BCA BUDGET SUBMISSION 2009–10

BUDGETING FOR REVIVAL

BUSINESS COUNCIL OF AUSTRALIA

HOW CAN WE FOSTER AND SUPPORT ECONOMIC RESILIENCE?

CONTENTS

EXECUTIVE SUMMARY

THE 2009–10 FEDERAL BUDGET IS BEING DEVELOPED AGAINST THE BACKDROP OF A SUDDEN AND SEVERE DOWNTURN IN THE GLOBAL ECONOMY AND SIGNIFICANT UNCERTAINTY ABOUT AUSTRALIA'S SHORT-TERM ECONOMIC OUTLOOK.

ECONOMIC OUTLOOK

The global economy has deteriorated rapidly and sharply, even compared with expectations in late 2008.

Recent data suggests Australia faces weak consumer spending and business investment growth and a drop in demand for its exports. Where just a year ago excessive demand was exposing Australia's supply constraints, we now find economic demand needs support.

FISCAL TRENDS AND DEVELOPMENTS

Fiscal policy can help to support economic demand. Australia's enviable fiscal position leaves substantial scope for fiscal action.

The challenge for the government is to use fiscal policy to address a number of frequently competing objectives. These include:

- Boosting aggregate demand in the near term, both by allowing the 'automatic stabilisers' to work and through discretionary measures.
- Supporting long-term economic growth through quality spending measures that build productive capacity, including in particular education and infrastructure.
- Maintaining a sustainable fiscal and debt position.

The Budget will almost certainly move into deficit at some point over the coming two years. The BCA considers this appropriate for the economic times. Running a deficit, however, is not an excuse for poor policy. Deficits should be clearly recognised as a temporary measure justified only in exceptional circumstances and which should not become 'entrenched'.

FISCAL PRIORITIES FOR 2009–10

Support growth

- Support growth in the short term by using the Budget to limit the slowdown and to partially offset declining private sector consumption and investment. Allow automatic stabilisers to work and remain prepared to introduce additional short-term fiscal stimulus to support demand. Initiatives should continue to be:
  - targeted to those most likely to spend;
  - timely so that they affect the economy as soon as possible; and
  - temporary so as to create fiscal stimulus only for a short time, rather than indefinitely.

  These are known as the '3 Ts' of fiscal stimulus.
- Bring forward wherever possible long-term investments which, when well executed, will not just support short-term demand but bolster long-term growth by building the productive capacity of the economy.

Lift the quality of spending

- Prioritise budget spending that delivers the greatest gains in Australian economic and social prosperity.
- Resist calls for new spending that ranks poorly in terms of economic and social objectives, but which may be politically expedient.
- While achieving net fiscal stimulus, seek to partially offset new or increased spending with cuts to underperforming or low-priority programs to allow maximum spending on current needs and priorities.
- Work towards effective funding arrangements with the state and territory governments to ensure spending supports the productivity agenda – notably in infrastructure, education and health – and delivers the required outcomes.
- Commit to a comprehensive review of spending similar to the 1996 National Commission of Audit.

Explain the deficit

- Communicate the implications of new spending and explain how deficits will be reduced as higher growth returns.
- Publish estimates of the structural and cyclical components of the budget balance.

Ensure state fiscal policies support national policy

- Seek agreement with state and territory governments for consistent expansionary settings across jurisdictions. All governments should work in concert to support growth.

Avoid structural changes to the tax system ahead of the Henry review of taxation

A CONTINUING REFORM VISION

The BCA continues to aspire for Australia to be the best place in the world in which to live, learn, work and do business. Reaching that aspiration demands a broad reform agenda to improve productivity, address long-term demographic challenges and overcome the political challenges of our federal system. With sound financial management, these goals can be preserved as we meet the more immediate challenges of 2009–10.

INTRODUCTION

The 2009–10 federal Budget is being developed against the backdrop of a sudden and severe downturn in the global economy and a great deal of uncertainty about the economic outlook in Australia and elsewhere.

The global financial crisis started as a breakdown in the financial markets of developed economies. Downturns originating in financial market collapses tend to be unusually severe,[1] and this downturn has conformed internationally to that pattern. Tighter credit conditions and falling confidence in developed economies have now led to slower or declining economic activity and rising unemployment. Emerging economies are now being affected and previously high growth rates in those economies are slowing sharply.

For Australia, the economic downturn poses particular challenges for the federal Budget as the run of strong increases in taxation receipts comes to an end, welfare payments increase, and demands grow for government spending to offset lower private spending.

The Budget is very likely to move into deficit by 2009–10. The BCA considers this appropriate for the economic times.

Running a deficit, however, is not an excuse for poor policy. Nor can deficits be allowed to become 'entrenched'.

Now more than ever, spending needs to be highly effective and well targeted – it is the quality and composition of spending, and not just quantity of spending, that will determine the extent to which fiscal policy supports Australia's economic resilience and future prospects.

Government spending should seek to temporarily and partially offset retreating private sector expenditure in an effort to dampen the economic cycle. Once unemployment rises, it is difficult to bring down again and this brings significant costs to the individuals impacted and the wider economy. This justifies efforts to limit the scale and duration of the downturn. But the key objective should be to return as quickly as is feasible to an economy driven by investment and spending by business and consumers – that is, to revive sustainable drivers of growth and prosperity.

Measures aimed directly at supporting near-term growth can prove effective in smoothing the economic cycle. The BCA endorsed this principle in welcoming the government's October 2008 emergency stimulus package. Over time, however, measures that invest in long-term economic and social prosperity by growing the productive capacity of the economy will do more to position Australia well for recovery.

NOW MORE THAN EVER, SPENDING NEEDS TO BE HIGHLY EFFECTIVE AND WELL TARGETED

The government's commitment to ensuring fiscal sustainability, as an important foundation for long-term growth, incorporates the aim of achieving budget surpluses on average over the medium term. That means that as the economy recovers, the Budget will need to be returned to surplus. History shows how difficult this is in practice. Highly disciplined policy today will make the return to surplus relatively easier and less costly. The BCA considers that the government has so far responded well to the downturn in the economy and to the issues relating to the global financial crisis. The challenging economic circumstances continuing to face Australia underscore the importance of maintaining this policy discipline, across its entire agenda, but particularly in the area of fiscal policy.

