, particularly the latest attempt to balance the budget by driving a wedge between the living standards of welfare recipients and wage earners. But it cannot be overcome by simply refusing to talk about the issue.

Unlike the Henry Tax Review, the Government's 2015 Tax Discussion Paper was permitted to consider the evolution of the GST and options for reform. While refusing to rule any particular reforms in or out at this stage of the White Paper process, Treasurer Joe Hockey was at pains to highlight the likelihood that the states would not agree to GST changes (Hockey 2015b), while Shadow Treasurer Chris Bowen immediately ruled out any prospects of future changes to the GST under a Labor Government (ABC 2015) The challenge for policy makers, at State and Commonwealth level, should not be finding new ways to deny or delay an inevitable conversation about the GST. They must do the hard work of envisaging and implementing a package of tax reforms that can accommodate a bigger role for the GST, or developing and advocating appropriate alternatives.

If Australians want to budget smarter, not harder, the GST reform conversation can no longer be avoided. Avoiding it simply allows fiscal problems to accumulate while creating new barriers to change and denies a broader package of tax reform with a set of measures and trade-offs that present clear and more compelling choices to the electorate. The electorate must be involved in the conversation about how to balance competing priorities: it cannot do so with key issues shielded from the discussion.

3. The conversation we need: drivers of intergenerational wellbeing

> The budget deficit is not the biggest or most significant deficit we face in our long-term policymaking. Our real deficit is in our national conversation.

The gap between the current trajectory of the budget and a more sustainable path for longer-term finances has been the focus of the conversation on the IGR. As discussed above, it is significant. But it is not the biggest or most significant shortfall we face in our long-term policy making. The most worrying deficit is between the national conversation envisaged by the 2015 IGR and the actual conversation we need to have about our longer term wellbeing. There are a series of interconnected policy issues that we should be considering in order to prepare our economy and society to meet the full range of long-term challenges awaiting us

This is a deficit embodied perfectly by the 2015 IGR. The report was narrowed significantly in substance and in scope compared to its 2010 predecessor. The previous IGR not only considered long-term demographic and fiscal trends, but placed these in the broader context of the economic, social and environmental factors and policy challenges that were relevant to sustaining our intergenerational wellbeing. The 2015 IGR replaced this discussion with a formulaic nine-page foray titled 'Preparing for the future' that totalled less than 10 per cent of the document. This section of the IGR, inasmuch as it discusses Australia's future, lacks policy innovation and foresight. 'Preparing for the future' primarily covered old ground on participation, business regulation and sketched out upcoming reviews of competition policy, the tax system and the Federation. It is a piecemeal and superficial description of well-trodden policy paths. The Government might well respond that it is reasonable to expect these reviews, rather than the IGR, to provide a fully-fleshed out vision of the future in specific policy areas. However, if the Government's recently-released Tax Discussion Paper is anything to go by, they are more likely to focus on established trends and long-standing policy options than to facilitate far-sighted debates. They are also likely to skirt important but politically inconvenient issues like climate change and resource rent taxation.

The narrowed focus of the IGR cut firmly against Treasury's long-standing emphasis on taking a broader perspective on the determinants of wellbeing – including the importance of social, civic, and environmental factors that can sustain wellbeing in the long run (see for example Gorecki and Kelly (2012) and Parkinson (2011)). Initiatives that could have played a key role in sustaining this broader conversation about the future – such as the Australian Bureau of Statistics' *Measures of Australia's Progress* program and the National Sustainability Council – have been scrapped as part of attempts to reduce the near-term budget deficit. The IGR cannot be expected to make up the shortfall – but it should be expected to play a larger and more impactful role, especially given changes elsewhere. Instead it focuses the weight of its forty-year projections not on the distant future but on the budget politics of today. Which begs the questions – exactly where is the wide-ranging conversation we were meant to have and who will provide it?

The final section of this report sets out some key policy areas and challenges that will occupy an increasingly prominent place in our policy debates and demand attention in any serious conversation about Australia's future. These are childhood development

and community wellbeing, cities and connectivity, commerce and capital, climate change, and the concert of Asia. Several of these challenges were touched on briefly in the IGR. An extended discussion of any or all of them would help to start a conversation far more important than the one the IGR delivered. Each challenge bears heavily on the population-participation-productivity framework that drives the IGR's outlook for long-term economic growth. They will each be central to broader determinants of wellbeing. Most importantly, each of these challenges generates complicated trade-offs and choices that will have to be considered and made for Australia to thrive in the twenty-first century.

