Tax Review White Paper Submission #2

Sovereign Wealth Fund

Australia has a sovereign wealth fund, which consists of the following funds (with fund balances as at 31 March 2015):

- Future Fund ($116.96 billion)
- Building Australia Fund ($3.73 billion)
- Education Investment Fund ($3.59 billion)
- Health and Hospital Fund ($1.78 billion)
- Disability Australia Fund ($1.67 billion)

Future Fund

The Future Fund was established by the Future Fund Act 2006. The object of the fund is to strengthen the Australian Government's long term financial position by making provision for unfunded Commonwealth superannuation liabilities. These liabilities will become payable at a time when an ageing population is likely to place significant pressure on the Australian Government's finances. The Future Fund has received contributions from a combination of budget surpluses, proceeds from the sale of the government's holding of Telstra and the transfer of remaining Telstra shares. The Future Fund Board of Guardians is responsible for deciding how to invest the assets of the Fund. Legislation stipulates that money may not be withdrawn from the Future Fund until 2020 except for the purpose of meeting operating costs or unless the Future Fund's balance exceeds the target asset level as defined by the Future Fund Act.

It is sobering to note that the unfunded liability the future superannuation payments to public servants could have achieved with a small fraction of the cost of establishing the Future Fund, had the Australian Government simply provided funds as and when public servants made their ongoing superannuation contributions. Nevertheless, the Future Fund will prevent a bad situation from becoming even worse. The Future Fund is well on target to reach its objective of $140 billion by 2020, which should provide $7 billion annually, to meet the ongoing superannuation liability. This will, in effect, remove $7 billion from the Governments recurrent expenditure, and this will mean that the Government will need to raise $7 billion less in the form of taxation each year to meet its ongoing budget commitments.

It is fortunate that:

- The Government of the day placed strict conditions of the use of the Future Fund, which has avoided one attempt to raid the fund to build the NBN.
- The Government of the day also determined that the fund would need to build to $140 billion (or wait until 2020) before funds could be withdrawn, which should enable the fund to fully provide for the unfunded public servant superannuation liability at the earliest possible date.
- Withdrawals are limited to 5% of the value of the fund, thereby enabling the fund to continue to grow over time (likely at a rate slightly less than CPI)
- These funds are being managed on an independent, prudent, and commercial basis, by the Future Fund Board.

It is important to realize that there may be a good case to reduce the ($140 billion / 2020 / $7 billion) requirement to ($120 billion /2016 / $6 billion), as this change would improve the Governments deficit/debt position over the forward estimates by more than $24 billion.

Building Australia Fund, Education Investment Fund, and Health and Hospitals Fund

The Building Australia Fund was established by the Nation-building Funds Act 2008. The object of the fund is to enhance the Commonwealth's ability to make payments in relation to the creation or development of transport, communications, and energy and water infrastructure and in relation to eligible national broadband matters. The Future Fund Board of Guardians is responsible for deciding how to invest the assets of the fund. Payments from the fund are determined by government, with advice from Infrastructure Australia, in accordance with the legislation.

The Education Investment Fund was established by the Nation-building Funds Act 2008. The object of the fund is to enhance the Commonwealth's ability to make payments in relation to the creation or development of higher education infrastructure, research infrastructure, vocational education and training infrastructure, eligible education infrastructure and to make transitional Higher Education Endowment Fund payments. The Higher Education Endowment Fund was discontinued in December 2008 and its assets transferred into the Education Investment Fund. The Future Fund Board of Guardians is responsible for deciding how to invest the assets of the fund. Payments from the fund are determined by government, with advice from the Education Investment Fund Advisory Board, in accordance with the legislation.

The Health and Hospitals Fund was established by the Nation-building Funds Act 2008. The object of the fund is to enhance the Commonwealth's ability to make payments in relation to the creation or development of health infrastructure. The Future Fund Board of Guardians is responsible for deciding how to invest the assets of the fund. Payments from the fund are determined by government, with advice from the Health and Hospitals Fund Advisory Board, in accordance with the legislation.

These three funds identified important areas of where the Government should be strengthen its long term financial position by making provision, so that funding for these areas could be sustained in the long term, and not be subject to budget cut backs, due to the state of the budget in any single year. The level of the fund balances for these three funds is disappointing. Nevertheless, it is far preferable to identify the need for these three funds, and establish them. The alternative is that they would never be established.