A disciplined and effective budget strategy that directly targets economic risks and is clearly expressed and communicated will help to underpin business and consumer confidence. It will position Australia to navigate the current global crisis, and will also help to position Australia to both capture opportunities arising through the recovery and deal with the longer-term challenges.

This submission outlines the BCA's priorities for fiscal policy for the 2009–10 Budget.

ECONOMIC OVERVIEW

The outlook for the Australian and global economies has worsened dramatically since the 2008–09 Budget was delivered.

After a period of sustained credit growth, which produced a prolonged period of strong demand and robust global economic growth, credit market contraction and declining asset prices are eroding growth and confidence around the world. The downturn that originated in financial markets is now flowing through to the real economy, adversely impacting investment, demand and employment.

The global economy has deteriorated rapidly and sharply, particularly when compared with expectations when last year's Budget and even the more recent Mid-Year Economic and Fiscal Outlook (MYEFO) were being formulated.

The most recent IMF forecasts are for a contraction of growth in the major advanced economies of ¼ per cent in 2009. If this eventuates, it will be the first contraction in economic activity in those economies since World War II.[2] This compares with a forecast for growth of 1¼ per cent less than 12 months ago.[3]

Global growth is now projected by the IMF to be 2.2 per cent in 2009, compared with 3¾ per cent in 2008 and 5 per cent in 2007. This is a very significant slowdown. In April last year, the IMF was predicting that the global economy would grow in 2009 at a still-healthy 3¾ per cent.

WE REMAIN IN A SITUATION WHERE THE ECONOMIC OUTLOOK FOR THE GLOBAL AND AUSTRALIAN ECONOMIES REMAINS HIGHLY UNCERTAIN

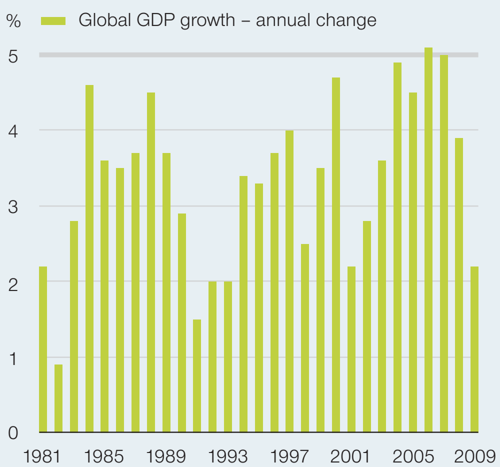
The United States, Japan, the United Kingdom and the European Union are in recession. The economies of China and India are also expected to slow. Projections at this stage are for relatively modest reductions in growth, although more recent information provided by the IMF, OECD and the World Economic Forum suggests that China, in particular, may be slowing by more and much faster than expected.[4] This suggests that further downward revisions in economic forecasts around the world are likely.

Australia is in a stronger position relative to other countries. It entered this difficult period on the back of 17 years of sustained economic growth, record lows in unemployment, fiscal surpluses and low levels of public debt.

Nevertheless, Australia has not been immune from these developments. Just a few months ago its economy reflected excessive demand running up against supply constraints; now, demand needs support. Concern about inflation has become concern about deflation at the same remarkable pace.

FIGURE 1

GLOBAL GDP GROWTH IS IN STEEP DECLINE



Source: IMF World Economic Outlook database at www.imf.org accessed on 27 January 2009.

Note: Media reports at the time of publication indicated the IMF was set to significantly downgrade the 2009 growth forecast to below one per cent.

The Australian Government's most recent published forecast for growth in 2009–10 is 2¼ per cent. The Reserve Bank, OECD and IMF also continue to forecast positive, although significantly slower, growth in the years ahead, as do the majority of Australia's market economists.[5] But in all likelihood these forecasts too will be revised as risks to the economic outlook are now almost entirely to the downside and significant. These risks include:

- The magnitude of the global deterioration and ongoing uncertainties regarding further downgrades to growth projections and the duration of the economic slowdown.
- The impact of declining commodity prices and the terms of trade on domestic income and demand.
- The impact of declining asset prices on wealth and balance sheets, and hence consumption and investment.
- The impact of declining confidence on household and business decision making.
- Continued uncertainty regarding the availability and cost of credit.
- Australia's reliance on offshore funding to finance its current account deficit.

RISKS TO THE ECONOMIC OUTLOOK ARE NOW ALMOST ENTIRELY TO THE DOWNSIDE

FIGURE 2
SIGNS OF THE TIMES

Source: Reserve Bank of Australia, ANZ, Westpac and National Australia Bank.

More recent indicators and market projections suggest a weaker outlook than 'official' forecasts. The period ahead will be characterised by a retreat in private demand. Consumer spending and business investment growth are slowing, the labour market has begun to weaken significantly, and demand for our exports will be seriously dampened by the decline in the economies of our trading partners. The remaining component of growth – public spending – will assume greater importance in determining the final outcome for GDP growth.

While significant policy stimulus has already been delivered through fiscal and monetary easing and the depreciation of the exchange rate, the timing and magnitude of the impact on real economic activity is more than usually difficult to predict in the current environment.[6]

THE SUDDEN REVERSAL OF FORTUNES UNDERLINES THE NEED TO MAXIMISE FISCAL OPPORTUNITIES AND STRENGTHEN OUR NATIONAL POSITION

FISCAL TRENDS AND DEVELOPMENTS

Australia has a fiscal position that many other developed countries would envy – a sustained run of budget surpluses and negligible public debt. This provides Australia with welcome policy flexibility – again in contrast to many other advanced economies.

Nonetheless, the sudden reversal of fortunes we are all now experiencing underlines the need to maximise fiscal opportunities and strengthen our national position during the good times.