Childhood development – more than just participation

The 2015 IGR turned repeatedly to childcare, largely in the context of increasing female workforce participation. Treasurer Joe Hockey described women as "the second underutilised workforce army" after the aged. The female labour force participation rate has increased from around 46 per cent to almost 59 per over the last three decades. The gap between female and male participation is forecast to narrow over the next decade – albeit not rapidly enough to meet the G20 target of reducing the gender gap in participation by 25 per cent by 2025. Significantly, of the gains made in Australia, nearly all of the increase has been in part-time rather than full-time work, while historical and contemporary gender gaps in participation have led to entrenched disparities in retirement savings adequacy between men and women.

The IGR takes up these issues by emphasising the role of childcare in supporting participation and the Government's commitment to addressing barriers to the quality, availability, flexibility and affordability of childcare as a part of its participation agenda. Despite significant support for childcare through the tax and transfer system, a majority of families with children under five experience difficulties with the availability and affordability of childcare (Stewart et al, 2015). However, as the recent Productivity Commission report on Childcare and Early Childhood Learning indicated, decisions on whether and how much to work are determined by a broad range of work, family and financial factors (Productivity Commission 2015), beyond options for childcare. The PC cautioned that its proposed reforms – which the Government has indicated it is carefully considering ahead of a childcare policy package for the 2015-16 Budget – would have a relatively small impact on workforce participation if adopted. It estimated that the number of working mothers would increase by around 16,000 (or 1.4 per cent) based on its reforms. As a result, the estimated positive first-round impact on GDP from increased output increased output is low – 0.1 per cent in 2013-14. The PC notes this figure is supressed due to the "comparatively low" average productivity and value of workforce contribution of the lower and middle-income families whose participation would be supported most by the proposed changes (PC 2015, p.39).

This raises more questions about the usefulness of GDP in measuring wellbeing than it does on the merits of expanded investment in childcare – a shortcoming noted by the Productivity Commission in its report. GDP captures the impact of increased participation on output, but not the individual and societal value of a wide range of non-

market activities that may be reduced as people move into work. This means that even though increasing participation through expanded childcare boosts GDP, the overall

impact on welfare and wellbeing will be smaller than GDP-based calculations suggest. It is also true that focusing narrowly on the immediate impact on participation and GDP does not capture the broader long-term *benefits* of investing in childhood development. The longer-term benefits for Australia's human and social capital from having an effective policy framework for childhood development – including better access to childcare and ancillary support packages, adequate maternity/paternity leave and high quality early childhood learning – are significant, as are the flow-on effects from helping to sustain long-term workforce attachment for parents. In both cases the positive impacts are immediate as well as intergenerational. This is particularly significant for children, families and communities that are disadvantaged or at risk. These are benefits that a narrow focus on participation and GDP can only begin to capture.

This suggests that one of the analytical strengths of the IGR – the analytical clarity and tractability of the PPP framework – is also a shortcoming, at least in terms of its ability to guide the broader conversation the Treasurer wants to have. In this case, the focus on participation can send a clear message about the longer-term impacts on the budget and GDP. But is also begs crucial questions about how we should weigh these imperatives against a much broader set of considerations about wellbeing and welfare: the ability of parents to spend time with children, for childcare and education to break cycles of disadvantage and barriers to development that weaken communities and for ability of government policy to support the skills, social bonds and community wellbeing,

These, while less amenable for traditional economic measurement, are much more immediate and tractable in the lives of the people the Treasurer wants to engage than intergenerational projections of workforce participation. The conversation needs to feature both – but the IGR systematically strips back the discussion of the broader economic, social, civic and environmental drivers of intergenerational wellbeing that were included as a starting point in the last report. The IGR not a perfect vehicle for the full discussion of all of these issues but it would have been a good place to start.

Cities – where the rubber hits the road

Despite the entrenched focus of the IGR on the "three P's" at a whole-of-economy level, it has little to say about the places where the rubber hits the road, literally and metaphorically – in Australia's cities. Cities that will accommodate the large net migration flows are a crucial element of the IGR's strong long-term outlook for growth in population and GDP. Cities are where the vast majority of this population is physically connected to opportunities to participate in workplaces and markets, producing around 80 per cent of Australia's output. It is in cities where the forces of agglomeration, specialisation and technological progress interact to drive productivity growth, supported by services sectors that connect Australia to the opportunities and efficiencies associated with global trade.

