BUSINESS COUNCIL OF AUSTRALIA

SUBMISSION

TO THE

THE BUDGET PROCESS
2002

13 February 2002

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Executive Summary

The Business Council of Australia <u>notes</u>

- the secular improvement in Australia’s fiscal position;
- the current position of near structural Budgetary balance;
- the global uncertainties; and
- the longer term challenges facing Australia.

In this context <u>we recommend</u>:

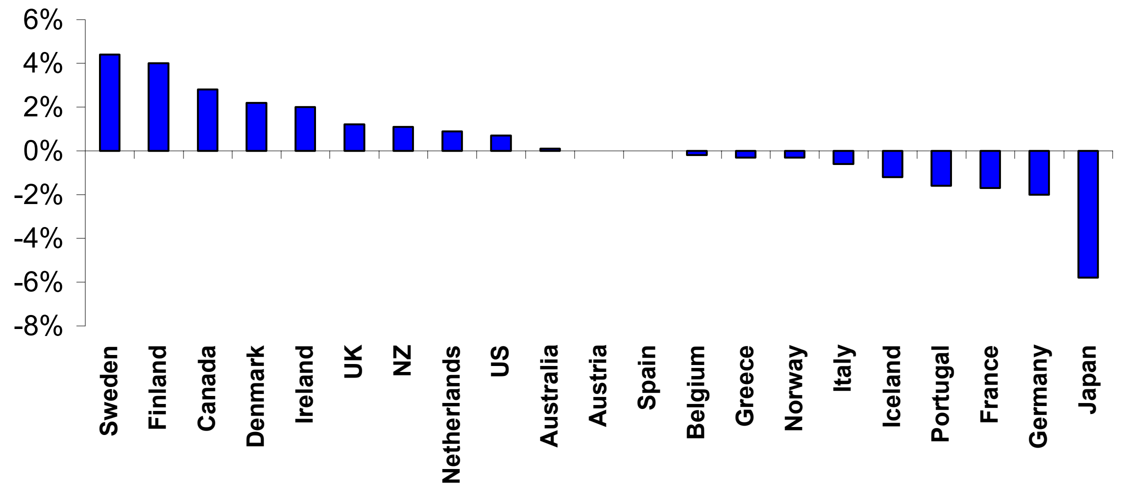
- the need to be cautious this year;
- a preparedness to move quickly to prevent any significant rise in unemployment if jobs growth should slow sharply;
- the need over time to improve the structural position of the Budget for precautionary reasons;
- a preference for expenditure reduction in areas of ‘consumption’ rather than ‘investment’; and
- an awareness of the desirability of reducing long term unemployment on both grounds of social cost and to improve the longer term budget position.