The current government took a number of positive steps in its first Budget to rein in spending and improve the structural underpinnings of the fiscal position. For example, it imposed limits on welfare payments such as maternity payments and Family Tax Benefit B.

The recent slowdown highlights how quickly hard-won surpluses disappear when the economy slows. It also highlights the extent to which Australia's strong fiscal position was more reflective of a strong economy than a significant 'structural' surplus.

Reflecting the impact of slower growth in reducing tax receipts and increasing spending, including the government's $10.4-billion Economic Security Strategy measures, the Mid-Year Economic and Fiscal Outlook forecast a reduction in the projected budget surplus:

- from $21.7 billion (1.8 per cent of GDP) to $5.4 billion (0.4 per cent of GDP) for 2008–09, and
- from $19.7 billion (1.5 per cent of GDP) to $3.6 billion (0.3 per cent of GDP) for 2009–10.

'... Headline numbers mask a structural deterioration that has left fiscal policy increasingly sensitive to fluctuations, pressures and changes in economic growth here and internationally'.

BCA Budget Submission 2008–09: Budgeting for Prosperity, p. 30.

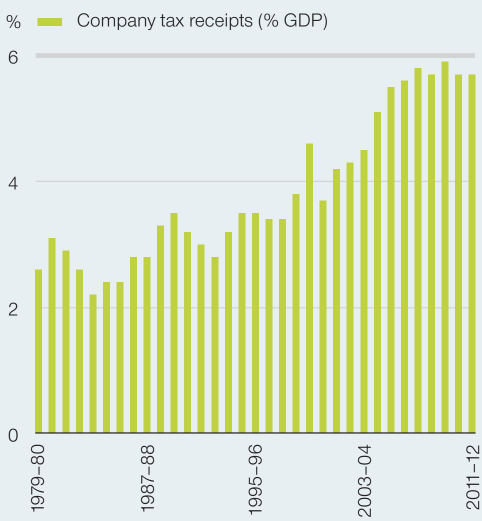
While these are significant revisions in themselves, the risks to the broader economic outlook suggest that the fiscal position will almost certainly deteriorate further over the coming two years.

A significant risk to the forecasts in the years ahead lies with the outlook for tax revenue and in particular company tax receipts.

The BCA's 2008–09 Budget Submission incorporated research undertaken by Access Economics that showed Australia's tax base has become more sensitive to the business cycle, in large part as a result of the growing reliance on company taxes.[7]

FIGURE 3

WEAKER OUTLOOK FOR COMPANY TAX RECEIPTS



Source: 2008–09 Commonwealth Budget, Budget Paper No.1 and, for the years 2008–09 and beyond, BCA calculations based on company tax projections in the 2008–09 MYEFO.

The BCA has also consistently drawn attention to the extent to which company taxes – and specifically, higher than projected company tax receipts – have underwritten new policy measures and the fiscal surplus in recent years.[8] Historically, company tax receipts have averaged around three per cent of GDP. In recent years company tax receipts have been over five per cent of GDP.

To the extent that the increase in company tax receipts was related to rising commodity prices, we can now expect a corresponding reduction to occur as commodity prices fall. The magnitude of this impact will largely depend on medium-term commodity prices, which are notoriously difficult to predict.

The MYEFO projections recognise these issues and include a significant reduction in forecast revenues compared with the 2008–09 Budget, totalling $37.4 billion over the four years to 2011–12.

Even with these revisions, the expected share of company tax revenues to GDP over the forward estimates remains very high compared with longer-term averages, as Figure 3 shows. Access Economics, in its most recent *Budget Monitor*, concludes that the risks are that company tax receipts will be even lower still than projected in the MYEFO. In 2011–12 the difference between the Access Economics forecasts and those in the MYEFO amount to around $7 billion – an amount larger than the surpluses now projected in 2008–09 and 2009–10.[9]

THE FISCAL CHALLENGE

The challenge for the government in forming the 2009–10 Budget is to address a number of potentially competing objectives, in the context of a slowing economy where uncertainty exists about the depth of the downturn. These objectives include:

Boosting aggregate demand in the near term:

- through discretionary measures; and
- by allowing the 'automatic stabilisers' to work – that is, by allowing revenue to fall and spending (for instance, on unemployment benefits) to rise in line with the fall in economic activity.

Supporting long-term growth through quality spending measures that build productive capacity in the economy, including in particular through education and infrastructure.

- Bringing forward spending in these areas can support aggregate demand in the near term. But this should only be done in cases where projects are economically beneficial over the long term *and* ready to go.

Maintaining a sustainable fiscal and debt position.

- This supports long-term growth and confidence, but requires spending discipline.

The government has also committed itself to a number of specific fiscal goals.

- Achieving budget surpluses, on average over the medium term.
- Keeping taxation as a share of GDP on average below the level for 2007–08.
- Improving the government's net financial worth over the medium term.[10]

For the Budget to be credible, and therefore to have the best possible impact on confidence and economic activity, it will need to be consistent with the government's fiscal commitments and clearly articulate how they are to be achieved.

Past experience, discussed below, suggests that if the first two of these specific goals are to be achieved, while also supporting economic growth, significant policy discipline, particularly on the spending side, will be needed in this and subsequent budgets.

SIGNIFICANT POLICY DISCIPLINE IS NEEDED, PARTICULARLY ON THE SPENDING SIDE OF THE BUDGET

LESSONS FROM HISTORY

The speed, nature and magnitude of the current crisis make it difficult to draw lessons from past experience. But there are a number of observations that can be drawn from Australia's fiscal history over the past three to four decades that point to some valuable 'lessons' to guide future policy.

Fiscal surpluses disappear remarkably quickly.

Annual deficits tend to be larger than surpluses.

– Deficit troughs in the last two significant slowdowns have tended to the 3–4 per cent range, compared with a peak surplus over the last 30 or more years of 2.3 per cent.

Deficits are persistent.

