Solving the structural deficit

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What this is about. And why now?

This publication is about responsibility. It is about the obligation we have to the long-term social and economic future of Australia. It is about the legacy and burdens we will pass on to future generations – gens Y, Z and Alpha. That is, fundamentally, what our structural deficit is about.

As business and community leaders, we should consider the sustainability of what our governments do, and what they don't do. We need to think through the desirability, efficiency and contributive justice of what we raise as revenue. And we need to think through the sustainability, effectiveness and distributive justice of what we spend.

This is not easy. But it is imperative.

Our paper is a contribution to this discussion. In July 2015 we published our position on taxation reform. We considered the taxation system as a whole and presented a large number of ground-breaking ideas. In this publication we extend the conversation, giving broader thought to fiscal sustainability by focusing largely on the expenditure side, as well as contributing some additional ideas for revenue measures.

The challenge can be put quite simply. It is clear that based on our current policy settings, government expenditure will increase faster than revenue projections. What we are doing now, and have been doing for almost a decade is simply not sustainable. There is no ideological foundation in this simple statement. The entire political spectrum – spanning government and business leaders - needs to be concerned about, and agree to act on this.

Australia is a remarkable society. We attained the very highest per capita incomes in the world by the mid-nineteenth century, a remarkably short time after British settlement. This position was maintained until about 1900 where we lost top place to the United States. And with the United States, United Kingdom, Canada, the Netherlands, New Zealand and Switzerland we have been one of the world's richest countries for about 170 years. More recently, we have experienced a major minerals boom on the back of substantially beneficial terms of trade. We are now in our 25th year of uninterrupted growth.

This history should not give rise to complacency. Our future does not look as rosy as our past. We will need to be cleverer than we have been to maintain our competitive position.

Now, we are in our eighth year of substantial and unsustainable fiscal deficit. To be sure, this is partly due to the GFC and governments' additional spending in response to this. But that additional expenditure was temporary. What we are dealing with now is structural.

In these pages we urge change in four broad areas: health and aged care, welfare, superannuation and age pension, and education. Our estimates are that these would improve the budget position on a long-term basis by around $12 billion in today's terms annually.

Our pathways are not 'slash and burn', but rather the search for sensible and rational changes, drawing both on our expertise at KPMG and beyond. We look forward to your thoughts on this critical topic for our nation's competitiveness.

Peter Nash
Chairman

Gary Wingrove
Chief Executive Officer

The critical role of tax reform

In July 2015, KPMG released a publication on tax reform, *Tax Reform: KPMG's submission to Treasury*, which can be accessed **here**. It looked at the revenue system as a whole and made more than 60 recommendations for a more efficient, equitable and simpler taxation system. We believe that publication is and remains a sound basis for rethinking the future on how we raise revenue. It involves a principled approach and is not focused on simply raising or lowering the revenue take. To the extent that solving the structural deficit needs to consider raising revenue, KPMG believes that the tax reform publication is a strong starting point.

While this publication focuses on the expenditure side, there are revenue measures contained within it, particularly in relation to superannuation and linking the indexation of fuel excise to health inflation.

Our structural deficit is grounded in the difference between expected revenue and expected expenditure in the future. Expected revenue is largely based on the growth of nominal GDP. It would greatly assist if part of our revenue base was directly linked to the growth expenditure. This is the thinking behind linking the indexation of fuel to health inflation.

We need to think creatively here.

Grant Wardell-Johnson

Leader, Australian Tax Centre

Why talking about our structural deficit is difficult

1 It is hard to gain traction discussing the need to address our structural deficit because we live in largely prosperous times. It is now a quarter of a century since our last recession. One would need to have been born before 1972 to have felt its impact.

2 The expression "structural deficit" has become part of the lexicon of the argument for smaller government, with political and ideological connotations caught up in the expression. Although dealing with the structural deficit could be a balance of expenditure and revenue measures, or even solely revenue measures, the label has a focus on cutting expenditure – not something many wish to embrace.

3 The structural deficit is very difficult to define. It is the deficit you are left with when you extract cyclical factors, including most importantly the business cycle. In working out the cyclical factors, one must determine the natural terms of trade for instance. Historical averages may help, but won't give you the full answer. Another way of looking at the structural deficit is to think of the inherent rate of growth in expenses, based on health cost inflation, demographics and similar items, and compare that to growth in nominal GDP, which is the main foundation of our revenue base. The fact that one cannot clearly define the structural deficit, does not mean it can be ignored.

4 The structural deficit is about the future. Many will assert we are either overly optimistic or pessimistic when we think about the future. There are those who ask: what will the future ever do for me? Thankfully, not most of us. And there are those who assert that if we are borrowing from our grandchildren, then they can borrow from theirs. Intergenerational equity is very difficult, conceptually and politically.

5 Using international comparisons, we are doing pretty well. Our Net Public Debt as a percentage of GDP, based on the most recent figures in the IMF database, is 18%. By comparison it is 27% in Canada, 49% in Germany, 81% in the UK, 89% in France, 81% in the US and 128% in Japan.

6 Community and media focus has been overwhelmingly on the *current* deficit. This has been politically driven. The conservative side of politics attacked the Rudd Government's short-term fiscal injection in response to the GFC. With a change of Prime Minister to Gillard, the effectiveness of short-term action was not adequately defended.

The political discourse turned to the current deficit number itself. Hysteria might be overstating it, but it certainly was not a measured discussion and was in some sense counter-productive. Tricks, such as changing the timing of company tax payments, were used to deal with the current deficit, while more considered programs dealing with the structural deficit failed to gain political traction.

7 In our Federation, our structural deficit needs to take into account the whole of the government – Federal, State and Local. We tend to think of both current and structural deficits in terms of the Federal Government. The interactions between the State and Federal Governments are simply opaque, not only to the wider community, but to the educated and political elite.

8 There is a level of discourse that all government debt is intrinsically bad. By contrast, we would not think in these terms for a household, where obtaining a mortgage for a first home can be one of the exciting and sensible courses of action that most of us undertake. Moreover, for a company, given the cost of debt is lower and, indeed in our times, significantly lower than the cost of equity, the concept that debt is bad is simply silly. Some forms of debt are good. Debt for sensible and properly evaluated, rather than politically driven, infrastructure projects that give rise to a net benefit in GDP and budgetary terms over the long run, is clearly beneficial.

9 Many measures have an upfront cost and a long-term benefit, both in economic and political terms. The benefits may be borne by a few, who are often vocal, while the costs may be borne by the many, some of whom may not yet be born.

10 Solving the structural deficit is hard. Very hard. Structural deficit solutions tend to be big. They involve lots of moving parts. Many aspects of the system may be impacted and the solutions are hard to reduce to simple formulae. Solutions, such as cutting the public service by 10,000 through a recruitment freeze for 2 years, can create their own micro inefficiencies. Such measures can also be a blunt instrument.

Why dealing with the structural deficit is important

1 Continual failure to deal with the structural deficit produces a very poor endgame. If our government finances are not sustainable, it limits what we can do in the future. The cost of failing to maintain a sustainable fiscal position is accentuated with its deterioration. As our credit rating declines, our interest bill rises for a given level of debt.