Cities are also where concerns about access to property markets are most pressing. This issue has become a key touchstone in public debates about intergenerational wellbeing. Entrenched supply-side failures in large cities have contributed to inequities in access to housing (and associated wealth) that are pronounced and likely to be prolonged. Price pressures in key markets have also complicated the task for macroeconomic policymakers, particularly the Reserve Bank of Australia, in supporting economic growth without entrenching vulnerabilities associated with high asset prices. The 2015 IGR conspicuously overlooks the importance of broader aspects of wellbeing that are largely driven by cities. These include the amenity of natural and built environments, the importance of civic participation, the intrinsic value in social connectedness and the benefit of innovation and creativity hubs.

All this means that while regional areas, communities and industries have an important role to play, cities are where our ability to respond to intergenerational pressures and opportunities will be tested immediately and acutely. To highlight three areas in which cities will play a leading role:

- Addressing climate change and carbon abatement: Cities are major contributors to CO_2 emissions and are likely to face key threats to infrastructure and quality of life from long-term climate change. They are also where opportunities for developments in energy sources, utilities, zoning, transport, construction and design that can have a major influence on the future path of carbon emissions. This is likely to be particularly important in an Australian context where prospects for national leadership and action on this issue have stalled.

- Developing new models of governance and demographic participation: Large, dense populations, multiplicity of community groups and the opportunities to experiment with different governance models at local government level mean that cities can play a key role as hubs of increased civic participation and springboards for democratic renewal.

- Addressing entrenched disadvantage: Cities will continue to be a key site of tension between opportunities from globalisation and technological change, and the economic and social disadvantage that can go hand-in-hand with disruption. Even as concentration of knowledge and innovation in leading urban areas becomes increasingly crucial to growth, addressing spatial (and intergenerational) pockets of pronounced disadvantage and isolation that manifests in terms of physical infrastructure, economic opportunity and social cohesion will be key to spreading prosperity across the community. This poses key challenges for urban planning and the design and delivery of social services. The challenge of breaking down economic and social fragmentation in cities will have to be addressed in parallel with urban-rural disparities, where issues of connectivity (in terms of physical infrastructure and technology), the spatial distribution of population, production and

disadvantage, and environmental pressures associated with traditional modes of economic activity are equally complex and pressing.

Commerce and capital – preparing for change and counting what matters

The IGR touches on the profound impacts that technological change is having on patterns of business, production and consumption and the implications for Australia's Government, economy and society. These range from the implications of cutting-edge research and innovation on the future of employment and productivity growth, to the potential for new technologies to revolutionise government service delivery. In remarks before and following the launch of the IGR Treasurer Hockey was particularly keen to highlight the potential opportunities, and also the disruptive impact, of technological change – from driverless cars to the impact of internet commerce on the future of the GST (Hockey 2015c).

While the IGR touches on each of these issues in isolation, the broader trends raise fundamental questions about how effectively Australia can participate and compete in a twenty-first century trade and business environment. Three issues are particularly crucial:

- Participation in global value chains: Lower trade barriers and new transport and communications technology have led to the development of global supply chains that are the new defining feature of international trade in both goods and services. The mining boom has seen Australia bucking a global trend amongst advanced economies by moving further upstream in global production processes, with our exports driven more by commodities than by concepts or components. Succeeding beyond the resources boom means increasing value-added trade in services and other sectors – something that will require moving beyond 'old' trade paradigms focusing on preferential access for raw materials and finalised products. Trade deals that have driven promising services sector liberalisation with China and other key trading partners are a crucial start – but only that. The quality and competitiveness of Australia's human capital will determine our success in adapting to this new world.

- Technology, knowledge and innovation: Australia ranks 29th out of 30 in the OECD for collaboration, and Australia bets more on the Melbourne Cup than the Australian venture capital industry punts on start-ups every year (Ferrier Hodgson 2014). In these globalised supply chains Australia's capacity to develop, commercialise and harness good ideas will be as crucial as our ability to absorb and adopt advances and practices from the cutting-edge of global practice. The IGR identifies absorption of global advances as key to sustaining growth for Australia as a net importer of technology. But participating in the twenty-first century economy cannot simply be about buying ideas and processes off the shelf. A renewed focus on breaking down

silos across Australian industry, academia and Government, and in particular addressing our poor performance on business-to-research partnerships, is needed to develop a national capacity for collaboration that matches our strong commitment to ensuring competition. Progress on this front would offer opportunities not only to deliver the rates of productivity growth forecast in the IGR, but to develop knowledge-and-tech-based industries that can participate and compete on a global scale. Australia should be able to build winning ideas at home, not import them all from abroad.