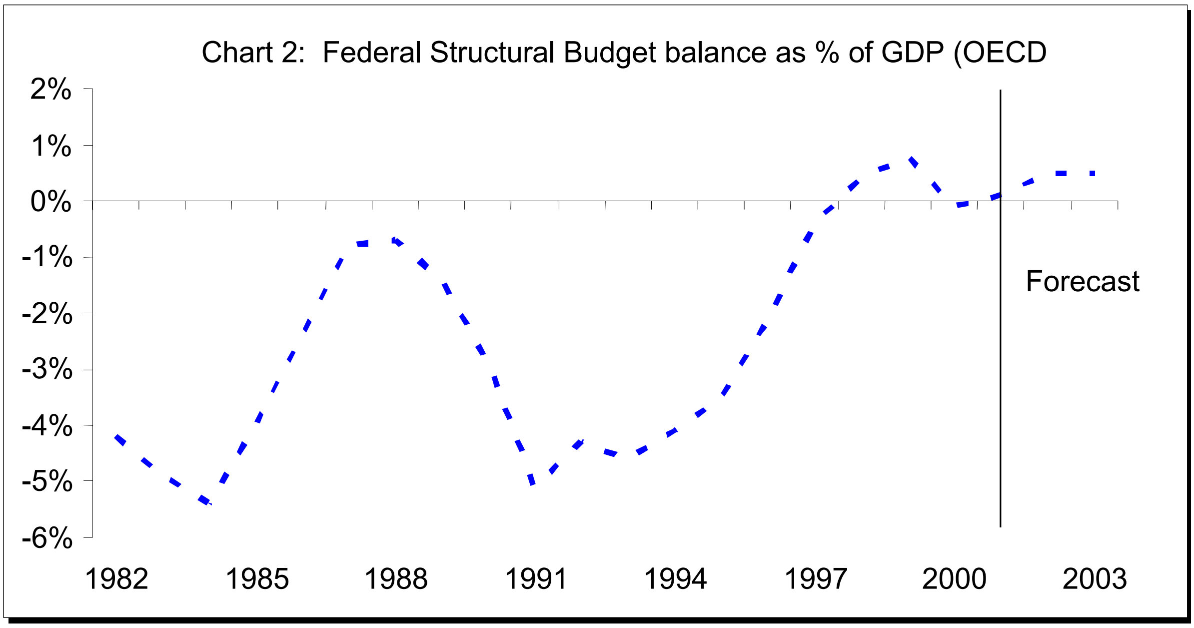
Business Council of Australia Pre-Budget Submission

1. The overall fiscal context

The lead up to the 2002-03 Federal Budget sees Australia's fiscal position as middle ranking among OECD nations. Australia ranks marginally behind those in heavyweight economic powers such as the US and the UK but well ahead of Japan, Germany and France.

Chart 1: Structural Budget balance as % of GDP in 2001 (OECD estimates)





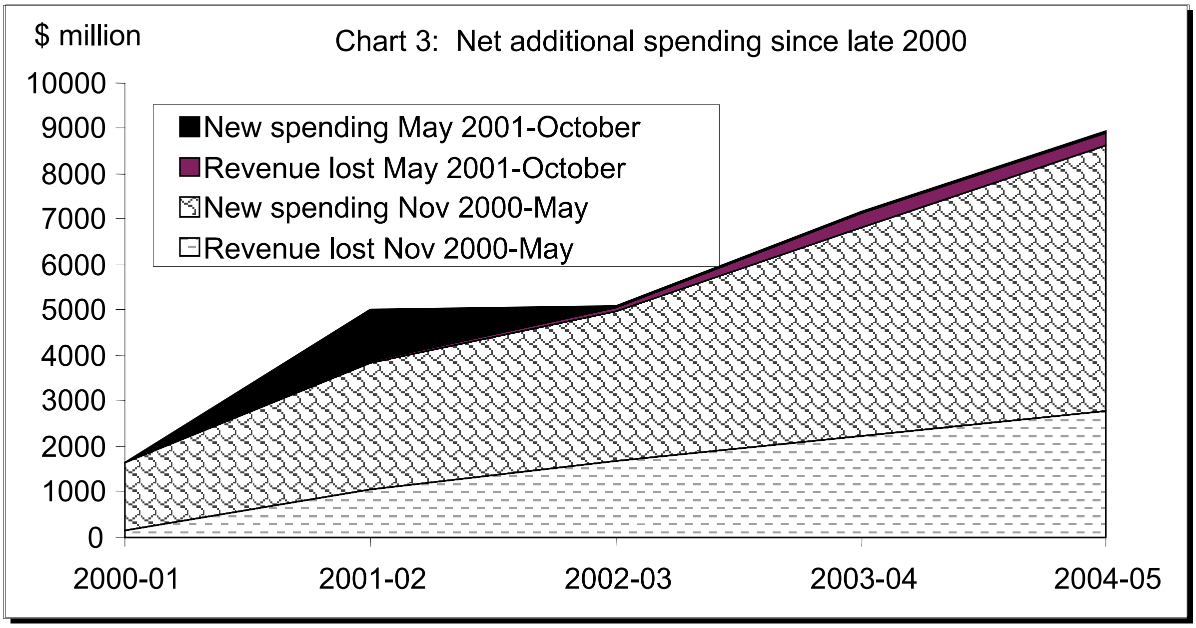
It stands to the credit of the Federal Government that Australia's public sector debt is now a small proportion of national income. Chart 2 traces the secular improvement in the relationship of budget balance to GDP.