2 An early fix is the least costly option. The very nature of the problem is one that grows as interest on borrowings grow. In addition, the longer that expectations of provision of benefits by governments continue in our culture, the harder it is to change.

3 Fixing the structural deficit also provides the ability of governments to adjust fiscal policy and thus 'smooth' through the cycles, thereby reducing the human cost of a downturn. To do so, however, requires surpluses in the "up years".

4 Structural deficits by their nature dissipate the ability for governments to make discretionary expenditure. Sometimes this is a good thing. But there are serious programs that both sides of politics would like to embrace that are limited by structural deficits. In an odd but profound way, structural deficits provide limitations to our democracy. With restrictions on what governments can actually do, political parties start to look similar. While the rhetoric remains different, 'action' does not. This drives cynicism.

5 Structural deficits represent a borrowing from the future. Put simply, they impose an ever-increasing burden on our children and their children. This is an inter-generational equity issue. We have an obligation to the unborn child who inherits our society, our economy and the decisions that shape it. There are some nuances here. Borrowing for hard infrastructure with a clear net positive return to GDP presents a legacy for the future, even though it might contribute to the current deficit. The same might be said of education, as it clearly is an investment in the future. However, education is so intrinsically wedded to what government does on a day to day basis, that it should be treated as part of the structural expenditure and thus part of the structural balance of our budget position.

Ten principles for fixing the problem

1 Community expectations need to be reset about what governments can and should do. This is an important element in fixing the problem. Over the last two centuries, and particularly since the Second World War, we have a history of governments providing more to citizens. The National Disability Insurance Scheme (NDIS) is a recent example. It was welcomed by both sides of politics and rightly has strong support in the community. But the community needs to be aware that what governments do is in one sense limited by the growth in our economy and the changing demographics. This does alter the fact that, in some areas, what governments currently do can be moved to the private sector. Privatisations, such as Qantas and the Commonwealth Bank, have driven huge efficiencies in the Australian economy and will continue to do so.

2 Related to this there needs to be a specific clarity of purpose surrounding all public expenditure and tax concessions provided. Expenditure and concessions need to be evaluated against that purpose. It would seem clear that we have gone astray on superannuation tax concessions, principally because we did not define their purpose.

3 Defining the purpose of expenditure and tax concessions is part of the story. The expenditure must be efficient in meeting that purpose. Often, expenditure and tax concessions are blunt instruments, even if the objective is clear. Sometimes their impact is indirect. One can rightly query whether a subsidy to private health insurance is the most efficient mechanism for taking away pressure from the public hospital system. A grant for technology that would reduce carbon emissions is only valuable if amounts spent on the technology are additional to what would have occurred in any event. This is the principle of additionality in the carbon context, but there is a broader principle of efficiency here.

4 Government expenditure programs themselves should not inflate the cost of service. This is difficult. If a government subsidy for $100 worth of childcare is increased from $50 to $60 and all that has occurred is that the cost of childcare has increased from $100 to $110, everyone is a loser except the owners of the childcare centre. Thus some initiatives need to be undertaken with other initiatives, such as those designed to increase the number of childcare places to mitigate the price effect of an additional subsidy.

5 We are not clever when we estimate the costs and benefits of a project for the purposes of our government accounts. We tend to analyse only direct and clearly known costs over the period of the forward estimates. This is appropriate for conservative budgeting, but it does not provide a true picture of the costs or benefits of a project. A change in family and child benefits which promote an increase in female participation will have substantial long-term benefits for the economy. A policy that promotes women as homemakers, as we had in the early 2000s, should also be evaluated for its long-term economic detriments in terms of reduced female workforce participation.

6 A program for reducing the budget deficit must meet community standards of equity, including gender equality. A glaring problem in one particular area can undermine support for sensible changes. We believe such is the case for Newstart presently. Political rhetoric has left Newstart behind community standards. This is clear to most sensible commentators with knowledge in the area. A failure to fix this is an impediment to change. Also reductions in expenditure and changes to concessions need to be viewed through a lens of gender equality. This does not mean that measures which affect gender unequally should not be embraced. It does mean, however, that how we proceed in solving a structural deficit needs to be evaluated based on gender impacts.

7 Measures adopted to fix the structural deficit must meet community standards of fairness. Related to this, is that our safety net must be driven by a proper empirical assessment of needs and not ideology. An empirical assessment of needs may draw greater distinctions in some areas. For example, pensioners who own their own homes and those who do not.

8 Another major consideration is productivity. It needs to be taken into account as a principle of evaluation. The estimated productivity benefits of the NDIS were rightly part of the evaluation process for the decision to proceed. However, superannuation concessions for high net worth individuals may not produce significant productivity benefits and this needs to be considered.

9 Transitional costs are acceptable. They should be recognised to be part of any reform process. Sometimes these will be financial in nature and sometimes involve additional complexity for an interim period.

10 Finally, it is important to recognise that debt is not of itself an anathema, but debt to finance recurrent expenditure is problematic. This principle is particularly important when we consider how one finances hard infrastructure.