- Workforce skills and planning: These trends also raise fundamental questions about the skill-sets Australian workers will need for the workplaces of the future – and whether current models for linking education and training with employment will be sufficient. Research out of the Oxford Martin School suggests 47 per cent of the United States' employment and 35 per cent of the United Kingdom's employment is at risk of automation (Oxford Martin School 2013). Such research does not argue technology is a job destroyer – in fact Pew has confirmed the opposite is often true (Pew Research Centre, 2014) – but it does require Australia to think carefully about what the jobs of the future look like, which industries we will be in and which ones we will not be in. It also reinforces the importance of education and lifelong learning. This is particularly the case given Australia has entered a period of relatively high unemployment (highest since August 2002) and has record levels of youth unemployment.

"To ensure the long-term strength of our economy and sustainability of our wellbeing in this challenging environment, we need to make sure that we are counting what matters."

To ensure the long-term strength of our economy and sustainability of our wellbeing in this challenging environment, we need to make sure that we are counting what matters.

When it comes to capital, the imperative for Australia to attract capital in a competitive global marketplace to drive investment and growth is clear. But economic capital is only a small part of the overall stock of capital that underpins long-term wellbeing. The 2010 IGR also emphasised the crucial role that social, human and environmental capital play in shaping the capabilities and choices of future generations – and ensuring that wellbeing is sustainable over time.

This means that future wellbeing depends not just on how much machinery or financial capital we accrue, but also on the skills and attributes we develop, the social fabric we build and the resources and natural environment we bequeath. Australia's strong endowments across each form of capital has supported some of the highest living standards in the world. Australia consistently ranks as a leading country for quality of life, such as in the recently announced Deloitte Social Progress Index 2015 where Australia was in the overall top 10 (Deloitte 2015). But our position at the top of the world order is vulnerable. Sustaining this into the future will rely on our ability to factor all forms of capital into our decision making about choices we make today, rather than focusing solely on the kinds of capital that are easiest to measure.

This is true at level of individual industries and businesses as well as at the level of the national economy. Businesses are increasingly likely to support measures to broaden measurement of capital for commercial reasons as well as due to commitment to social and environmental sustainability. For example, in Australia, National Australia Bank is poised to become a leader in accounting for natural capital in the agriculture sector, strengthening ability of farmers and their financiers to understand how the stock and quality of resources like soil and water shape long-term sustainability. Supporting efforts to develop new measures for different kinds of capital, as well as fleshing out notions of individual and collective wellbeing that extend beyond income and GDP, will be crucial priorities for ensuring that economic promise outlined in IGR projections translates into sustainable prosperity.

Climate change – budgeting for a low-carbon future

The 2015 IGR said very little about the long-term challenge that will underpin intergenerational welfare this century: climate change. This was in marked contrast to the previous report, which devoted an entire chapter to the subject. The effects of climate change will be pervasive and will exacerbate the range of Australia's economic and social challenges.

While the 2015 IGR only included a handful of cursory references to climate change and associated environmental trends, there was one vital statement: Australia will join with the international community to establish post-2020 targets for reducing greenhouse gas emissions in line with the international target of keeping global warming to less than 2 degrees Celsius above pre-industrial levels. Most disappointingly, the 2015 IGR passed up a perfect opportunity to include a substantive discussion of *how* this could be achieved. Such a discussion could have incorporated consideration of the United Kingdom's 'carbon budget' approach to monitors how emissions are tracking relative to our immediate commitments and those that would be necessary to meet the 2 degree target and provide guidance as to the different contributions (and associated adjustment costs) to be expected from key sectors.

As well as providing accountability on progress towards established commitments, and those due this October in the lead-up to COP21, this approach could have indicated that, as with fiscal consolidation, the pace of adjustment required will become more onerous if we delay action to meet targets already set. Crucially, addressing Australia's climate change challenge presents opportunities for developing world-leading practice and technology. For instance, Australia can invest in finding innovative breakthroughs across energy efficiency, smart grids, public transport innovation and industry-scale renewable energy provision. In doing so Australia can ensure intergenerational wellbeing in diverse areas ranging from smarter and more sustainable cities to a more resilient and adaptable defence force.