That said, there has been a considerable erosion of the Budget surplus since mid-2000. In particular, that erosion brought with it two enduring benefits:

- the much needed reform of Australia's tax system, and
- the increased investment in innovation, human capital and roads by the Federal Government.

However, Council notes that much other spending (as well as revenue erosion in indirect taxes and the weakening of measures to avoid the alienation of personal income) may have rather less enduring benefit to either the Australian economy or to the future path of the Federal Budget.

Chart 3 looks at the net additional spending and reductions to revenue from policy decisions made since November 2000. It is a reminder of the size of the rundown in the Federal surplus occasioned by policy decisions since then, and also points to the need for caution in the period ahead.



Our basic position is thus that the size of the recent rundown in the Budget balances suggests a need to ensure that no further loosening of policy occurs.

A significant further international downturn would change this perspective. The years of negative job growth, 1983 and 1991, resulted in major and persisting level of long term unemployment. These bad years caused significant social and economic loss to the nation. If 2002-03 should see a similar major downturn, we would support a significant fiscal expansion.

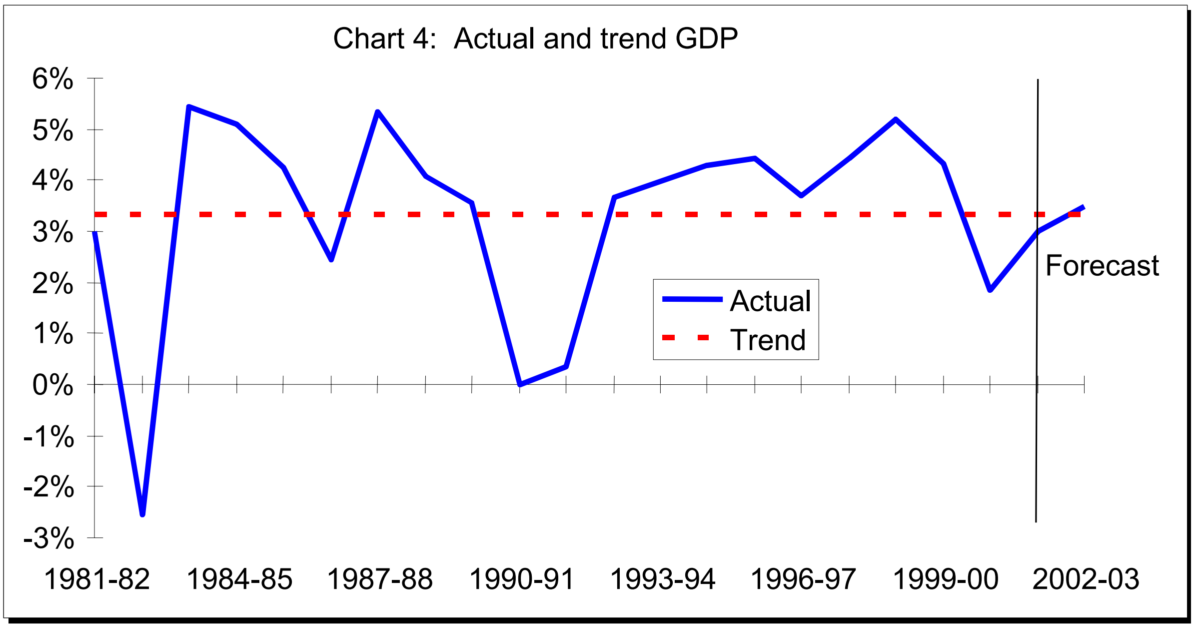
However, assuming the worst does not happen, three further questions are worth considering before deciding whether tightening should be recommended for the 2002-03 Federal Budget:

- might any tightening in 2002-03 prove a risk to the macroeconomy in 2002-03?
- given low net indebtedness, is there a case for strengthening the structural integrity of the Budget at all?
- where should the burden of any tightening fall? is there a reason to revisit fiscal priorities, favouring 'investment' outlays over 'consumer-type' outlays?