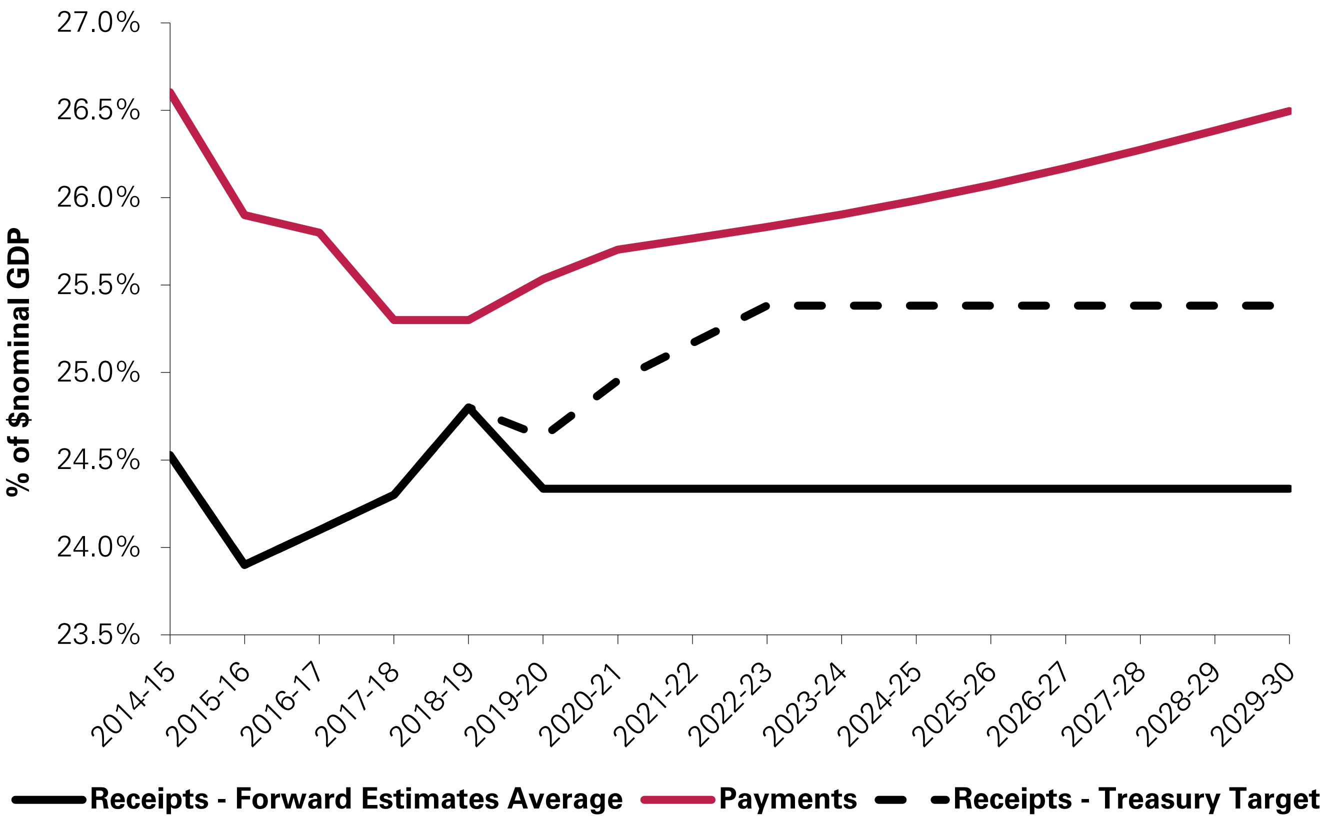
The structural deficit

The below diagram shows the expected level of government receipts and payments over the forward estimates and beyond into the medium term. Government receipts are estimated based on Treasury's assumption that tax income generated would equal 23.7% of nominal GDP into the medium term (ie: beyond the forward estimate period). However, the latest MYEFO has this ratio at only 22.7% by 2018-19, which suggests to achieve the Treasury target tax reform would need to occur. Given the Government's record so far with the White Paper process such an assumption may be possibly too much of a stretch, so we have also taken the medium term projections forward on the basis of the lower tax generation percentage.

In terms of payments, we have split out Defence and payments to the states for hospitals and schools as these items are likely to be significantly different to what has been costed in past budgets. For example, Defence spending is projected to increase to the equivalent of 2% of nominal GDP (where it is currently around 1.8%/1.9%); while payments to states for hospitals and schools has been earmarked for only CPI and small factor increases from 2018-19 and beyond. This future funding profile is not likely to be sufficient, and consequently we have grown these payments by historical growth rates which are higher than Treasury's latest projections. We have however kept the remaining government expenditure, being 'base payments', constant at 21.5% of GDP, which equals the average value of the current forward estimates position.

As you can see, government receipts never cover government payments over this forecast period; and depending whether you believe there can be proper tax reform implemented in the forecast period, this gap ranges from between around 0.5% of GDP at its best, to 2.2% of GDP at its worst. Worse still, the budget remains in a structurally deficit position throughout the whole forecast period, with its best result about -2.2% of GDP in the out years.

Projected Commonwealth Government Receipts and Payments



Source: KPMG Economics, Treasury

Health and Aged Care

By international standards, Australia has a very good health care system. The Australian community has come to deeply value the universal coverage of our health care, achieved by a mix of public and private components. That said, we spend a lot of money on health. Health care costs nearly 10% of GDP or $150 billion. Thirty years ago, this was about 6.5% of GDP. The Productivity Commission has indicated that in the decade to 2012–13, health care costs grew an average of 4.2% in real terms. This trend is likely to continue. Health is funded through our taxes, both Federal and State, and by insurance and direct payments.

The health system is complex with many inter-relationships, not only within it but also with aged care, welfare, disability, insurance, superannuation, road transport, and consumption taxation, including the taxation of tobacco, alcohol and gambling.

The reasons why the cost of health care are expected to continue to rise are essentially threefold. The first is chronic disease, the most prominent and complex of which are the effects of obesity. The second is the ageing of the population along with rising community expectations about health care for the aged. The third and arguably the most far-reaching is the combined impact of new medical technologies (in their widest sense including new pharmaceuticals) and a fee-for-service system in which providers generate more income for themselves by performing more services, with the risk of straying into over-servicing.

Another component of health care is the complexity around how we deal with expensive and intrusive interventions to prolong life. This has come to the fore in current times, but "end of life care" will be an increasing feature of the health expenditure debate. Our present system is expensive without necessarily giving people what they really want.

Dealing with a complex system invites a number of different approaches. The "Big Overhaul", while it should never be ruled out, is generally an inappropriate approach for a system that is not fundamentally broken.

Rather, change should arise from areas where there is a broad consensus from astute observers to deal with arrangements in a different way. In this endeavour, vested interests must be put aside. Pilot programs need to be embraced. Change should be implemented gradually, not because of timidity, but so that any potential unanticipated consequences can be dealt with and any damage is minimised.

Broad directions for health and ageing

A full root and branch inquiry into the health system including related expenditures should be conducted approximately every 10 years. This should be on the scale of the Henry and Asprey Reviews into taxation. Such reviews should be forward looking over 20–25 years and draw on international health expertise. Any such a review will raise the debate about health economics, diminish the power of inefficient vested interests and help to ensure that community expectations are realistic whereby people have thought properly about the values underlying the system.

Six other points have been identified about health care reform before dealing with our specific measures.

First, where appropriate, greater competition should be introduced into the framework of the healthcare system. This is the basis of some of the recommendations below. This does not mean that the health system loses compassion or empathy or a commitment to universal health coverage. Already over 60% of non-emergency surgery is performed in private hospitals, and a number of states are already purchasing capacity in the private system for their public patients, though predominantly through 'spot purchasing' rather than through more structured and durable commissioning arrangements. Islands of excellence exist that demonstrate what may be possible in relation to strategic commissioning, but more could be done to broaden the role of this transformative lever in the delivery of healthcare.

Second, the health system should become more 'client-focused'. While this sounds clichéd, the health system should not be viewed from the inside, but rather from the individual's perspective. Individuals should be treated as partners in the joint management of their own health. This needs to be cleverly done. People's attitude to their health is a bit like their attitude to money. For some, it is status. For others, it is security for the future. Many try not to think about it. Different approaches are needed for different people.

Third, as health becomes more technology intensive, we should be wary of losing the human dimension. Health isn't like many other industries in that labour (particularly clinical labour) continues to play a pivotal role in delivering patient care and driving patient experience. Even where opportunities exist to substitute efficiency-improving technology for labour, considerations of risk management and patient centricity continue to play a counter balancing role.

Fourth, clients rather than clinicians should be seen as owning their medical data. We need greater transparency in all areas of the system. Privacy provisions should be sensible. IT systems need to cater for the ease of transfer of information. Prescriptions should be written electronically which could address prescription shopping and provide significant other benefits such as improvements to quality and safety of care, clinical decision support, improved planning and management capability.