Disability Care Australia Fund

The Disability Care Australia Fund was established by the Disability Care Australia Fund Act 2013. The object of the Act is to reimburse States, Territories and the Commonwealth for expenditure incurred in relation to the National Disability Insurance Scheme Act 2013 and to fund implementation of the National Disability Insurance Scheme Act 2013 in its initial period of operation.

This fund has identified another important area where the Government would probably not otherwise be able to provide funding on a sustainable and ongoing basis from its budget. It does have a dedicated funding source, being the additional 0.5% increase in the Medicare levy. This fund does enjoy broad popular support, which demonstrates that people will support additional taxes, when they can see that the funds being directed to a worthwhile social purpose, and in a transparent manner.

Analysis

The issue of Australia's sovereign wealth fund strategy should be quite central to considerations of the Government's Taxation Review Process. I was unable to find any mention of either "sovereign wealth fund or future fund" in the Tax Discussion paper. This is very disappointing, and makes me question the Government's commitment and ability to undertake a long term view of tax reform, as it is difficult to contemplate tax reform without a proper consideration of the role sovereign wealth funds in the taxation system.

The basic questions that should be asked as part of the Government's Taxation Review Process, regarding a sovereign wealth fund are as follows, and this submission discusses each of these questions in some detail:

What are the benefits of a sovereign wealth fund?

The benefits of a sovereign wealth fund are obvious, and some key benefits are listed here

- Provide a source of Government revenue, other than taxation, thereby reducing taxation
- Strengthen Government ability to meet its future liabilities
- Insulate important expenditure area from budget cuts, when economic conditions decline
- Improve the standard of living, with additional (non-taxation) funding being available
- Improve economic stability, through the ability to adjust the level of the sovereign fund
- Provide funding for worthwhile social expenditures that may otherwise not eventuate
- Transfer of wealth to future generations, as opposed to a transfer of debts
- Protects against call 'Dutch Disease', where windfall profits are squandered with unsustainable improvements in living standards and declines in other areas of the economy (such as manufacturing).
- Potentially, mitigate against national economic calamity

What should be the overall size of a sovereign wealth fund?

Wikipedia provides a listing of the sovereign wealth funds of individual nations. Australia has the 13th largest sovereign wealth fund at $US95.3 billion. This compares with Australia being the 13th largest economy. China has the largest fund at $US1461.6 billion. Norway has an a gold benchmark fund of $US882 billion, based on all its North Sea oil profits being directed into its fund, as opposed to being squandered, The USA (often considered the richest nation) has a paltry fund of some $US141.6 billion, and Canada does not even rate and is an example of a country that did establish a sovereign wealth fund which was squandered it by repeatedly raiding its fund. Twelve of the nations in the top 20 size funds have used oil revenue to provide their funding.

Having the 13th largest fund and being the 13th largest economy does not provide the full picture for Australia. Australia is endowed with a wealth of resources (coal, iron ore, and gas, gold, uranium, etc.). Yet these commodities provide zero contribution towards the sovereign wealth fund, which can only be described as hopeless. Furthermore, Australia is a wealthy nation, with 23 million people making it the 13th largest economy, so it must has considerable capacity to make a considerably greater contribution towards a sovereign wealth fund. The Australian taxation system (Federal, State, and Local) raises about $400 billion in taxes annually, yet the sovereign wealth fund (by 2020) will contribute less than $10 billion in revenue. This represents some 2.5% of Government revenue, and this after more than 100 years of federation. The Government has had repeated opportunities to provide funding to the sovereign wealth fund, such as the recent mining boom and the fairly recent large scale asset sales – opportunities which have largely been squandered.

I would suggest that the Government set a target of providing 5%, then increasing to some 25% of its budget via sovereign wealth funding within a medium term time frame. This would require a fundamental change in the mindset of the Government. Instead of running ongoing deficits, it would need to considerably improve its performance and efficiency, so that it provided a surplus over the long term. State governments (who are the beneficiaries of mining royalties), would need to allocate a share of mining royalties towards state wealth funds. While 25% of the budget being sourced from a sovereign wealth fund may seem large to some people, particularly politicians, this is roughly equivalent to Norway's current position. Norway's sovereign wealth fund equates to more than $150,000 per person. This means that each person can contribute more than $5,000 less in taxation each year, and yet still enjoy a the same standard of living from Government benefits as would be achieved as compared to not having a sovereign wealth fund and paying an additional $5,000 in taxation.