– In most episodes of economic slowdown since the early 1970s, deficits have persisted for at least five years:[11]
  – The Budget went into deficit in 1982–83 by 1.8 per cent of GDP, and did not reach surplus again until 1987–88, five years later.
  – The Budget went into deficit in 1990–91 and did not reach surplus again until 1997–98, seven years later.[12]

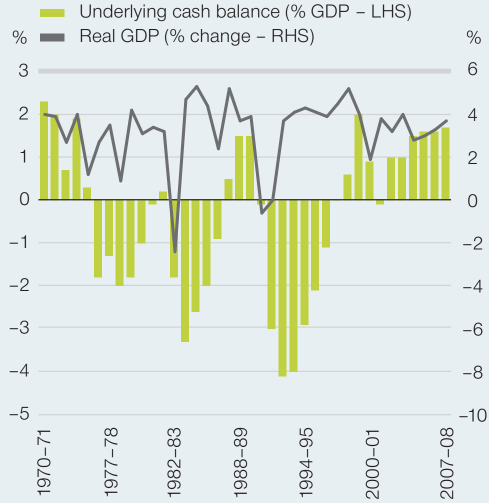
Surpluses are typically built on higher taxation.

– Since 1970–71, every period of sustained improvement in fiscal balance from deficit to balance/surplus has been accompanied by a new peak in the tax to GDP ratio.

– Leaving aside the effect on tax to GDP from the introduction of the GST, this demonstrates how higher government activity during periods of expansionary fiscal settings can become entrenched over time.

FIGURE 4

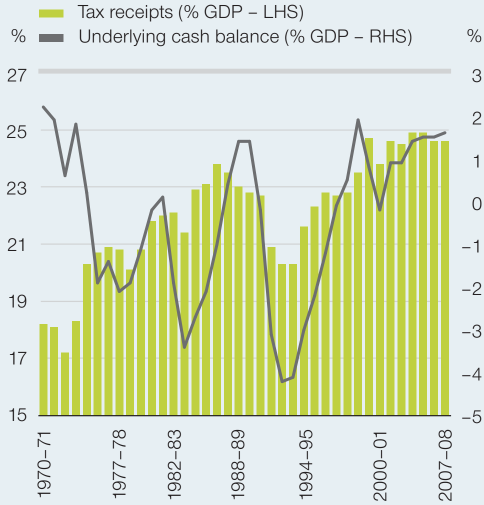
DEFICITS PERSIST WELL BEYOND ECONOMIC RECOVERY



Source: MYEFO 2008–09 (p. 248) and ABS Catalogue No. 5206.0, *Australian National Accounts: National Income, Expenditure and Product*, September 2008.

FIGURE 5

RETURNS TO FISCAL BALANCE HAVE BEEN ACCOMPANIED BY HIGHER TAXES



Source: MYEFO 2008–09, p. 248.

These findings demonstrate the importance of fiscal discipline not only during a period of economic downturn but also during a period of recovery.

In making these observations it is also notable that the longest sustained run of surpluses since 1970–71 has occurred over the last decade. This followed the previous government's formalisation of a framework for sound fiscal policy with the introduction of the Charter of Budget Honesty legislation in 1998.

By definition, deficits limit future budgets by requiring tax revenues to be directed towards the payment of interest on the debt generated to fund the deficit as well as the repayment of the debt itself. Sustained deficits come at a cost in terms of lower national saving and higher interest rates.[13] These findings are particularly pertinent given the credit constraints currently facing the private sector.

In a mid-sized, open economy like Australia with a large current account deficit, a poor fiscal position can affect business competitiveness by raising the costs of doing business, particularly through higher taxes. Furthermore, Australia faces future costs associated with the ageing of the population and dealing with issues like climate change. The decisions we make about the Budget now will have significant implications for our ability to meet the costs of the future.

EXHIBIT 1
HOW WOULD PAST DEFICITS TRANSLATE IN 2009–10?

What do past downturns and budget deficits tell us about the potential size of a budget deficit in the years ahead?

The circumstances of each downturn are different. But we can draw upon the experience of the economic downturns of the early 1980s and 1990s to illustrate how far the current budget position could deteriorate should economic conditions and fiscal settings match those earlier episodes.

- In 1983–84 the deficit on the underlying cash balance troughed at 3.3 per cent of GDP. The BCA calculates that this would be equivalent to a deficit of around $41 billion in 2009–10.
- In 1992–93 the deficit was 4.1 per cent of GDP. This would be equivalent to a deficit of around $51 billion in 2009–10.

Deficits of this magnitude would impose a significant burden on future budgets by way of debt repayments and interest expenses. This would be made worse should a deficit position become entrenched over several years.

FISCAL PRIORITIES FOR 2009–10

This global economic slowdown is the type of event that can define a nation's future. The economic and fiscal challenges are potentially as difficult as any that have existed in the postwar era.

Australia has earned a reputation for sound economic management and for its ability to respond to recent global economic crises. Charting a course through this downturn will require a clear set of economic growth objectives and a process for determining the fiscal settings that will best achieve those aims. The course that the government chooses now will have a significant bearing on Australia's prosperity, not just over the next year or two, but for many years beyond.

The government's fiscal priorities for 2009–10 should be to:

Support economic growth

- in the immediate term by using the Budget to smooth the effects of the economic cycle, and
- in the long term by building economic capacity.

Strengthen budget processes and communication

- by lifting the quality of spending – now more than ever it is important to ensure all spending is as effective as possible and to reprioritise spending to support growth and productivity, and
- by explaining the deficit

Coordinate fiscal stimulus efforts with the states

Stay the course on long-term reform

- and in particular, defer consideration of any structural tax initiatives until after the Henry review reports in late 2009.

SUPPORT ECONOMIC GROWTH

The government should continue to actively use fiscal policy to smooth the more extreme effects of the economic cycle on growth and employment and to support growth in the immediate and the long term.

The government should allow the automatic stabilisers in the Budget to work.