Fifth, there is increasing evidence to suggest that significant variations exist in the prescription and utilisation of health services. Reducing this variation through better use of a rapidly evolving evidence base in the delivery of care has potential not only to improve the efficiency of care, but also to avert unwarranted and potentially harmful interventions on patients.

Finally, the problem of defensive medicine, where the fear of being sued by patients may change the way some doctors practice medicine, and the significant yet unnecessary, and sometimes damaging, tests that flow from this attitude needs to be addressed. The interaction between the legal system, insurance and the medical profession needs to be closely examined with a view to reducing inefficiency. Here there are clearly strong vested interests that should be challenged. International best practice needs to be considered.

End of Life Care

The last month of many people's lives is spent receiving treatments that do not ultimately improve the quality of the person's death, nor meaningfully prolong their lives. This can include quite expensive interventions, such as admission to an intensive care unit and surgical procedures.

There are many reasons for this, but amongst them are the lack of useful pre-emptive discussions between health care providers, patients and their families about how to make the final days of life most satisfying and avoid unnecessary interventions (tests, treatments and admission to acute facilities).

Those conversations need to occur well before events relentlessly take patients by default down a pathway of aggressive intervention. With the burden of chronic disease rising and the elderly population rising as a percentage of the total population, likely end-of-life experiences are increasingly predictable. The rapid turnover model of GP consultation makes these pre-emptive conversations harder to have.

Health staff can be disinclined for medico-legal reasons to be perceived as not "doing everything possible" to prolong life, with family members also often worried that if they do not push for everything possible to be done it will appear that they are unloving of their ill relative.

The further down a pathway of aggressive treatment, the harder it is for health care providers and relatives to pull back or reverse treatment decisions. Yet many studies have shown that approximately 70% of people would prefer to die at home if they had a terminal illness.

There is no suggestion in this consideration of advance planning for a patient's end-of-life care that pain relief and making the patient comfortable should be omitted; rather, the focus in many end-of-life journeys needs to be much more on comfort, care and palliation rather than intrusive, and ultimately, ineffectual intervention.

Integrated Care

Our health care systems remain fragmented and siloed despite considerable efforts to bring about sustainable reform that would see better integration. Citizens living with chronic disease and those who care for them continue to experience challenges in navigating through an unnecessarily complex system and in gaining access to the right service at the right time. While improvements in technology (for example shared health records and tele-health) continue to be delivered at State and Federal level and have provided opportunities to better connect the continuity of care, this has not gone far enough. Current incentive arrangements produce only a hybrid of traditional fee for service approaches with payments designed to align provider behaviour with more integrated care models. Unlike other systems, we have not moved towards reimbursement mechanisms that shift the focus away from outputs and activity toward outcomes and quality.

Chronic disease management

For the more complicated patients with chronic disease who frequently require admission to hospital, a mature chronic disease management system will reduce hospitalisation by 2.4 admissions per annum. Since hospital admissions for these more complicated patients often cost more than average, the potential savings are in the hundreds of millions of dollars across the nation, with an acute hospital bed costing $1,100 per day and an Intensive Care Unit bed $4,000 per day.

Treatment rates for common procedures

Australia's treatment rates for common procedures are above the international average. If these treatment rates were aligned with the international average, the estimated savings are valued at $1.63 billion (Australian Commission on Safety and Quality in Health Care (2015)) per annum.

If regions of Australia with high variation in the rates of common procedures were matched with the average for the region, the estimated cost savings could be up to $228.3 million.

In 2011-12, 'high priority complications' were assessed by clinical experts as a group of cases which were both preventable and had a significant impact on patients and health services. The estimated cost of this group was over $973 million – just over 4% of the total cost of public hospital separations in 2011-12. Based on these figures, a 25% reduction in those complications would save $243.3 million (equivalent to 172,000 days of bed occupancy).

Pharmaceutical reforms

We advocate the introduction of pharmaceutical reforms similar to New Zealand's to bring prices down to a level closer to international markets. If Australia can obtain Pharmaceutical Benefits Scheme (PBS) medicines at more competitive prices through regulatory reform, there is considerable scope to improve the efficiency of the PBS, to the benefit of governments, taxpayers and patients.

Duckett (2013) estimated that Australians are paying at least $1.3 billion per year more than necessary for prescription medicines, and that Australian prices for pharmaceuticals are generally more than six times higher than in New Zealand.

Workforce substitution

Many health care staff are capable, when adequately trained, to perform tasks and roles traditionally provided by staff from other disciplines. Resistance to broadening scope of practice within the health workforce is often shrouded in concern for quality of care and patient safety. When workforce substitution has been piloted, it almost invariably confirms that patient satisfaction and clinical performance are as good or improved compared to traditional practice.

Tasks	Currently done by	Potential for expanded duties
Performing basic personal care (washing patients) and indirect care (clerical work)	Registered nurses	Nurse assistants
Performing endoscopy and sedation procedures	Medical practitioners	Nurse practitioners
Assisting with patient procedures, administration tasks and patient transfer	Allied health professionals	Allied health assistants
Administering vaccines, monitoring blood pressure, diabetes testing, and issuing some medical certificates and repeat prescriptions	General practitioners	Pharmacists or nurse practitioners
Diagnosing patients, performing examinations, prescribing medicines, and referring patients to specialists	General practitioners	Physician assistants
Diagnosing and treating some patients within hospital emergency departments	Medical practitioners	Physiotherapists
Treating patients in their usual place of residence rather than in hospital emergency departments	Medical practitioners	Paramedics

Source: Productivity Commission (2014)

Ten recommendations for changing the health and aged care system

The ten recommendations outlined below exist within the current framework of the provision of healthcare in Australia.

Our specific recommendations comprise eight measures on the savings side and two on the revenue side. While some are uniquely KPMG ideas, such as the health inflation indexation of 50% of fuel excise, many are ideas which are being considered by health economists and other interested parties as viable areas of pursuit.