2. The state of the Australian economy

The current official forecasts are relatively optimistic. For example, they point to economic growth of 3% this financial year, and 3½% in 2002-03. This suggests growth going from slightly above to slightly below its longer term average between this financial year and next (see Chart 4).

Some private sector forecasters expect better still from the Australian economy than do the latest official forecasts. For example, the *BRW* survey of private sector forecasters currently points to a consensus gain of 3.3% in GDP in 2001-02, while the *Consensus Economics* survey points to growth of 3.3% in calendar 2002 and 3.7% in calendar 2003.



However, that is not to say that the Council is sanguine about the short term macroeconomic outlook for Australia. Two factors stand out:

- the first is that, although the trend in global (and particularly) US economic news has been pleasantly good through 2002 thus far, there remains a risk that the US economic recovery will be slow until the end of 2002 or the start of 2003;
- the phase of over-investment in IT and new technologies has left US capacity utilisation at rates last seen in 1983; and
- the further stimulus package championed by President Bush may not pass Congress.

Under those circumstances it may be that global recovery is delayed or anaemic during 2002, to the detriment of economic conditions in Australia.

Second, and partly related to the first point, Australia's current economic growth is skewed in an unsustainable manner. Short term economic growth is being driven by housing construction, retail spending, the inventories cycle, and by public sector (notably Federal) spending.

However sustainable growth requires a return to export growth and renewed momentum in business investment spending. Yet export growth cannot be expected to revive its fortunes until clear global growth returns. Equally much business investment spending is also tied to the international business cycle rather than the domestic one.

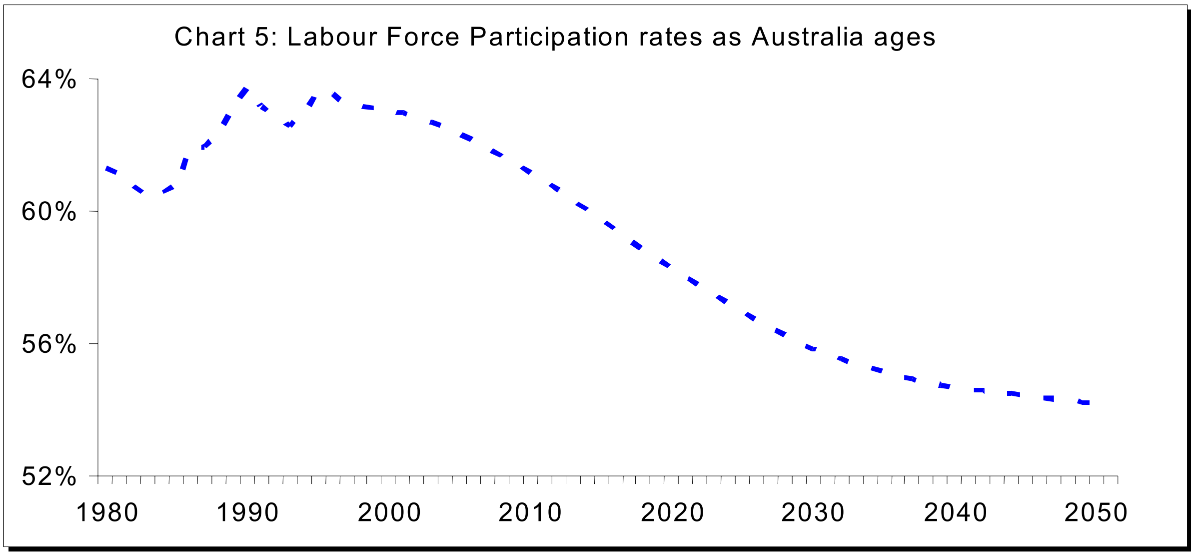
The Bureau of Statistics has noted that a considerable proportion of planned business investment spending in 2001-02 and 2002-03 arises in the mining sector. If global recovery is delayed, then so too may the recovery in Australian investment spending be delayed.