Further discretionary measures should remain on the government's agenda. The fiscal stimulus provided late in 2008 was timely and well targeted. While anecdotally it appears this has had a positive impact, the magnitude of that impact and its ongoing influence is not yet clear, particularly given there is more uncertainty than usual about its transmission (because of poor confidence, household indebtedness, lingering credit concerns and balance sheet adjustments, etc.). A similar level of uncertainty surrounds the effects of monetary policy stimulus.

The balance of risks remains clearly weighted towards a further deterioration in economic activity. While this remains, the government should err on the side of continuing to support growth. It should be decisive in doing so.

Additional stimulus measures should be in development for implementation should the outlook deteriorate substantially. The government should be openly communicating both its capacity and preparedness to undertake further fiscal stimulus. This will help to ensure that any additional measures are not unexpected or perceived to be 'dramatic' shifts in policy, which could have a perverse impact on confidence and spending.

The guiding principle for short-term demand stimulus remains the ‘3Ts’ framework set out by Elmendorf and Furman,[14] which suggests fiscal stimulus be timely, targeted and temporary:

Timely: act to counter the slowdown when it commences and use measures that can be implemented quickly and which will have an immediate effect.

Targeted: ensure maximum effect on output for each dollar of stimulus by targeting those most likely to spend.

Temporary: use initiatives that will not affect the core structure of the Budget beyond the period of the stimulus.

Measures most likely to immediately impact demand are direct purchases of goods and services by government, and/or transfers directed to members of the community with a high propensity to spend.

Direct purchases of goods and services should meet the tests of quality spending that we outline in the section below. Expenditure initiatives that support long-term growth, such as infrastructure or education, should be a priority for inclusion within a fiscal stimulus package, but only where those projects are consistent with strategic policy objectives and which can be effectively implemented at relatively short notice.

If the desired stimulus package is greater than that which can be provided from a list of suitable direct spending initiatives or investment projects, it would be better to round out a stimulus package with transfer measures targeted at those in the community who will be most likely to spend the money rather than spending on unsuitable projects.

The government should proceed with the tax cuts already announced for implementation on 1 July 2009. However, a significant body of research highlights that additional tax cuts, unless very specifically targeted, tend not to be the most effective measures for stimulating demand in circumstances of rising unemployment and poor confidence. This would suggest that the expenditure options outlined directly above represent better ways to inject demand into the economy than bringing forward the tax cuts scheduled for 1 July 2010.

A notable exception involves the Low Income Tax Offset. There is a case for combining and bringing forward the change to the Low Income Tax Offset due on 1 July 2009 and 1 July 2010 given there is a high likelihood that this income will be spent in the 2009–10 year.

Notwithstanding the changed economic outlook in the near term, spending in the Budget that supports increased economic capacity remains essential for Australia’s long-term growth, as outlined in the BCA’s Budget Submission last year.

FISCAL STIMULUS PACKAGES SHOULD BE TIMELY, TARGETED AND TEMPORARY

STRENGTHEN BUDGET PROCESSES AND COMMUNICATIONS

Lift the quality of spending

Revenues available for government expenditure in 2009–10 will be scarcer than in recent years. The result is to underline the need for 'high-quality' spending – that is, spending that delivers the greatest contribution to the ongoing economic and social prosperity of Australia.

High-quality spending will more likely be achieved if the government has in place processes that support and enable:

- selection of the best initiatives;
- effective implementation; and
- timely and comprehensive review.

The government will face many pressures to increase spending in the year ahead. Sections of the community will seek public funds to alleviate difficulty and hardship associated with the economic downturn. Many of the government's completed policy reviews have already made recommendations for greater funding (e.g. the Cutler review of innovation and the Bradley review of higher education). The government has undertaken to increase pensioner payments permanently from 2009–10 after a one-off payment in December 2008. And some spending, notably unemployment benefits and other welfare payments, will increase naturally as the economy slows.

To ensure high-quality spending in 2009–10 and in future budgets, the government's expenditure review process should ensure all new spending initiatives:

- are subject to a rigorous process of cost–benefit analysis;
- require clear policy objectives, targets and timelines;
- demonstrate that expenditure is the best means for achieving the policy objectives over alternative policy instruments; and
- are subject to regular and transparent performance reviews.

In the current environment, Australia can ill afford programs that are not well targeted, poorly justified, or ineffective. Programs that fall into these categories must be cut to make room for additional temporary stimulus and/or effective longer-term capacity building measures. The BCA recognises the difficulty associated with cutting back any programs at present. However, retaining spending which does not meet economic or social objectives will swell future budget deficits in ways which will impact many of the program beneficiaries in the long term.

As one example, and as argued in the BCA's 2008–09 Budget Submission, welfare payments should be targeted to those genuinely in need through appropriate means testing. The introduction of a significant, non-means-tested child care rebate does not meet these criteria and should be reviewed.

The BCA has also called for close scrutiny of additional spending committed in recent years in those areas where spending growth has been exceptionally strong, for example in defence. Defence spending historically suffers from relatively poor program implementation. The engagement of an independent consultant to review the defence budget is a welcome step and we hope that it will produce tangible and transparent results. Health spending has shown similarly disproportionate recent growth.

Against this background, the BCA considers that the efforts and outcomes of the government's 'razor gang' review of spending – the so-called 'Razor Gang II' – have become crucial. As the BCA understands, this process has now become part of the regular budgetary processes. This raises concerns that it will not produce the same results as would a standalone process. A fully transparent process with the opportunity for public consultation and input would be preferred. As a minimum, the government should publish the criteria by which it will identify savings items to build public confidence and acceptance in the final budget outcome.

The BCA continues to call on the government to commit to a comprehensive and regular (five-yearly) review of spending similar to the 1996 National Commission of Audit.

The BCA in its submission last year called for a redirection of spending towards investment in infrastructure and education. The BCA welcomes recent policy decisions by the government that have redirected spending towards building capacity and long-term growth.