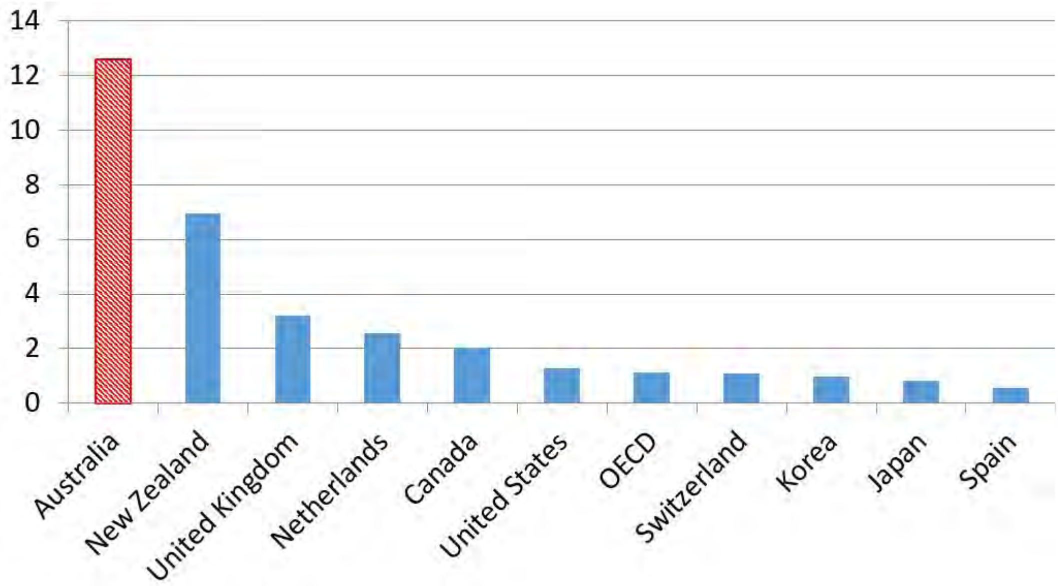
	Measure	$b	Reference
1	Change the Medical Benefits Schedule for the primary care sector to provide for integrated care for chronic diseases	0.3	KPMG Estimate
2	Reduce overtreatment of common procedures by reference to international standards and regional variations based on hospital admissions and complications	2.0	ACSQHC (2015)
3	Greater competition amongst pharmacies as proposed by the Harper Review	-	(Harper)
4	Prescription medicines should have greater limits on drug types enabling negotiation of cheaper prices and greater tendering for generics	1.3	Grattan (2013a)
5	Bundle procurement of services such as medical imaging, radiation oncology, and dialysis to provide diversity, and through additional competition, reduce costs	0.2	Grattan (2016)
6	Restructure payments for pathology services, abolish the bulk billing incentive and require pathology service providers to bulk bill	0.1	Grattan (2016)
7	Introduce a program of Advanced Care Planning to improve end-of-life experience and elimination of needless treatment	1.0	Grattan (2014)
8	Extend the professional role of assistants, nurses and pharmacists and other workforce substitution (see table)	0.4	Productivity Commission (2015)
9	Cut private health insurance rebate by 6% initially, then 12%	0.9	Grattan (2013) MYEFO (2015)
10	Link 50% of fuel excise increases to health inflation which goes to the States and Territories	1.8	KPMG Estimate
	Change in Federal position before additional funding to States	8.0	
	Introduce efficiency funding from the Federal Government to the States for Hospital Procedures ($50 billion over 10 years less an additional efficiency component of 20%	(4.0)	
	Net budget savings on health and ageing	**4.0**	

Welfare

Welfare is a broad topic and large area of government spending. In this section, we include income support payments for unemployment, care and disability support, family and child care payments. We have included payments for the age pension in the next section which deals with retirement incomes.

Australia has one of the most targeted welfare systems in the OECD. Unlike most other OECD countries our transfer payments are not referable to income earned by recipients and are largely both income and assets means tested. For the most part, this high targeting is a very good feature of our system. The graph below shows that the poorest 20% receive about 12.3 times the amount received by the richest 20% in transfer payments in Australia. By way of contrast in Spain, the poorest 20% receive only marginally more than the richest 20%.

Ratio of transfer payments to the poorest quintile relative to the richest quintile in the OECD



Source: Stewart et al (2015)

Our value system underlying the transfer system has four main elements

First, is the relief from poverty, or the sense that we should create a safety net where circumstances warrant.

Second, is that one should use one's private resources when circumstances change and support is required, before the state is called upon to provide support or a safety net.

Third, is that we recognise there is some role for society to play in providing additional support for those with children – hence our family benefit system. This system, however, together with support for childcare, should not be structured to hinder female participation in the workforce. We believe certain changes in 2000 to family and childcare benefits were unfortunately structured to hinder female participation and instead provided women with the "choice" to stay at home.

Finally, an unfortunate, but understandable value is that we give greater weight to an impression of deservedness rather than need. A particularly relevant example of this is the higher payments for disability support compared with those for unemployment.

Newstart

This publication is largely about reducing government expenditure to eliminate the structural deficit. It thus may seem odd that the first recommendation is to increase Newstart.

Due to political rhetoric, payments for those who are unemployed have fallen behind other payments, to the point that it is commonly recognised that Newstart is inadequate, and significantly so. We propose to raise Newstart from $250 per week to $300 per week.

Why is this measure appropriate? *First*, it is very difficult to deal with budget expenditure issues in the public domain where there is clear inadequacy in a particular area. By ignoring one aspect of the system that clearly needs to be addressed, one lacks the political capital to deal with other areas of the system.

Second, as the Business Council of Australia (BCA 2014) has pointed out, the low level of Newstart is actually forming a barrier to employment: it is difficult for unemployed people to get work ready. Income support needs to be sufficient to allow for one to actively seek employment. Thus the concept that a low level of unemployment benefit will provide a greater incentive for people to work has strong limitations. Such reasoning is being recognised by senior business leaders as counterproductive. Increasing Newstart is truly a question of balance and we do yet not have the balance right.

Third, the low level of Newstart is encouraging the unemployed to seek higher income support in the form of disability payments. This is both psychologically damaging for the individuals and costly for government. The differential between the disability payment and Newstart needs to be substantially reduced although it need not be eliminated.

Finally, the low level of Newstart has the effect of locking people into jobs for fear that they could not survive on Newstart and cannot risk moving jobs. There may even be dimensions here in the start-up and small business sector. The very low safety net may act as a disincentive to take risks.

Family and childcare payments

Transfer payments for children dates back to Child Endowment, which was introduced by the Menzies government in 1941. This was a universal payment and paid to women. Unfortunately, it was not indexed and was of diminishing value in the 1950s and 1960s, where support for children was provided by a tax deduction and thus usually paid to men. It was highly regressive.

Whitlam changed the tax deduction to a tax rebate to reduce the regressiveness and introduced other highly targeted and strongly means-tested payments, which were largely continued by Fraser, Hawke and Keating.

In the Howard era, family and child assistance were revamped. Twelve existing programs were reduced to three in 2000 with the addition of a fourth in 2004. Many of these revamped benefits were based on family or joint income. This was designed to provide "choice" to women who wanted to stay at home. One unfortunate impact has been to create very high "effective marginal tax rates" for women who are working part-time but seeking to increase their hours of work, when the rate at which the family or child payment reduces is taken into account. This has the impact of discouraging female participation. The benefits of restructuring our family and child assistance will only be evident in the longer term as female participation grows.

Our recommendation, made in our tax submission in response to the Re: Think Tax Discussion Paper is to conflate the current Family Tax Benefit A and B, the Child Care Benefit and the Child Care Rebate into two transfer payments.

The first payment would be child care assistance for all forms of childcare, provided it is recognised as income by the child care provider.
We recommended that it be based on a percentage of the cost of child care, with 100% payment for low costs tapering to 75% for high costs, with a cap based on the highest average major city cost of childcare.

The second payment would be for primary carers and would be made on a per child basis, with cut off at twice average weekly earnings of the primary carer.

Simplification

The McClure Inquiry into Welfare Reform has pointed out that, currently, there are 20 income support payments and 55 supplementary payments. This makes the system difficult to understand and navigate. Following McClure, we recommend simplification into five main payment categories with a single primary working age payment.