Concert of Asia? Australia's engagement in international affairs

The IGR is not intended to be a Defence or Foreign Affairs White Paper as well. However, it would be folly to believe Australia's decisions alone impact its intergenerational destiny. Many of the challenges above escape the control of any one country or

parliament. Much of Australia's destiny depends on ongoing regional order and stability in Asia. Without such a state of international affairs, Australia will struggle to pursue prosperity and security at the domestic level. Hugh White attempted to start a discussion about Australia's role in the region in his book *The China Choice*, where he advocated a Concert of Asia. While friends will disagree on the composition of the power-sharing White proposed, it is clear that Australia requires a deeper conservation about its role in Asia and the choices that entails for existing alliances.

Australia's ability to sustain intergenerational wellbeing will rely heavily on its relations with the rest of the region, and the world at large. We know this because three billion members of the new middle class and half the world's population will live to our north by 2030, just as borders become more porous and the 'perfect storm' of rising demand for food, water and energy is increasingly exacerbated by climate change. Fostering effective and durable policy solutions in the key areas identified in this section – communities, cities, commerce and climate change – depends on Australia's international relations, its international standing and its international competitiveness. It is by no means clear that Australia's leaders understand the changing nature of East Asia, how this changing geopolitical dynamic impacts us, how the diffusion of power and increasing integration requires more active regionalism and how preserving order and stability will require moving foreign and security policy beyond commerce, crisis management and alliances towards a deeper and more strategic long-term framework.

Put simply: Australia needs to comprehensively engage in international affairs at a level of sophistication rarely seen in our history. Our competing overlay of strategic relationships require significant policy work that we are not currently undertaking. We remain at the whim of unforseen crises and at the mercy of competing expectations by our allies and economic partners. Without greater coherency and strategic vision in our international affairs, our longer term prosperity and peace are inherently compromised, with the ever-present risk that events will overwhelm us.

Our national conversation about the longer term needs to start acknowledging fundamental regional realities. First, that traditional understandings of sovereignty are substantially transforming. Like our key partners and neighbours alike, Australia will need to take advantage of phenomena such as global value chains, digital technology and the 'internet of things', whilst also adapting to pervasive threats such as climate change. Federation in 1901 may have marked our entry as an independent nation into the world, but Australia's success in the twenty-first century will depend on its interdependence with other nations in order to maintain stability and prosperity. Engaging formidably in regional institutions, gathering neighbours together to reach multilateral agreements and demonstrating leadership and proactive decision making on key items will be pivotal to national success at home and abroad. Whilst the Government of the day will continue to provide varying levels of leadership in our international relations, a truly successful international policy relies also on international linkages forged at the business level through commercial partnerships and transactions, at the societal level through exchanges and cultural programs, and at the family level through connecting diasporas.

Any credible intergenerational policy framework must explicitly address the regional realities Australia is facing whilst actively working to develop a coherent, sophisticated doctrine to manage our position in this concert of nations. This must be a cross-party and cross-sectoral project.

Conclusion

The Treasurer was not wrong in attempting to use the 2015 Intergenerational Report to kick-start a conversation about Australia's future. As this report shows, however, there is a sizeable gap between the conversation the Treasurer has started and the conversation the country needs. Right now the conversation is about a budget problem. This report shows the IGR's depiction of the problem and pathways for overcoming it as illusory. A better place for the Treasurer to start would have been a conversation about smart and sustainable budget repair. This report picks up this baton to show there is a package on the table that significantly starts the job, by prioritising the key vectors of effectiveness, balance and sustainability.

Finally, this report outlines the key elements of the conversation Australia needs about the future. One that rises to meet the speed, scale and complexity of challenges vital to intergenerational wellbeing but largely written into obscurity by the 2015 IGR and other governmental processes. There are no easy answers to addressing these challenges – we cannot hope to find them without having that conversation sooner rather than later.

Australia cannot completely control its destiny. But we can shape it far more constructively than the most recent IGR allows us to. When introducing the package of legislation that introduced the Intergenerational Report as an institution of Government, then Treasurer Peter Costello hailed it as a document that would allow the Parliament to assess the viability and sustainability of existing policies and assumptions. The ultimate test was to be the 'reasonableness' of the assumptions. The view of CPD is that the reasonable person went missing with this report. It is time to bring her back and get the conversation back on track.

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