For example, there has been a shift away from personal benefits payments and an increase in current grants to the states and territories, two of the largest expenditure items in the Budget:

- Personal benefits are expected to fall from $98.9 billion in 2008–09 to $95.7 billion in 2009–10.
- Current grants to the states and territories will rise from $73.0 billion in 2008–09 to $75.6 billion in 2009–10.

It is important to acknowledge that in our federal system, the delivery of capacity-building investments in areas such as infrastructure and education rests mostly with state and territory governments. In other words, the Commonwealth relies heavily on the state and territory governments to deliver its productivity agenda, and funds them to do so.

This underscores the importance of effective intergovernmental relations. The national government needs to reach agreements that clearly set out the outcomes expected from the states and territories and to ensure that spending by the states is effective and in accordance with the agreed outcomes and timelines.

Reforms to specific purpose payments (SPPs) and the new national partnership payments announced by COAG late in 2008 are designed to do this. The changes are consistent with the direction of reforms called for by the BCA in the past and are very welcome. As noted above, program implementation cannot be allowed to slip or the quality of spending to decline.

Further spending on building economic capacity should be informed by the advice of statutory authorities established over the past year – Infrastructure Australia and Skills Australia.

As outlined by the BCA in its submission to Infrastructure Australia, all infrastructure projects considered for funding should:

- be accompanied by a pre-feasibility study, including an outline of the project timetable;
- provide detailed calculations of benefits and costs and the project's overall contribution to national productivity; and
- be accompanied by a 'statement of context' that outlines how the project fits into infrastructure plans and with other projects. That is, the project should not be seen as a 'one-off', but as part of a wider plan to meet particular objectives.[15]

These prerequisites are particularly important if spending is to be effective in an environment where, on balance, the desire is to spend more rather than less and sooner rather than later.

As the BCA has highlighted previously, better infrastructure outcomes will not be achieved through spending alone. The BCA has identified that the key blockages to successful investment in infrastructure are:

- a lack of planning for and inadequate information on future infrastructure needs and projects; and
- inadequate development of national infrastructure markets, poor pricing policies, poor regulation, lack of competition and ineffective investment processes.

Implementing policy reforms that address these issues will result in improved infrastructure outcomes at little or no cost to the Budget.

Likewise, Skills Australia has been set up to provide advice on how to best target support for skills and workforce development and its input should inform any new or increased spending in this area.

A key focus of the BCA's education agenda has been teacher quality. Here the BCA has supported higher payments linked to quality performance. The National Partnership agreed last year under the title 'Smarter Schools – Quality Teaching' agreed the creation of structures and made funds available for rewarding excellence. The onus is now on the states and territories to deliver the outcomes in the agreement.

The government has indicated that some of the funding for these types of initiatives will come from the three funds established by the government last year – the Building Australia Fund, the Education Investment Fund and the Health and Hospitals Fund. It has also said that projects will be selected according to 'rigorous evaluation criteria' and 'may depend on negotiations with state and territory governments'.[16]

To give confidence that these allocations represent high-quality spending, the government should publicly release the evaluation criteria it uses to select projects and the assessments it makes against those criteria. It will also need to establish agreements with state and territory governments where necessary to ensure that spending is effective.

Getting these processes right will help to deliver better budget outcomes in future years and safeguard against inefficient and ineffective spending.

Explain the deficit

Experience shows that spending initiatives designed to address a shortfall in demand can become entrenched and politically difficult to unwind. While budget deficits are appropriate during periods of declining demand, they need to be repaid. The implications of this reality must be communicated very clearly.

Against this background, there is a temptation to define ‘rules’ as a guide to what is an ‘acceptable’ fiscal outcome, either in terms of spending, or an appropriate fiscal balance. Given the magnitude of the slowdown around the world, the degree of uncertainty that continues to surround this slowdown, and therefore the uncertain outlook in Australia, the BCA considers it unconstructive at this time to set arbitrary limits on, for example, the size of the deficit.

Firstly, it must be acknowledged that important drivers of fiscal outcomes in the years ahead are outside of the control of government, for example tax receipts.

Secondly, the BCA’s priority is for the government to implement effective policies decisively as new information emerges. This is best achieved by encouraging and demanding good policy processes and communication, not by judging decisions against a single narrow measure.

In other words, the BCA’s priority is to achieve the highest degree of openness about the strategies and measures adopted, their expected and actual impact, and the processes that support quality decision making.

The following are important steps towards that end.

The announcement of any new fiscal measures should include a clear explanation of their scale and duration and an analysis of their impact on the fiscal balance over time.

Where new measures/commitments are not one-off or time limited, the government should explain when and the circumstances under which those measures will be unwound and how they will impact the Budget over time if they are not removed.

Budget documentation should clearly summarise the extent to which the economic cycle has eroded tax receipts and raised spending, and the projected size and duration of the impact of discretionary spending and tax decisions on the fiscal balance.

The government should produce an estimate of the structural budget balance.

The Budget should contain a clear roadmap for the elimination of the deficit, including the role of cyclical and discretionary measures in delivering this.

The Budget should include a clear analysis of the implications of deficits for the future debt burden and its evolution over time under different interest rate scenarios.

To ensure that fiscal policy remains counter-cyclical, automatic stabilisers should be allowed to operate fully as the economy recovers.

The Budget and MYEFO should incorporate an analysis of the net impact and effectiveness of discretionary fiscal measures already adopted.

Ensure state fiscal policy supports national policy

The present economic circumstances have thrown light on the relative fiscal performances of the state governments and the inconsistency of federal and state/territory fiscal settings. Queensland, New South Wales and South Australia, with deteriorating budget positions, are either raising taxes as the economy slows and/or deferring the abolition of inefficient taxes agreed as part of the introduction of the GST. This will add to business costs and runs counter to the efforts of the federal government to stimulate the economy.[17]

Australia cannot afford to have state governments running fiscal policies that work against growth. Now is the time to abolish lingering inefficient state taxes, not to lift taxes.