This single working age payment would provide for differential rates, reflecting work capacity either as a result of caring responsibilities or disability. In addition, rates, income free areas, tapers and income definitions would be modified to create greater simplicity and support a simpler understanding of the benefits of work.

Investment approach

Drawing inspiration from New Zealand to target individuals and groups at risk of long-term welfare dependence, the notion here is to firstly better understand the long-term cost of welfare dependence (in the welfare system and beyond) through actuarial analysis, and secondly to better understand the markers of risk of long-term welfare dependence. The Government would then target earlier and more intensive wrap around services – both existing services and new specialist services to divert these individuals and families from long periods of dependence with the economic and social disadvantage that presents.

These highly vulnerable groups often have contact with services run and funded by state and territory governments too. There is a real opportunity for the Australian Government to move beyond traditional siloed service offerings to more innovative, outcome based approaches and to make a genuine attempt to change the pathway of social and economic disadvantage for some highly vulnerable families.

Commonwealth Rent Assistance

Commonwealth Rent Assistance should be extended to all tenancy types, with costs offset by reductions in Commonwealth transfers to states and territories. Income linked rents should be phased out as they provide perverse incentives.

	Measure	$b	Reference
1	Lift Newstart from $250 per week to $300 per week	(1.2)	KPMG Estimate
2	Simplification into 5 main payment categories as recommended by the McClure Inquiry	-	McClure (2015)
3	Review rates, income free areas, tapers and income definitions to create greater consistency and support benefits of work	-	McClure (2015)
4	Pilot an "investment approach" targeting clients at risk of significant long-term dependence on income support with intensive early intervention	-	
5	Simplify family payments to be paid on a per child basis with a cut off based on primary carer income of twice average weekly earnings	-	KPMG Tax Submission
6	Child care payments for all forms of child care provided it is paid to someone who treats it as assessable income. 100% for lower cost care down to 75% for higher cost care	-	KPMG Tax Submission
7	Extend Commonwealth Rent Assistance to all tenancy types with costs offset by reductions in Commonwealth transfers to the states and territories	-	

Superannuation and Age Pension

It would seem clear to virtually all that the superannuation system requires change. Yet it is less than 12 months ago that the then Prime Minister ruled out changes to superannuation.

The superannuation system needs to be considered in the context of retirement income policy generally. That includes the age pension. It would also seem clear that superannuation concessions strongly favour those who are better off.

Below is a 12 point plan for revising the superannuation and age pension system, which is expected to deliver savings of approximately $4.6 billion per annum in a mature phase.

1 Formalise "retirement income" as a purpose of superannuation

Australia needs to properly formalise the purpose of superannuation. This will light a candle to the current rules to see if we have the policy settings correct.

In the 1980s, the reforms to superannuation were expansive. It was considered that local savings were needed to reduce our dependence on foreign capital given the background of the now discredited twin deficits theory. Local savings were also required for infrastructure. Superannuation provided considerable assistance in these objectives. Superannuation was also considered to result in consumption smoothing over a lifetime and to reduce reliance on the age pension.

The Murray Inquiry provided a narrower concept of the purpose of superannuation. For Murray, it was to encourage savings to supplement or replace the age pension. It was not to lower taxes on savings in general and it was not a mechanism to provide for bequests.

The Government has held consultation on the purpose of superannuation. KPMG has lodged a submission to that inquiry which can be accessed here.

2 Reduce annual income threshold at which a 15% tax rate applies for concessional super contributions

Concessional contributions, such as payments made under the Superannuation Guarantee, salary sacrificed contributions, where a taxpayer has claimed an income tax deduction, are currently subject to tax in the fund at the rate of 15%.

However, “high income earners”, which are deemed to be those that earn over $300,000, pay an additional tax at the rate of 15%. The taxpayer can either choose to pay this tax directly, or direct the fund to pay the tax out of its balance. In effect, those earning over $300,000 are paying a 30% tax rate on their concessional contributions.

Assuming a 45% tax rate, the benefit for those on incomes above $300,000 is 15%. By way of contrast, the benefit for those in the income bracket between $180,000 and $300,000 is 30%. For income earners in lower tax brackets the benefit is between 19% and 22% except for those under the tax-free threshold where there is in fact a detriment in the absence of the Low Income Super Contribution discussed below.

It would thus not seem unreasonable to reduce the threshold over which employees pay 30%.

3 Reinstate the Low Income Super Contribution

The Rudd-Gillard Government introduced a Low Income Super Contribution, or LISC, for those earning less than $37,000 per year. The contribution effectively refunds the 15% contributions tax paid for concessional contributions. This ensures that low income earners are not disadvantaged by superannuation savings. The Coalition abolished the LISC operative from 1 July 2017. This should be restored on simple grounds of equity. A low income earner should not be disadvantaged by contributions to a superannuation fund.

4 Introduce lifetime concessional and non-concessional caps

Concessional contributions are, in broad terms, contributions that are deducted by an employer. The most common two of these are payments made under the superannuation guarantee and salary sacrificed super. Currently, there are annual concessional contribution caps, being $30,000 for those under 50 and $35,000 for those 50 and over.

Non-concessional contributions are contributions that are made to a fund using after-tax dollars. A taxpayer should have paid tax at their particular marginal rate of tax. There is no additional tax concession at the contribution stage.

There is, however, an annual non-concessional contribution cap, currently at $180,000. In addition, a taxpayer may contribute up to three times this cap in a particular year within a three-year period, that is, $540,000.

This provides the ability to contribute large amounts of post-tax dollars into superannuation, the earnings on which would be subject to tax at 15% in the accumulation phase and 0% in pension phase.

Given the purpose of superannuation it would be more than generous to impose lifetime caps for concessional and non-concessional contributions. The use of a lifetime cap, rather than an annual cap, caters for those that have entered and exited the workforce intermittently. This currently has strong application to women, but, one hopes, will increasingly apply to men as they take on a greater share of child rearing through part-time employment.

5 Requirement to divest fund balances in excess of a specific balance over 4 years

Excessive fund balances cannot sit comfortably with the purpose of superannuation as a replacement or supplement to the age pension and for people to live comfortably in retirement. Our proposal would require individuals to take excess funds out of the superannuation system once they exceed a reasonable threshold. That is, they could make other investments which do not receive the same tax benefits.

6 Reduce CGT discount from 33% to 25%

Currently, the CGT discount is 50% for individuals and 33% for superfunds. Our tax proposals recommend a 25% discount for all personal capital taxation. Thus, only 75% of interest income would be taxed to an individual and the benefits of negative gearing would be reduced by 25% as would the detriment of positive gearing. Applying a 25% discount, rather than 33% discount, for capital gains of a superfund would be consistent with that treatment. A 25% discount would appear to be closer to the underlying purpose of the discount, which is to provide a “rule of thumb” relief for inflation so that only real gains are taxed.

7 Segregation rule which crystallises unrealised gains at conversion from accumulation to pension phase

There is a difficulty under our superannuation regime which emanates from the fact that latent capital gains, which have arisen in the accumulation phase when the superfund is taxed at 15%, are not taxed when “transferred” into the pension phase where the superfund bears no tax. While there may be different ways of dealing with this administratively, what is required is a taxation pick-up on the latent discounted capital gain, when assets move from the accumulation phase to the pension phase.