However, there are always risks to the macro outlook. In that light, the Council does not see the macroeconomic outlook for 2002-03 as standing in the way of a modest tightening of fiscal policy. This would need to be done in the awareness that any significant deterioration of the macroeconomy would require quick intervention and decisive intervention.

3. Why improve the Budget's structural integrity?

(i) Demographic challenges for the Budget

Australia's ageing reflects both low birth rates and increased life expectancy. Chart 5 shows the expected declines in Australia's labour force participation. Fewer workers means less tax revenue and more dependents – both will tend to undermine the budget in the longer run.



But even before the ageing of Australia leads to a rise in demands on Government expenses, it may lead to a weakening in Government revenues as the baby boomers retire)(lowering their wage and salary income and, at least in some cases, reducing their spending on consumption, and therefore the indirect tax take as well).. The Chart shows, the national participation rate may drop below 60% by as soon as 2015, causing considerable losses on the revenue front along the way.

(ii) Technological challenges for the Budget

The rapid lift in the availability of new health technologies has been accompanied by an equally rapid lift in the cost of those technologies. With health costs rising faster than other prices in the economy, and with the Federal Government effectively financing much of the national health care bill, there are key risks ahead.

That said, not all the technological risks to the Federal Budget are negatives. Higher productivity generally may lower the costs of delivery of a range of services.

(iii) Infrastructure challenges for the Budget

While it is important that the existing service potential of the Federal infrastructure be maintained, there will also be fiscal pressures on the Government for additional infrastructure to keep pace with the economy's needs in the face of ongoing structural change and population. For example:

- additional infrastructure may be required to supplement the capacity of existing infrastructure where demand for services provided by such infrastructure has outstripped available capacity (such as major roads);
- technological change and structural change may bring about the need for new forms of infrastructure (eg transport infrastructure, and information and communication related infrastructure).

However, the largest already identified risk on the infrastructure front is that of 'block obsolescence' among the capital equipment of the Defence forces. Even after the White Paper adopted by the Government last year, across the next twenty to thirty years there remains a substantial (but largely unquantified) funding gap ahead. Press reports (prior to the White Paper) have speculated that the cost of capital re-equipment in the defence forces over the next twenty years may be in the range from $88 to $106 billion.

(iv) Environmental challenges for the Budget

There are a number of potential environmental risks which could have a large impact upon the national economy and Federal Government finances over the next three decades, such as air pollution, threats to the marine environment, water quality and changing patterns and/or severity of bushfires. While many such issues could potentially have significant impacts, the timing and significance of such risks is uncertain.

Two environmental issues, however, may be better described as likely pressures (involving a combination of high probability and large economic impacts), as opposed to the risks described above. They are the issues of greenhouse gas abatement and the management of the increasing salinity of land and rivers (in particular, salinity in the Murray-Darling basin, and in Western Australia). These two could pose large costs to the Federal Budget in the years ahead.

Great care should be taken to impose efficient responses which minimise their impact on business and government. Market-oriented solutions to greenhouse, and minimal-additional-damage strategies on salinity, should control their impact on the Federal Budget.

(v) Conclusion on risks

That combination of demographic, technological, infrastructure and environmental costs points to the need to plan now for the major challenges ahead. That is why the Council would like to see a commitment in the 2002-03 Federal Budget to a planning process aimed at nailing down Australia's longer term fiscal responses to the challenges which lie ahead.