What should be funded by a sovereign wealth fund?

This is definitely best determined by an independent commission, rather than by being based on the latest thought bubble by some politician wanting to leave their mark, and leaving everyone else with a mess to clean up. There would be numerous worthwhile candidates, and I would suggest the following as a starting point:

- Aged Pension Fund (with the Government contributing a share of taxes from reducing superannuation tax concessions, particularly to individuals with above average taxable income, during each person's working life)
- Dental Fund (with the Government able to provide basic Medicare dental services)
- Mental health (with the Government able to provide basic Medicare mental services)
- Affordable housing and homelessness
- Illicit drug misuse education
- Climate Change Fund (with the Government using a modest level on fossil energy production emissions to fund climate change initiatives, but excluding compensation as under the previous ill-fated policy)

The priority of the proposed Medical Research Fund should be independently evaluated and queried, as most of the funds listed above would likely be considered higher priority.

What options are available to fund a sovereign wealth fund?

It should be noted that a sovereign wealth fund should be broadly self-funding, once it is fully established, provided it does not draw down too heavily (perhaps 4% per year) and is properly managed (earning CPI + 4% per year), and is not used for purposes other than what it was established to achieve.

Having said that, funding can and should be achieved using a range of strategies. Like any form of saving, funding does require discipline and commitment. Additionally, the first step, is simply to make a start. These key principles are simple, and apply to individuals, households, and even Governments.

I would recommend the following methods be used:

- Contribution from a share of the proceeds of asset sales
- Contribution from a share of the proceeds of mining royalties

- Contribution from a share of additional tax revenue from reducing tax superannuation concessions for individuals with above average taxable incomes
- Contribution from a share of Medicare levy (for dental and mental health funds)
- Contribution from fossil energy levy (for a climate change fund)
- Contribution from a share of economic productivity improvements (which equate to standard of living improvements). This would require a significant improvement in Government economic management.
- Contribution from the Budget Appropriation Bill (as happens with Foreign Aid)

It is important to recognise the folly of adopting a strategy of simply allocating a share of future Government surpluses to fund a sovereign wealth fund, as has been suggested by some politicians, as history would show that such an approach would not have provided almost a meaningful sovereign wealth fund over the past 50 years.

What are the risks of not having a sovereign wealth fund?

Many countries continue to function without a sovereign wealth fund or without a meaningful sovereign wealth fund. Australia did not have a significant sovereign wealth fund before the Future Fund was established in 2006. This means that all the Governments liabilities are unfunded, and are wholly dependent upon revenue raised via taxation and other Government charges, combined with running deficits, which are funded by borrowings (either domestic or foreign). This approach can depend upon an ever increasing economy to service the ever increasing debt.

Greece is a current example of what can go wrong with his economic approach. In spite of having a retirement system, established as long ago as 1950, and which was funded by (a combined 20% of wages) from employees and employers, it failed to build meaningful retirement benefit reserves in the multitude of retirement funds. No doubt the problem was exacerbated by other factors such as the lack of integrity of the taxation system, corruption, cronyism, and the lack of independence, commercialism, and competence of the management of the retirement funds, combined with the political inability to adequately address the problem - which was identified as far back as 1990. Then, in the face of ongoing deficits and ever growing debt, combined with sudden impact of the GFC, which torpedoed Greece's ability to raise revenue to service the debt, the nation has reached a position where it is incapable of servicing its debt. There is no need for a crystal ball to understand that Greece would not be in its current predicament, if it had managed to build a meaningful sovereign wealth fund before the impact of the GFC. It is uniquely placed with tourism revenue, which has the potential to provide the funds for a sovereign wealth fund. This, combined with competent management of the retirement fund revenues should have enabled the country to provide a significant sovereign wealth fund. Greece's predicament is not unique. Any number of other nations, particularly in Africa and South America, have suffered similar economic calamity. The difference is the press coverage that they receive, and their impact on the broader regional and international economy. The question is not if this can happen again, but rather when it will happen and who will be the next victim.

For Australia, the immediate risk is not economic calamity. However, it is important to question whether the decline in manufacturing and other industries has been, in part, due to the sudden increase in wealth from the recent large scale asset sales and the mining boom, and whether ongoing erosion of aged pension and other social benefits has been, in part, due to the inability to build a sovereign wealth fund to protect the funding source for these expenditures, particularly considering the long term and predictable impact of demographic changes.