State governments are also responsible for significant infrastructure spending. Growth-enhancing projects should not be postponed, but accelerated. Similarly, significant spending is to be undertaken through new financial arrangements linked to the COAG reform agenda and commitments. The quality and timeliness of reform implementation cannot be allowed to slip.

The federal government recently issued a joint declaration with other G-20 nations stressing the importance of working together to restore global growth, including taking 'immediate steps to use fiscal measures to stimulate domestic demands to rapid effect'. A similar principle should apply within our federation. The Budget should set out the need for strong fiscal coordination between our two top tiers of government. The stance of fiscal policy across jurisdictions and the need for greater coordination across governments in Australia should be a priority issue for discussion at the first COAG meeting in 2009.

STRONG FISCAL COORDINATION IS NEEDED BETWEEN THE TOP TWO TIERS OF GOVERNMENT

THE BROADER ECONOMIC REFORM AGENDA

KEEP SIGHT OF LONG-TERM ASPIRATIONS

The BCA's vision is for Australia to be the best place in the world in which to live, learn, work and do business and for it to become and remain a top-five economy among OECD countries by 2012. The overriding objective is to enhance prosperity in Australia.

At present, it is appropriate that significant attention be paid to creating a buffer against job loss and rising unemployment through this downturn. As challenging as this task is, the BCA considers that the government cannot lose sight of longer-term aspirations for Australia.

Soon after winning government, the Prime Minister initiated the Australia 2020 Summit. That summit captured the interest and imagination of people and communities far beyond those attending or being represented. It drew attention to a population optimistic and excited about its long-term opportunities and future. While economic circumstances and sentiment have shifted dramatically since then, the Australia 2020 Summit and the ideas produced were not simply a luxury of better economic times.

Australia cannot give up on its long-term aspirations and opportunities, particularly when the reforms they necessitate are, on the whole, complementary to immediate policy challenges.

Past experience has clearly shown that progress across a broad reform agenda, including in areas such as regulation, tax, competition policy, finance sector reform and the elimination of trade barriers, can deliver bigger than expected gains in growth and prosperity.

Failure to progress broader reforms now, or worse still, to reverse the direction of reforms, is likely to be detrimental to growth prospects now and in the future.

Recent market developments have led to calls for tighter business regulation in some quarters. However, it is important that efforts are made to understand the factors that have led to and contributed to the sudden and sharp deterioration in economic and financial circumstances around the world, and that governments respond appropriately.

Governments must respond effectively as well as visibly. In a slowing economy, the costs of regulation are more difficult to bear. Poorly designed regulatory responses that increase costs to business with little to show elsewhere will weigh on recovery. It is also important to recognise that Australia's regulatory systems appear to have played a role in reducing the extent of the global financial crisis's impact in Australia. Now and in the future, Australia's investment, jobs and growth prospects will depend on a competitive and dynamic business sector, well placed and well equipped to deal with new challenges and opportunities.

Promoting growth over the longer term requires a sustained emphasis on the supply side of the economy. Many supply-side weaknesses previously highlighted by the BCA[18] persist. They will become apparent again, and quickly, as the economy recovers.

Productivity growth in Australia is a particular concern as it has been in trend decline for some years now. Productivity growth can occur in cycles and it may be that we are at a low point. But the concern is that the current level of productivity growth will become entrenched if we do not put in place policies to deliver and sustain better outcomes. We should be aiming to lift productivity growth and maintain average annual productivity growth rates above two per cent.

Looking further ahead there are still significant weaknesses in Australia's longer-term budget outlook. Two successive Intergenerational Reports have pointed to a significant deterioration in the federal Budget by the middle of this century. The second Intergenerational Report (IGR2) concluded that, on a 'no-policy-change' basis, the Budget would be in deficit by around 3½ per cent of GDP by 2047–48.

The Intergenerational Reports assume that trend productivity growth of 1.5 per cent will be sustained. In the absence of continuing reform, there are significant downside risks to achieving productivity growth at that level.

FIGURE 6

PRODUCTIVITY GROWTH NEEDS TO LIFT

Source: ABS.

THE BCA'S AGENDA

The BCA has identified a number of necessary reforms to increase productivity, competitiveness and participation. Priority reforms include:

Infrastructure

- The establishment of genuine national markets, competition, and market-based pricing, with greater accountability.

Regulation

- The creation of a seamless economy for business regulation by 2010.
- Better regulation-making processes that seek to avoid the introduction of regulation that is ineffective, unnecessary and/or excessively costly.

Workplace relations

- Delivery of a system that supports enterprise-based agreement making, flexibility, innovation and productivity. The impact of the system being introduced in 2009 will rest heavily on how employers, employees and their advocates interpret and respond to the new rules and laws.

Innovation

- Implementation of a national innovation framework encouraging greater linkages and collaboration between business, research institutions and universities.

Workforce participation

– More flexible job design and improved child care options.

Education

– Increased investment in the quality of school education, particularly through stronger incentives for higher-quality teaching.

– Higher education reforms focused on improving employability skills and on linking investment to measurable improvements in outcomes.

Global engagement

– A continued push for greater liberalisation through multilateral agreements, supported by appropriate bilateral arrangements.

– Strengthening the focus on and performance of services sector trade and investment to better capture new and emerging global opportunities.

Health

– Reforms to rein in unsustainable cost increases, reduce disparities in outcomes, ease skills shortages and improve the effectiveness of outcomes.

Boosting our national prosperity also means positioning Australia to deal appropriately with growing environmental risks and issues, particularly in regard to water and to climate change, including through the development and implementation of an emissions trading scheme.[19]

FEDERAL–STATE RELATIONS

Improved fiscal relations between federal and state governments are fundamentally important to the performance of the economy and to the BCA policy reform agenda outlined directly above. Areas of policy that are critical to increasing participation and productivity, such as education, health and infrastructure, require effective policy coordination across federal and state jurisdictions.

COAG's commitment in December under the Intergovernmental Agreement on Federal Financial Relations to reform specific purpose payments to five key areas and to focus funding arrangements on policy outcomes is a big step forward. These are also confidence-boosting measures.