It is also why, despite Australia's low public sector net indebtedness, we believe that there is a case for strengthening the structural integrity of the Budget.

In that regard the move to stabilise the indirect tax base by the shift from the Wholesale Sales Tax to the GST was a distinct benefit. Alone however it is not enough to guarantee the health of Federal (and State) finances over the longer term.

4. The chance to revisit fiscal priorities

There is a considerable need for new physical infrastructure, especially in transport linkages. The latter are the arteries of any economy, and the tendency for their ownership or regulation to be in the hands of governments runs the risk of artificial under-investment in them. There is a case that that has occurred in Australia, in both road and rail. (Further micro-reform is also needed to encourage private sector investment in sea transport linkages.)

There is also a need for a focus on human capital. In that instance the Business Council welcomed the *Backing Australia's Ability* statement, which did increase the prospective investment in 'innovation' in Australia, including in human capital.

With that in mind, and within any overall tightening of the Federal Budget, the Council urges the Government to revisit fiscal priorities, favouring 'investment' outlays over 'consumer-type' outlays. That means that savings in the 2002-03 Budget should be directed at real cuts in Government recurrent expenditures rather than cuts to capital/infrastructure expenditures, with a particular focus on greater efficiency in administration. This may be combined with a revenue policy centred upon opposition to tax increases, especially those adversely impacting on business input costs and competitiveness.

The failure to restore discipline on the spending side of the Budget would put at risk the hard won gains of 1996-97 and 1997-98.

That said, long term unemployment remains a particular concern. Strategies which get people out of a long term state of unemployment, and back into work, are an investment in the long term structural integrity of the Budget. As such this would not be an area we would like to see cut.

As the Council has noted in previous pre-Budget submissions, there is no particular advantage to the Budget itself from privatisation per se. Such transactions merely sell assets for cash, and there is a danger that Governments look to measures of net indebtedness rather than to measures of the balance sheet.

The Government is quite correctly seeking the full privatisation of Telstra. However, such a sale is simply a change of ownership. There is little case for using privatisation receipts to fund new capital works. Were the full sale of Telstra to fund large scale infrastructure projects, it would be mean competition with the private sector for funds and for skilled labour.

It is the view of the Council that a Government-owned enterprise should be sold if:

- it operates in an industry in which Governments should not be both a player and an umpire in the same game at the same time,
- the business could be run more efficiently in private sector hands than in the public, the proper regulatory controls are in place, and
- the Government will do better things with taxpayers' money (such as paying off debt).

5. The importance of related policy reforms

Australia's economic expansion of the past decade has been both impressive and sustained. Council is of the view that a reversion to greater discipline on both expenditures and on the reform task ahead in the 2002-03 Federal Budget can only help maintain Australia's impressive scorecard.

Therefore, outside the fiscal and monetary fronts, Council urges the Government to further micro reform, particularly that reform focussed on economic infrastructure services, as well as continued labour market and industry protection (tariff) reforms.

Reform fatigue pressures are on the rise, at both the State and Federal levels. At the State level, the Council has been disappointed with the attitude of some State Governments towards the pace of electricity reform. Energy market reform, involving drastic simplification, is a clear priority.

There have been difficulties of adjustment to some reforms. However, as the Government has stressed, the answer does not lie in abandoning reform. Rather, it lies in more careful reform with a watchful eye on social consequences. That too must involve a more active marketing of reform to Australians – often Governments of all stripes have done too little to dispel populist arguments against reform, and too little to help people understand the wider benefits of reform.

Another element of that reform task lies in taxation policy. The later has already undergone considerable reform – and much progress has been made along the way. However, tax reform is, of its nature, a task which never finishes. The Council looks to the 2002-03 Budget to continue the process of international and business tax reform, with particular attention to the need to minimise taxes on business inputs.