8 Abolish the anti-detriment deduction

Broadly, the anti-detriment deduction enables a super fund to pay an additional lump sum death benefit, reflecting the additional amount the fund could have paid if the member’s account had not incurred contributions tax during his or her lifetime. It is grounded in certain historical circumstances and for the most part, the logic behind the anti-detriment deduction has ceased to be relevant.

The deduction is not properly targeted. It is biased in favour of lump sum death benefits as it is not available for pensions, and it links poorly with terminal illness benefits. For all of these reasons, and as a simplicity measure, it should be abolished.

9 Rules for dealing with transition to retirement

Once a person has reached retirement age, they can convert a portion of their super into a non-taxable pension. At the same time, if they are working, they can make superannuation contributions under a salary sacrifice arrangement which can wash through to finance the pension. This planning can give rise to very low tax rates. Rules should be put in place to deal with this planning.

10 Single means test for pension with deemed income amounts including own home above $1.8 million

Currently there is a two-part test for means testing the pension, which is complex and inconsistent in its treatment of inclusions.

The tests are based on assets and income. Prospective pensioners take both tests and adopt the method that results in lower pension entitlements. The Henry Review recommended a single more consistent test where assets are deemed to give rise to an income return. This included one's own home above a certain threshold, which was not specified by Henry.

Our proposal would involve including the family home in the means test where it exceeded $1.8 million in value. This inclusion would not preclude one from obtaining the pension. Rather an amount would be calculated which would equate to the difference between the pension entitlement with the inclusion of the home and without the inclusion of the home. This amount would become a claim against the home and would be collectable on transfer or sale. This claim would be capped at 25% of the value of the home.

11 Revaluate SAPTO thresholds and taper given low rates of taxation

On one estimate, if Australia had the same older worker participation rates as New Zealand, our GDP would be about 4% higher (Chomik and Piggott (2012)). This would amount to about $66 billion to GDP and $15 billion in tax revenues (Stewart & Ingles).

In Australia, the combination of the tax-free threshold, age pension, Seniors and Pensioners Tax Offset and the Work Bonus give rise to very high marginal effective tax rates for those on the age pension. Between about $300 and $1,000 per week of income, the effective marginal rate is between 50% and 90%. It then falls to about 40%.

What is required is a complete resetting of the pension and SAPTO taper rates. In our Tax Submission, we recommended the abolition of the tax-free threshold and the establishment of two offsets – a Low Income Tax Offset and a Work Incentive Tax Offset. Using these mechanisms, one can reduce the very high effective marginal tax rates for older workers. This may require a more generous taper rate which commences earlier. Some commentators have indicated that this could be more than self-funding.

Approximately 42% of people over the age of 65, which is the eligible pension age, receive the full pension. 28% receive the part pension and 30% no pension at all. Pensioners are also able to receive a range of valuable State and Federal government concessions, such as the health care card and transport concessions. It would seem that some relatively wealthy individuals may structure their affairs to ensure they gain a nominal part pension in order to gain the benefit of the valuable concessions. This benefit needs to be factored into both the structure of the age pension, SAPTO and taper rates, but also the inclusion of one's own home into the means test.

12 Rebalance pension between those owning their own home and those renting

Approximately 75% of pensioners own their own home, while 25% do not. Financial stress is most likely to exist for those who do not own their own home. The pension should be rebalanced to increase payments to those who do not own their own home.

Superannuation and age pension

	Measure	$b (Estimate for total)
1	Formalise "retirement income" as a purpose of super	-
2	Reduce annual income threshold at which a 15% tax rate applies for concessional super contributions from $300,000 to a lower threshhold	↑
3	Reinstate low income super contribution	↓
4	Introduce a lifetime concessional and non-concessional caps and abolish annual caps	↑
5	Requirement to divest excessive fund balances over 4 years	↑
6	Reduce CGT discount from 33% to 25%	↑
7	Introduce rule which crystallises unrealised gains at conversion from accumulation to pension phase	↑
8	Payments from super made in the benefits phase should use up the tax-free threshold	↑
9	Rules for dealing with transition to retirement "washing"	↑
10	Single means test for pension with deemed income amounts including own home above $1.8 million	↑
11	Revaluate Pension taper, SAPTO thresholds and taper to change high effective marginal tax rates including age pension concession cards	-
12	Rebalance pension between those owning their own home and those renting	-
	Estimate of total	**4.6**

Education

Education is a key lever for Australia to unlock the productivity of the next generation. Merely maintaining our current standards will be going backwards. We will need a more qualified workforce in the future. Health, professional, scientific and technical services will grow in importance within the economy. We will be dependent on labour productivity for lifting our standard of living: some of this will arise from capital deepening; some from education.

Education is the pathway for mobility for those from a lower socio-economic background, which is critical to our social fabric. We need to be a meritocratic society and high standards in education are critical.

Education is not an area that is ripe for significant spending cuts. Federal Government investment and policy settings are critical, particularly in supporting Australia's higher education and vocational education and training providers to thrive and build the skills needed for the future of our community and the economy.

Needs-based school funding

There are very good reasons to continue our additional investment in education following the Gonski Review and the Federal and State Government commitments that flowed from that review. Gonski gave rise to a six year funding commitment from the Rudd-Gillard Governments, which the Abbott Government initially indicated it would continue, but in the 2015 budget reversed for the final two years of the funding agreement. The Turnbull Government has not clarified its position on the final two years of funding, but has outlined a plan to transfer full responsibility for public school funding to the states.

The terms of reference of the Gonski Review included the proviso that no school would be a dollar worse off under the revised funding model. This was a politically driven parameter and not one based on policy.

Gonski recommended that funding should be based on a "public-private sector-blind, needs basis". We agree with this. We believe that Federal contributions to needs-based funding models should continue, but the requirement that no school should be a dollar worse-off should be revisited.

University funding

The Commonwealth Grants Scheme which provides funding for an uncapped number of student places is under significant pressure due to the growth in expenditure over recent years. The significant increase in Commonwealth supported places between 2009 and 2013, from 440,000 places to 541,000, is likely to continue and subsequently increase the Commonwealth Government's direct funding of universities.

This policy has been questioned and some have argued that it is appropriate to reintroduce caps on university places, or alternatively to introduce a minimum entry score. While there may be merit in laying down a minimum entry score for academically challenging or over-subscribed courses, the benefits of improved access to higher education from uncapping places have been considerable.

It is clear that there is now more participation from those students from a lower socio-economic background and an increase in enrolments in priority areas for the economy including health, science and engineering. The flexibility of the system has reduced tension between a mismatch in supply and demand for places that is likely to arise under a capped system.

Ultimately, cutting back on university places, while effective at reducing Government expenditure, would not necessarily be in Australia's best interests.

Income contingent loans

A large proportion of student contributions (fees) for both higher education and vocational education and training (VET) are financed by income-contingent loans from the Federal Government. This scheme has been called the Higher Education Loan Program, or HELP, since 2005 with a number of sub-types. These include HECS-HELP for the student contributions paid by students who are also receiving a Commonwealth contribution, FEE-HELP for full-fee higher education students and VET FEE-HELP for vocational education students.