The onus is now on all governments to demonstrate the intent of this funding arrangement by delivering better service delivery outcomes in health, schooling, skills and workforce development, housing and disability services. National partnership payments which are designed to 'facilitate and/or reward states that deliver on nationally significant reforms' are also expected to play a significant role.[20]

The COAG Reform Council will play a critical role by assessing and reporting on performance. But it will be the ongoing commitment to the productivity agenda and leadership from all governments that will ultimately determine success.

TAX REFORM

The BCA supports reform of Australia's taxation system to ensure that it contributes to economic growth and productivity, supports social prosperity, enhances our engagement with the global economy, achieves simplicity, lowers compliance costs and provides fiscal stability.

In addition to addressing these issues, it is important that any specific tax changes are consistent with other policies (such as the Carbon Pollution Reduction Scheme) and longer-term challenges (such as population ageing).

The Australia's Future Tax System review, currently being conducted by an expert panel chaired by Dr Ken Henry, will recommend changes to position the Australian tax system to deal with the demographic, social, economic and environmental challenges of the future. It would be premature to make significant structural changes to the tax system before the review team delivers its report in late 2009. The government should wait for the review team's report and not limit the team's options in the meantime.

CONCLUSION

The BCA continues to aspire for Australia to be the best place in the world in which to live, learn, work and do business. The current slowdown represents a substantial challenge to that aspiration.

However, the slowdown is also an opportunity to accentuate our strengths – our fiscal strength, our scope for policy flexibility, and our willingness to embrace reform. By providing appropriate fiscal stimulus while locking in long-term fiscal and productivity-enhancing reforms, the 2009–10 Budget can form the platform for future economic growth.

NOTES

1 C. Reinhart and K. Rogoff, 'The Aftermath of Financial Crises', paper to the 2009 American Economic Association conference, accessed 15 January 2009 at http://www.economics.harvard.edu/faculty/rogoff/files/Aftermath.pdf.

2 International Monetary Fund (IMF), 'IMF Urges Stimulus as Global Growth Marked Down', *IMF Survey Magazine*, 6 November 2008.

3 IMF, *World Economic Outlook*, April 2008.

4 Between October and November 2008, the IMF revised downwards its 2009 forecasts for growth in China from 9.3 per cent to 8.5 per cent and for India from 6.9 per cent to 6.3 per cent. The OECD has warned of a 'strong slowdown' in China (OECD, 'Composite Leading Indicators Signal Deep Slowdown in OECD Area and Major Non-OECD Member Economies', news release, 12 January 2009). The World Economic Forum says that decline in demand for China's exports is 'increasing considerably' the risk of a 'hard landing' (World Economic Forum, *Global Risks 2009* report, January 2009).

5 Some market forecasts for growth over calendar year 2009 at the time of writing include Dun and Bradstreet (0 per cent), ANZ (0.4 per cent) and Westpac (1.6 per cent). Access Economics forecasts GDP growth over the 2008–09 financial year of 0.8 per cent, with 2.4 per cent growth over 2009–10.

6 Similar observations are made in a number of recent IMF publications. For example, *WEO Update* November 6, 2008 and *Fiscal Policy for the Crisis*, December 2008.

7 Business Council of Australia, *BCA Budget Submission 2008–09: Budgeting for Prosperity*, February 2008.

8 See previous BCA submissions including *BCA Budget Submission 2008–09: Budgeting for Prosperity* (see pp. 12–14), *BCA Budget Submission 2007–08: Passing on Prosperity* (pp. 12, 14, 26) and *Benchmarking Reform Action and BCA Budget Submission 2006–07* (p. 39) along with BCA publications on tax policy, for example, *Taxation Action Plan for Future Prosperity* (2005) and *Tax Nation: Business Taxes and the Federal–State Divide* (2007).

9 Access Economics, *Budget Monitor*, November 2008, p. 54.

10 Australian Government, *Mid-Year Economic and Fiscal Outlook 2008–09* (MYEFO), p. 35.

11 The exception being the policy-induced deficit associated with the introduction of the GST.

12 MYEFO, p. 248.

13 See for example W. Gale and P. Orszag, *The Economic Effects of Long-Term Fiscal Discipline*, Urban–Brookings Tax Policy Discussion Paper, December 2002.

14 D.W. Elmendorf and J. Furman, *If, When, How: A Primer on Fiscal Stimulus*, The Brookings Institution, January 2008. The IMF has subsequently released guidance on fiscal stimulus recommending that the optimal fiscal package should be timely, large, lasting, diversified, contingent, collective and sustainable. It concludes that, in the current circumstances, spending increases and targeted tax cuts and transfers are likely to have the highest multipliers. See IMF Staff Position Note, *Fiscal Policy for the Crisis*, December 2008.

15 A number of infrastructure projects have already been announced for funding in the government's 'Building Nation' statement in 2008 thereby reducing the pool of 'ready-to-go' projects that could be selected for funding over the next twelve months.

16 MYEFO 2008–09, p. 69.

17 'Taxes Being Held to Plug Black Holes in SA, Qld and NSW', *The Australian*, 19 December 2008.

18 In 2005 the BCA released four action plans in the areas of taxation, infrastructure, workplace relations and business regulation. See also the BCA 2007 publications *Infrastructure: Roadmap for Reform* and *Engaging our Potential: The Economic and Social Necessity of Increasing Workforce Participation*, as well as BCA reports released in 2008 including *Towards a Seamless Economy: Modernising the Regulation of Australian Business, A Better Tax Return: Reconsidering the Role of Australia's Tax System, Teaching Talent: The Best Teachers for Australia's Classrooms* and *Health is Everybody's Business: The BCA's Role in Australia's Health Discussion.*

19 Source: *Anticipating Success: BCA Submission to the Australia 2020 Summit.* The BCA has also produced detailed plans of action in many of these areas; see www.bca.com.au.

20 Council of Australian Governments Communiqué, 29 November 2008.

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