With projections that Commonwealth Government spending on student loans could blow out by 560% over the next decade (rising from $1.7 billion in 2015–16 to $11.1 billion in 2025–26), it is no surprise that the Government is considering significant changes to the management of the Higher Education Loans Program.

The drivers for the increasing cost of HECS-HELP/FEE-HELP and VET FEE-HELP are different. Increasing costs of HECS-HELP/FEE-HELP for university students are related to the move to a demand driven system, with student numbers increasing at a rapid rate, and will need to be carefully managed so as not to reduce participation from the students who need the support the most. The growth in VET FEE-HELP, however, has been driven by the inappropriate use of the loans scheme by some vocational education and training providers, enrolling students who are unlikely to complete their training or to be able to repay their loan.

This growth, regardless of the driver, leads to another problem with the entire HELP system which is the level of bad or 'doubtful' debt. In 2014-15, the Government lent $7.8 billion in HELP debt. It is estimated that 20% or $1.6 billion will not be repaid.

This relates to both the increasing cost of the loans to Government and the threshold on which debt commences to be repaid (currently around $55,000). There are a large number of debtors which do not earn enough to commence repayments. Many of these debtors are working part-time. Moreover, the threshold has been geared to university bachelor students and may be inappropriate for diploma or certificate-level students entering lower-paid professions.

We believe the repayment threshold should be lowered. The Grattan Institute has recommended that the threshold be lowered to $42,000. This would raise approximately $500 million. Our recommendation is that a proportion of these savings should be used to fund a program that would assist early school leavers to progress to university. This would contribute to social mobility and productivity.

There are a number of other changes to HELP that could be used to cut expenditure. Currently, a HELP debt is cancelled on death. We would recommend a rule that would claim 50% of the HELP debt from the estate to the extent that the estate exceeded $100,000. This has estimated to raise about $400 million.

International education

International education is Australia's third largest export (generating revenues of $18.8 billion to our GDP in 2014–15). Australia is the third most popular destination in the world for international students but has failed to attract strong government investment.

We believe there should be greater investment to support the National Strategy for International Education as well as global research partnerships. Further investment in the future could help to expand our reach and grow our capacity to undertake larger scale, formal collaborations. This could be facilitated by developing a Global Innovation Strategy to support research collaboration and innovation with leading countries in our region and around the world, with the aim to engage with the European Union's Horizon 2020 programme.

Early childhood development

Government investment into early childhood development and pre-school is achieved largely through payments for child care at the federal level and local government funding of facilities, although this differs significantly from state to state. While Australia experiences relative high levels of pre-school attendance at age five, our investment in those aged three and four is relatively low by OECD standards. This is something that we should address in the future. Reigning in the structural deficit will assist us to have the flexibility to achieve this.

Education

	Measure	$b	Reference
1	Reset school funding on a "sector-blind-needs based" methodology without the proviso that "no school will be $1 worse-off"	-	
2	HELP repayment threshold lowered to $42,000 and repayment thresholds adjusted	0.5	Grattan (2016a)
3	Early school leavers to university program	(0.3)	KPMG Estimate
4	50% of HELP cancelled on death where estate is over $100,000	0.4	Grattan (2016a)
	Change in Federal Government position	0.6	
	Increased funding to States for school education less a 20% efficiency dividend	(2.4)	
	Net Federal Budget increase on Education	(1.8)	

Conclusion

This publication is a call to arms on the structural deficit. It is an invitation for all business, community and political leaders to think more deeply about what can be done. It is part of a long-term discussion and not simply geared to the next election.

The publication provides concrete initiatives for discussion and debate in four main areas. Net expenditure savings of $12 billion are proposed with $8 billion in health and aged care, $4.6 billion in superannuation and the age pension and $0.6 billion in education. Against this we propose an increase of $1.2 billion in welfare, by increasing Newstart.

We welcome your thoughts and contribution to this important and difficult discussion.

Summary of measures

Summary of measures with estimated budgetary impact		$b	$b
Health & Aged Care	Change the Medical Benefits Schedule for the primary care sector to provide for integrated care for chronic diseases	0.3	
	Reduce overtreatment of common procedures by reference to international standards and regional variations based on hospital admissions and complications	2.0	
	Prescription medicines - greater limits on drug types enabling negotiation of cheaper prices and greater tendering for generics	1.3	
	Bundle procurement of services such as medical imaging, radiation oncology, dialysis	0.2	
	Restructure payments for pathology services, abolish the bulk billing incentive and require pathology service providers to bulk bill	0.1	
	Introduce a program of Advanced Care Planning	1.0	
	Extend the professional role of assistants, nurses and pharmacists and other workforce substitution	0.4	
	Cut private health insurance rebate by 6% initially, then 12%	0.9	
	Link 50% of fuel excise increases to health inflation	1.8	
			8.0
Welfare	Lift the base rate of the new working age payment "NewStart" from $250 per week to $300 per week	(1.2)	
			(1.2)
Super & Age Pension	Formalise "retirement income" as a purpose of super		
	Reduce annual income threshold at which a 15% tax rate applies for concessional super from $300k to a lower threshold		
	Reinstate low income super contribution		
	Introduce lifetime concessional and non-concessional caps & abolish annual caps		
	Requirement to divest excessive fund balances over 4 years		
	Reduce CGT discount from 33% to 25%		**4.6**
	Introduce rule which crystallises unrealised gains at conversion from accumulation to pension phase		
	Abolish anti-detriment rule		
	Rules for dealing with transition to retirement "washing"		
	Single means test for pension with deemed income amounts including own home above $1.2 million		
	Revaluate Pension taper, SAPTO thresholds & taper		
	Rebalance pension between those owning their own home and those renting		
Education	HECS repayment threshold lowered to $42,000 and thresholds adjusted per Grattan	0.5	
	Early school leavers to university program	-0.3	
	50% of HELP cancelled on death where estate is over $100,000	0.4	
			0.6
			12.0

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Contributors

Liz Forsyth
Global Lead for Human Service
+61 2 9335 8233
lforsyth@kpmg.com.au

Michael Hiller
National Leader, Infrastructure, Government & Healthcare
+61 7 3233 3299
mhiller1@kpmg.com.au

Paul Howes
Partner, Head of Wealth Management Advisory
+61 2 9346 6073
paulhowes@kpmg.com.au

Tony O'Connell
National Adviser, Health
+61 2 9335 7032
toconnell3@kpmg.com.au

Evan Rawstron
Partner, Health, Ageing & Human Services
+61 2 9455 9586
erawstron@kpmg.com.au

Damian Ryan
Partner, Corporate Tax Funds
+61 2 9335 7998
dryan@kpmg.com.au

Brendan Rynne
Partner, Chief Economist
+61 3 9288 5780
bjrynne@kpmg.com.au

Grant Wardell-Johnson
Leader, Australian Tax Centre
+61 2 9335 7128
gwardelljohn@kpmg.com.au

kpmg.com.au